Stock market gyrations fueled by credit, housing market crises

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US stock indexes eked out small gains Friday, following a massive sell-off Thursday on the New York Stock Exchange that sparked major losses on markets in Europe and Asia.

For most of the day the market was in the red, and turned positive only in the final hour of trading. This was despite an October employment report from the US Labor Department that announced a net gain of 166,000 jobs, more than double the Wall Street projections.

While the indexes advanced overall, financial stocks continued to record major losses. Merrill Lynch stock declined by 7.9 percent after the *Wall Street Journal* reported that the company may have engaged in questionable transactions with hedge funds in an effort to conceal its exposure to plummeting high-risk mortgage-backed securities.

Investment bank Bear Stearns declined by 5 percent. Morgan Stanley lost 5.6 percent. Lehman Brothers declined 0.6 percent and Goldman Sachs lost 4.4 percent.

Citigroup, the largest US bank, recorded a 2.6 percent fall, and JP Morgan Chase fell 2.6 percent.

On Thursday, the major US indexes fell sharply, more than wiping out large gains on Wednesday sparked by the decision of the Federal Reserve Board, the US central bank, to cut short-term interest rates for the second time in two months.

The Fed's decision, which placed greater pressure on the already sharply devalued dollar and came in the teeth of soaring oil and other commodity prices, was driven by fears that the accelerating meltdown in the US housing and home mortgage markets was destabilizing major banks in the US and Europe which have bet heavily on risky high-yield securities linked to subprime mortgages and other speculative investments.

On Thursday, all three major stock indexes lost more than 2 percent of their value. The Dow Jones Industrial Average fell 362.14, or 2.6 percent. The S&P 500 declined 40.94, or 2.6 percent. The Nasdaq fell 64.29, or 2.3 percent.

Stocks began to plummet at the opening bell, after a series of reports indicating that the banking and credit crisis, and the underlying collapse in the housing market, were worsening. Trading curbs were put in effect shortly after the opening of trading, and remained in place all day.

Losing stocks outnumbered gainers by more than six to one. But the rout was concentrated in financial stocks, including those of major banks, investment banks, brokerage houses and companies that insure the bonds held by banks and big investors.

The four financial companies in the Dow Jones index—American Express, AIG, Citigroup and JP Morgan Chase—accounted for 27.7 percent of the drop in the index. All 24 members of the KBW Bank Index fell, the worst day for the financial index in more than five years.

The massive sell-off occurred despite the announcement by the Fed that it had lent $41 billion to money-market dealers, the largest infusion of capital into the market by the Fed since the credit crisis erupted in early August.

The enormous volatility on the stock market demonstrates that the credit crunch which developed last summer has not been resolved by two successive interest rate cuts—a half-point cut on September 18 and Wednesday's quarter-point reduction. On the contrary, the underlying deflation of the credit bubble of the past several years, fueled largely by manic real estate speculation and a spree of leveraged buyouts, is far from having run its course, raising the specter of a prolonged tightening of credit and resulting slump in the broader economy.

Citigroup fared the worst of any stock. It fell $2.85, or 6.9 percent, to $38.51, its lowest level in four years. Bank of America, the second biggest US bank by assets, lost 5.3 percent. The number three US bank, JP Morgan Chase, fell 5.7 percent.

All three banks, as well as such investment bank giants as Merrill Lynch, Morgan Stanley and Goldman Sachs, have reported multi-billion-dollar write-downs in exotic securities such as collateralized debt obligations (CDOs), structured investment vehicles (SIVs) and other investments in various forms of debt, including subprime mortgage loans to home buyers with weak credit.

Last week, Merrill Lynch reported $8.4 billion in write-downs and a net loss for the third quarter of $2.2 billion. Earlier in October, Citigroup reported $6.5 billion in write-downs and a 57 percent decline in profits for the quarter.

Thursday's run on financial stocks began after three analysts cut their ratings for Citigroup, and CIBC World Markets said the company might have to reduce its dividend to shore up capital. A CIBC World Markets analyst wrote: "We believe over near term, Citigroup will need to raise over $30 billion in capital through either asset sales, a dividend cut, a capital raise or a combination thereof."

Citigroup is particularly vulnerable to the collapse of mortgage-based securities because it has established a network of structured investment vehicles—off-balance-sheet investment funds—that are nominally valued at $80 billion. The real value of these SIVs, which engage in highly speculative trades in various forms of debt, much of it linked to subprime mortages, is unknown.

With the drying up of easy credit, the SIVs have found it impossible to find buyers for their commercial paper, threatening them with collapse. This could compel Citigroup to move the assets of its SIVs onto its balance sheet, resulting in more and even larger write-downs and intensifying the general credit crunch.

Confidence in Citibank has been further shaken by indications that a scheme, brokered by the US Treasury and backed by the Fed, to raise $80-$100 billion to bail out the SIVs may fail to materialize.

