Decline in US service industries heightens recession fears, sparks stock sell-off

Barry Grey
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US stock markets plunged Tuesday following the release of a report showing a sharp contraction in service sector business activity in January. All three major stock indexes were in negative territory throughout the trading session and closed at or near their lows for the day.

The Dow Jones Industrial Average fell 370.03 points, a decline of 2.93 percent; the Nasdaq Composite Index lost 73.28 points, or 3.08 percent, to reach a 52-week low; and the Standard & Poor's 500 Index plunged 44.18 points, or 3.20 percent.

Tuesday's fall followed major declines on Monday, precipitated by analyst downgrades of banks and credit card issuers and a survey by the Federal Reserve Board showing that banks are tightening their lending standards for both consumers and businesses, even beyond real estate loans, and corporate demand for credit is weakening. The Dow fell 108.03 points, the Nasdaq declined by 30.51, and Standard & Poor's 500 lost 14.60 points.

The two-day loss was the worst for the S&P 500 Index in five years.

The sell-off reversed gains registered last week following the Federal Reserve Board's extraordinary moves to lower short-term interest rates. The Fed cut its federal funds rate by 0.75 percent in an emergency move following panic selling on international share markets, and a week later, at its regular policy meeting, slashed the rate by an additional 0.50 percent. This brought the major US short-term interest rate to 3 percent, down from 5.25 percent last September.

These measures, aimed at pumping liquidity into near-frozen credit markets and aiding banks hit by tens of billions in losses from failed subprime mortgage-linked investments, have not sufficed to ease fears on Wall Street and in corporate board rooms of a steep recession and potential collapse of the US and international financial system.

The markets reacted with near-panic to the report issued Tuesday prior to the opening of the trading session by the Institute for Supply Management (ISM) showing a major contraction in the US services sector. This sector, which includes restaurants, travel, banking, construction and retail, accounts for about two-thirds of the US economy.

The ISM reported the first decline in the sector in nearly five years. Its measure of non-manufacturing business activity fell to 41.9 in January from a revised reading of 54.4 in December. A reading above 50 indicates expansion, while one below 50 indicates contraction.

Economists had expected a slight slowdown but were still forecasting growth, with a median estimate for the index of 53. The ISM said that only three service industries reported growth, while 14 showed a decline. Among the indices that fell were those for new orders and employment, which came in at 43.5 and 43.9 respectively.

These negative readings were particularly ominous, since they point to future business activity. With manufacturing continuing to shrink, the service sector has up to now been the chief source of growth for the economy as a whole.

The ISM report compounded recession fears, as it came on the heels of last week's employment report for January, showing a net loss of 17,000 jobs, and the government's report on overall economic growth for the fourth quarter of 2007, which registered an anemic increase of 0.6 percent.

"This is an absolute collapse of this index," said Nigel Gault, chief US economist at Global Insight. Gault pointed out that in March of 2001, at the beginning of the last recession, the index stood at 50, and during the recession it remained at 48 or 49, several points higher than January's reading.

Speaking of economists' estimates of a current or imminent recession, Gault said the report would be "tipping plenty of people over the edge."

Anthony Nieves, chairman of the ISM's non-manufacturing business survey committee, said the consensus among survey respondents was that the services sector had "come to the end of a long-term period of growth."

"This is the most unequivocal sign we've had that the economy is weakening," said Stephen Stanley, chief economist at RBS Greenwich Capital.

The *Wall Street Journal Online* cited BNP Paribas' Richard Iley as saying the ISM report "suggested... that having flirted with recession the economy has reached a stage where it suddenly 'accelerates sharply into the downswing, surprising all forecasters and policy makers with the speed and severity of the downswing and leaving the debate over recession a complete irrelevance.'"

Other developments this week have added to fears of a deepening financial crisis and economic slump. On Monday, Thompson Financial reported that fourth-quarter 2007 earnings of the S&P 500 corporations were on track to dive 20.7 percent from a year earlier. The net decline is overwhelmingly the result of massive losses in the banking sector, which is expected to show a net loss.

Also on Monday, Standard & Poor's warned that downgrades of bond insurers would worsen the capital position of major banks that have already recorded huge losses from investments linked to the housing market. Another report said that major private equity firms might refuse to help bail out two of the largest bond insurance companies, Ambac Financial Group and MBIA.

Treasury Secretary Henry Paulson, testifying Tuesday before the Senate Finance Committee to push for passage of the Bush administration's $150 billion economic stimulus package, repeated the administration's mantra that the US economy is "fundamentally sound." However, he sounded an ominous note, warning: "Capital markets turmoil impacting our financial institutions is and can increasingly spill over to our real economy unless we do something about it." He urged struggling banks to "recognize losses and raise capital" rather than "shrinking their balance sheet and then restraining their lending."

Jeffery Lacker, the president of the Richmond Federal Reserve Bank, told the West Virginia Bankers Association that he was undecided on whether further interest rate cuts were warranted, even though he believed "job growth will be lethargic, at best, for much of this year," and he expected business investment to slow "since some firms are experiencing a higher cost of capital and most firms face an uncertain demand for their products."

He pointed to the signs of rising inflation and suggested that the Fed's easy money policy was undermining its credibility in holding down prices.

His testimony was evidence of divisions within the Federal Reserve Board, which are themselves rooted in the deep and systemic nature of the crisis wracking American capitalism. Years of financial speculation, based on low interest rates and cheap credit, accompanied by various forms of accounting fraud and financial manipulation, have enriched the corporate and banking elite at the expense of the country's industrial infrastructure and the living standards of the broad masses of the population.

At the same time, they have built up a huge edifice of corporate, consumer and government indebtedness. Attempts to bail out Wall Street by pumping cash into the markets threaten to unleash an upward spiral of inflation and undermine the already declining international position of the US dollar.