Credit fears spark stock market plunge

Patrick Martin
10 August 2007

Stock markets worldwide slumped Thursday amid mounting fears that the crisis in the subprime mortgage lending market is leading to a more generalized credit crisis. The Dow-Jones Industrial Average, the most widely followed stock index, ended down 387.18 points, its largest loss in six months and the fourth triple-digit movement in five days, an indication of the increasing instability in financial markets.

Thursday's triggering event was the announcement by BNP Paribas, the biggest publicly held French bank, that three of its subsidiaries engaged in trading in US mortgage-backed securities were suspending operations. This came as a German central bank meeting was under way to discuss a bailout of IKB Deutsche Industriebank, a regional bank overexposed to losses in the US subprime market. At the same time, the Dutch lender NIBC Holding said it had lost $189 million on United States mortgage investments.

BNP Paribas said that no redemptions would be made on the $3.8 billion invested in the funds until it could determine the value of the assets held by them. "The complete evaporation of liquidity in certain market segments of the U.S. securitization market has made it impossible to value certain assets fairly regardless of their quality or credit rating," the bank said in a statement.

Securitization is a process in which a home mortgage is resold by the mortgage lender and then combined with thousands of other mortgages in packages that are sold to hedge funds and other huge investment firms in the form of Collateralized Debt Obligations, or CDOs. The process is so complex, and the distance so great between the underlying asset—the home—and the paper held by the investor, that determining the actual value of the investment under conditions of rising defaults and foreclosures has become problematic.

French stocks fell 3 percent in afternoon trading, while Germany's DAX index dropped 2.13 percent and Britain's FTSE 100 fell 1.96 percent. The New York Stock Exchange fell 200 points in its first hour, then rallied, partly in response to well-publicized interventions by central banks to stabilize the financial markets.

The European Central Bank made available nearly 100 billion euros ($130 billion) at a cut-price 4 percent interest rate for bank lenders. It was the first such intervention by the ECB, which manages the value of the euro, since the terrorist attacks of September 11, 2001 shut down the New York financial markets for several days.

After the European action, the Federal Reserve Bank of New York injected $24 billion into the money markets by entering into repurchase agreements with major banks. The Bank of Canada also injected funds into the banking system, and issued a public statement that "it will provide liquidity to support the stability of the Canadian financial system and the continued functioning of financial markets."

Even President Bush joined in the confidence-building exercise, issuing a carefully worded reassurance to the market in the course of his last White House press conference before embarking on his month-long sojourn in Crawford, Texas. He avoided the subject in his opening remarks—since that would have underscored the magnitude of the crisis—and waited until reporters asked his reaction to the financial upheaval.

In comments that were clearly rehearsed, Bush declared, "The fundamentals of our economy are strong." He added, "Another factor one has got to look at is the amount of liquidity in the system. In other words, is there enough liquidity to enable markets to be able to correct? And I am told there is enough liquidity in the system to enable markets to correct."

Bush later added—in another reassurance to Wall Street—that he opposed any proposal to raise the tax rate on the earnings of hedge fund managers, by taxing so-called "carried interest" as income rather than capital gains. While endorsing the billion-dollar incomes of the big speculators, he rejected any effort to bail out homeowners facing foreclosure or huge increases in monthly payments under adjustable-rate mortgages.

But in afternoon trading in New York, the wave of selling returned, partly in response to further indications that the subprime lending debacle was having a wider impact. This included press reports of heavy losses and forced selling of holdings by North American Equity Opportunities, a hedge fund run by Goldman Sachs, the huge investment bank.

© World Socialist Web Site

A letter to investors in Black Mesa Capital, another hedge fund, noted that one “very large hedge fund” was liquidating a “massive” trading portfolio. The letter, reported Thursday by MarketWatch, declared, “‘ Clearly, something is amiss in the markets that few in our strategy, if anyone, have experienced before.”

American International Group (AIG), the largest US insurance company and a major mortgage lender, warned Thursday that defaults on subprime mortgages were increasing, and that the increased delinquency rate was spreading to mortgages in the category just above subprime, which AIG terms “nonprime.” AIG said 10.8 percent of subprime mortgages were 60 days overdue, compared with 4.6 percent in the nonprime category.

Press reports emphasized the shock effect of the French banking crisis on Wall Street trading. According to the Associated Press (AP): “The announcement by BNP Paribas raised the specter of a widening impact of U.S. credit market problems. The idea that anyone—institutions, investors, companies, individuals—can’t get money when they need it unnerved a stock market that has suffered through weeks of volatility triggered by concerns about available credit and bad subprime mortgages.”

The AP suggested that the massive intervention by the European Central Bank had had a boomerang effect. According to the Associated Press, “Although the bank’s loan of more than $130 billion in overnight funds to banks at a bargain rate of 4 percent was intended to calm investors, Wall Street saw the step as confirmation of the credit markets’ problems.”

Other events this week have demonstrated the deep-going crisis in the financial system. On Monday, American Home Mortgage, once the 10th-largest home mortgage lender, filed for bankruptcy, laying off nearly 7,000 employees, many at its Long Island, New York headquarters, and suspending most operations.

The giant investment bank Bear Stearns fired co-president Warren Spector, holding him responsible for the failure of two hedge funds that were part of the asset management group he supervised. The two funds, specializing in securities backed by subprime mortgages, filed for bankruptcy after losing billions, and last Friday Bear Stearns saw its credit rating lowered.

Figures reported in the financial press show a wider pattern of credit-tightening. Thomson Financial reported that sales of high-yield junk bonds fell from $22.4 billion in June to only $2.4 billion in July, while sales of investment-grade bonds fell from $109 billion in June to $30.4 billion in July, the lowest monthly figure in five years.

The *Los Angeles Times* noted, “many analysts say the real test will come in September, when private equity firms and investment banks will need to find investors for an estimated $330 billion in bonds and loans needed to finance corporate buyouts that already have been announced.”

The economics columnist for the *Washington Post*, Robert Samuelson, normally a free-market true believer, expressed the gloom settling in among financial observers. In Thursday’s column, written before the latest market plunge, he bemoaned the almost incomprehensible complexity of the mortgage securitization process: “The peril is that so much has changed so quickly that no one knows how the system operates. It’s often roulette. Monday’s defensible investment may become Tuesday’s silly speculation. Global markets are interconnected, and financial conditions are tightening. Some hedge funds—including foreign funds—have suffered huge losses on US subprime mortgages. These could harm banks that lent to hedge funds. Up to a point, losses are inevitable and desirable. They remind investors of risk. But too many losses—too much fear of the unknown — can trigger a chain reaction of selling and credit contraction. This must worry the Federal Reserve and other government central banks.”

Another *Post* business columnist, Steven Pearlstein, wrote: “Meanwhile, at hedge funds, insurance companies and the big Wall Street banks, masters of the universe are sweating bullets over what they are going to tell investors and regulators about all those assets on their balance sheets that, suddenly, nobody wants to buy. They include credit swaps and other fancy derivatives, along with loans to private-equity firms for corporate buyouts.”

Pearlstein was scathing about what he termed the Bush “administration’s Katrina-like response to the meltdown in the mortgage market, which has spread well beyond sketchy subprime loans... when, as result of market and regulatory failures, millions of Americans face the prospect of losing their homes, jobs or retirement savings, you’d expect the government to show a bit more urgency and candor about the problem, and more creativity and leadership in addressing it. This is hardly the time to head for the ranch and the beach and leave everything to Mr. Market.”

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site