"The Citigroup news is a wake-up call for those who think these issues will go away with the Fed cutting rates," said Micael Metz, the New York-based chief investment strategist at Oppenheimer Holdings Inc. "We're not going to get resolution on those credit issues for months."

Analysts at JP Morgan Chase recently reported that they expected bank credit losses on mortgages and debt securities to continue well into 2008, as housing prices weaken further. "As bank losses continue, we expect bank lending capacity to be reduced," they said.

In addition to the negative reports on Citigroup, other bits of ominous news about the financial sector stoked the near-panic that brought stocks tumbling on Thursday.

Credit Suisse reported a 31 percent drop in third-quarter net profit and a write-off of $1.9 billion in mortgage-linked and leveraged loan assets.

GMAC Financial Services said its third-quarter loss widened to $1.6 billion from $173 million a year earlier on losses in its real estate finance business.

Bond insurers slumped, indicating that the banks' troubles were reverberating across the financial sector. In the last few years, bond insurers such as MBIA Inc. and Ambac Financial Group aggressively wrote insurance on CDOs that were backed mainly by subprime mortgages. Over the past two weeks, some of the insurers posted large losses for the third quarter due to adjustments on credit securities they used to provide insurance on bonds.

Shares of Ambac Financial plunged 20 percent, bringing its market value loss in the past two weeks to nearly 50 percent. MBIA fell 12 percent. Its stock has shed more than a third of its value in the past two weeks. Radian Group, another insurer of mortgage and credit products, dropped 14 percent after reporting a $704 million third-quarter loss.

Negative reports on the underlying economy contributed to the market sell-off. Exxon's shares fell 3.8 percent after the oil and gas giant posted a bigger-than-expected 10 percent drop in third-quarter net income.

The Commerce Department reported that consumer spending rose by 0.3 percent in September, slightly lower than the 0.4 percent increase that analysts expected. And the Institute for Supply Management reported that its manufacturing index registered 50.9, down from 52.0 in September and below expectations. The index has declined for four straight months.

But most ominous were indications that the housing and subprime mortage crises are worsening. The percentage of subprime mortgages that were more than 60 days behind in their mortgage payments topped 20 percent in August, up from 18.7 percent in July and 17.1 percent in June, according to the latest data from First American LoanPerformance.

Home prices were down more than 4 percent in the month of August from a year ago, as measured by the S&P/Case-Shiller Index.

"Mortgages are still deteriorating at an accelerating pace, and that's scary," aid Karen Weaver, global head of securitization research at Deutsche Bank. "We haven't come near a stabilization, and we expect things to get worse as the bulk of resets" of interest rates on adjustable-rate mortgages "have yet to come."

An article in Friday's *Wall Street Journal* provides an indication of the potential financial toll from the housing collapse. It cites Mark Zandi, an economist at Moody's Economy.com, as estimating that "of the $2.45 trillion in especially risky mortgages currently outstanding—including subprime mortgages, interest-only mortgages and others—as much as a quarter could suffer defaults in the months ahead. Total losses in these mortgages, he estimates, could reach $225 billion."

The article goes on to say that Zandi puts the fall in home values at 10 percent by the end of 2008. "That would wipe out more than $3 trillion in home values," it says.

The *Journal* further notes that an index which tracks risky subprime bonds "has fallen to a record low of 17.4 cents on the dollar, down 50 percent from August." It continues: "But the recent turmoil stems from declines in the market for the safest securities, rated triple-A.... An index that tracks triple-A securities is trading at 79 cents on the dollar, down from roughly 95 cents just a month ago.

"Because banks must value many of their securities holdings at the price at which they could be sold—called marking to market—many have had to report losses.

"In October alone, ratings firms Moody's Investors Service, Fitch Ratings and Standard & Poor's have downgraded or put on watch for downgrading more than $100 billion in mortgage-backed CDOs."

One way to understand the burgeoning financial crisis—which contains the seeds of a deep and protracted recession—is to grasp that the ultimate collateral for much of the exotic credit securities from which Wall Street speculators made billions upon billions was the market price of homes and other real estate, whose rapid rise was fueled by the very debt bubble supposedly underpinned by home values.

The fact is, no one, including the banks and investment houses, knew the actual value of the assets underlying the CDOs, SIVs, derivatives and other forms of financial manipulation that are now coming crashing down.

As the *New York Times* financial reporter Floyd Norris put it on Friday: "No one seemed to be bothered by the lack of public information on just what was in some of these products. If Moody's, Standard & Poor's or Fitch said a weird security deserved an AAA [rating], that was enough.

"And then they blew up.

"Now we are learning that the investment banks did not know what was going on either, and they ended up with huge pools of securities whose values are, at best, uncertain. As the losses are estimated, confidence has vanished."