Bursting of credit bubble underlies stock market turbulence

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Global stock exchanges are gripped by extreme volatility, with wild swings in share prices. On Tuesday, the New York Stock Exchange saw a nearly 300-point shift in the Dow Jones Industrial average from positive to negative territory during the final 40 minutes of trading. The Dow finished the session down 146.3 points. That sparked sharp declines in Asian and European markets on Wednesday.

A nervous New York exchange moved back and forth from positive to negative for most of Wednesday, and then gained nearly 200 points in the final 40 minutes of trading to end the day up 150.38. The broader Standard & Poor's 500 index experienced a move of 1.9 percent between its high and low for the day—an extraordinary swing for a single trading session.

The turmoil on markets this week followed last week's plunge on Wall Street, with the Dow Jones average losing a combined 585 points on Thursday and Friday. Since hitting 14,000 on July 19, the Dow has lost about 638 points, or 4.6 percent, wiping out hundreds of billions in share values.

The sudden volatility on stock exchanges resembles the fever chart of a delirious patient. It reflects fears that the near-collapse of credit markets linked to subprime US home mortgages is spreading more broadly and leading to a major contraction of credit throughout the economy.

Under conditions where cheap and plentiful credit—much of it based on high-risk investments and speculative corporate buyouts—has been the indispensable ingredient in the stock market boom of the past several years, a credit crunch threatens to precipitate a wave of bankruptcies among corporations, hedge funds and private equity firms, and major commercial and investment banks both in the US and internationally.

Already big banks are issuing margin calls to shaky hedge funds heavily invested in home mortgages and demanding that existing loans be restructured, with higher interest rates. There are reports that banks are cutting back on loans more generally, in part to shore up their own defenses against the prospect of billions in loans they have extended going bad.

The sudden downturn on Tuesday was precipitated by signs that the crisis in the home mortgage market is intensifying. American Home Mortgage Investment Corp., the tenth largest US mortgage lender, announced it might be forced to liquidate assets, sending its shares down more than 90 percent. The company said increased margin calls—demands for more cash or collateral—from its lenders had rendered it unable to finance the mortgages.

In addition, two home loan insurers announced that their combined stake of more than $1 billion in a mortgage company called Credit-Based Asset Servicing and Securitization, or C-Bass, might be worthless. C-Bass, like American Home Mortgage, has been hit with margin calls from Wall Street banks and brokerages.

Finally, Bear Stearns, which earlier this month was forced to close down two hedge funds heavily invested in securities linked to subprime mortgages, announced that a third hedge fund had suffered losses in July and that requests from investors to redeem their stakes in the fund were not being honored. The news that the Bear Stearns Asset-Backed Securities Fund was in trouble was all the more unnerving because the $850-million fund has only a small fraction—less than 1 percent—of its investments in subprime mortgages. Its difficulties confirm that defaults and foreclosures are not limited to the high-risk subprime sector, but are spreading to the prime and near-prime mortgage markets.

The international scope of the crisis was demonstrated by the announcement from Australia's Macquarie Bank on Wednesday that retail investors in two of its funds face losses of up to 25 percent. And Deutsche Bank said it would suffer losses as a result of the subprime crisis and the broader credit crisis.

Worries over a credit crunch were compounded with negative reports on the general economy. Growth at US factories slowed unexpectedly, according to the Institute for Supply Management's manufacturing index reading for July. The gauge, which moved to 53.8 from 56.0 in June, showed the weakest gain in four months.

The National Association of Realtors index for pending sales of existing homes rose at a seasonally adjusted annual rate of 5 percent to 102.4 in June from May's 97.5. But the index was 8.6 percent below the level of June 2006.

Auto makers posted sharply lower July US sales, attributing the downturn to the fall in the housing market and high gas prices. General Motors said July light-vehicle sales dropped 22 percent from a year ago. Ford posted a 19 percent drop in sales of cars and light trucks. Chrysler Group reported an 8.4 percent decline to its lowest level in four-and-a-half years, and Toyota posted a 7.3 percent decrease for the month.

A column in Wednesday's *Washington Post* by Steven Pearlstein outlines the far-reaching implications of the credit crisis that underlies the fevered state of global stock exchanges. Pearlstein writes:

"The higher cost and tighter availability of credit is being felt worldwide, with impacts on Australian hedge funds, German banks, Russian oil companies, commodity prices in Africa and the government budget in Argentina.

"As this so-called repricing of risk unfolds, don't pay too much attention to the stock market... The real action is in credit markets where bonds, bank loans, financial futures and all sorts of newfangled derivative instruments are traded... What concerns people like Buffett is how much leverage there is in credit markets—how much debt is being used to buy other debt.

"In the simple model of yesteryear, a bank would essentially borrow money from its depositors and lend it to households or businesses that needed loans. For every dollar it lent out, however, the bank was required to set aside some of its own money in reserve to cover losses it might suffer if some loans were not repaid.

"But all that went out with deregulation and the rise of financial engineering. Big banks now borrow most of the money they lend by selling bonds to investors. And most of the loans they make do not remain on their books, but are immediately packaged with other loans and sold to buyers such as hedge funds.

"Unlike banks, hedge funds are under no obligation to maintain minimal levels of equity, so they can buy these instruments (that is, make loans) with as much borrowed money as anyone is willing to lend them. And because they don't have to disclose their investments, no regulator knows how much debt is in the system or where it is concentrated.

"By one estimate, for example, more than half the loans used to finance corporate takeovers are now packaged with other loans and sold as 'collateralized debt obligations.' And among the big buyers of CDOs are investment banks that package them with other CDOs and sell them again. Those are called CDOs-squared."

The article goes on to explain that "this financial engineering has encouraged debt to be piled on debt, making the system more susceptible to a meltdown if credit suddenly becomes more expensive or unavailable. And that's precisely what's been developing over the past several weeks."

The author then points to the heart of the crisis—the exposure of the major banks to potential loan defaults. "As this credit-market drama unfolds," he writes, "the big banks and Wall Street investment houses will move to center stage. According to the asset managers at Barings, these institutions have committed themselves to $500 billion in 'bridge' loans to finance corporate buyouts, with the expectation that they could quickly resell their loans at a profit. But several recent offerings have had to be pulled because of a lack of buyers, and there is a good chance that the banks will either be forced to sell many of these loans at a discount or hold them on their own books and write down their value.

"The extent of such writedowns won't become apparent until the third week in October, when the banks and brokerages report their third-quarter earnings. But if the market for takeover debt doesn't rebound by then, these blue-chip institutions could be looking at losses in the tens of billions of dollars."

An article posted Wednesday on the *Wall Street Journal Online* web site notes that the big banks are already responding to their inability to resell loans extended to hedge funds and private equity firms engaged in corporate buyouts by tightening or withdrawing credit from other companies. "Big banks facing the prospect of taking on billions of dollars in buyout-related debt this fall," the *Journal* writes, "are starting to clamp down on lending to companies that need to refinance loans or restructure their balance sheets.

"The tight-fisted approach shows how banks' willingness to back leveraged buyouts during the frenzied deal-making of the first half of the year could hurt companies with more ordinary funding needs now that efforts to finance those deals are running into trouble.

"As banks rein in riskier lending, companies could find themselves starved of capital to refinance loans that are coming due or to overhaul their businesses. The result, experts say, is that some struggling companies may be forced to seek bankruptcy protection—a development that would exacerbate bond market turbulence and could ripple through the broader economy."

This is a scenario for a downward, self-perpetuating spiral into a slump of potentially massive proportions.