Recessionary trends deepen, sparking gyrations on stock, commodities markets

Barry Grey
22 March 2008

In the wake of the bailout of Bear Stearns, brokered and largely financed by the US Federal Reserve Board, fears of a deepening recession and continuing uncertainties over the solvency of major finance houses fueled a week of wild gyrations on American stock exchanges.

On Tuesday, one day after the Fed engineered the takeover of Bear Stearns by JPMorgan Chase and announced that it would extend unlimited credit for six months to investment banks and brokerage houses—a measure without precedent since the Great Depression of the 1930s—the Dow Jones Industrial Average soared by 420 points. The jump was led by financial stocks, which benefited from the Fed's agreement to swap Treasury bonds for illiquid and dubious mortgage-backed securities.

The next day, the Dow plummeted by 293 points, buffeted by a sudden sell-off of commodities.

On Thursday, the final trading day in a week shortened by the Good Friday holiday, the Dow shot up again, closing with a gain of 261 points, despite a continued fall on commodities indexes.

The extreme market volatility was driven in large measure by growing indications that the US has slid into a recession and that the slumping American economy is leading to a global slowdown.

On Thursday, the US Labor Department reported that jobless claims jumped by 22,000 last week over the previous week, reaching its highest level in nearly two months. The Labor Department said applications for jobless benefits totaled 378,000 for the week, far more than had been expected. The four-week average for new claims rose to 365,250, the highest level since a wave of claims caused by the 2005 Gulf Coast hurricanes. The number of people on benefit rolls reached its highest level since August 2004.

The jobless claims report came on the heels of monthly employment reports for February and January which saw net declines in payroll jobs of 63,000 and 22,000 respectively.

Citigroup, the largest US commercial bank, announced that it was laying off 2,000 employees in its markets and banking unit. The layoffs, to take effect by the end of this month, bring the total job cuts announced by the bank since the mortgage crisis began last summer to more than 6,000—about 10 percent of the firm's global workforce. Citigroup said the layoffs would be concentrated in New York and London.

The Wall Street giant has written down the value of its assets by over $20 billion in the last year, and is expected to report billions more in losses from subprime and other risky investments in the coming months.

Since the eruption of the subprime crisis and credit crunch in mid-2007, US financial services companies had shed over 60,000 jobs.

The Conference Board, a New York research firm, reported that its index of leading economic indicators declined 0.3 percent in February, its fifth straight monthly drop, and the Philadelphia Federal Reserve said its factory index had declined in March, the fourth consecutive monthly fall in the index. Nationwide, manufacturing declined last month at the fastest pace in almost five years, according to a survey by the Institute for Supply Management.

Auto industry spokesmen projected a sharp decline in vehicle sales for 2008, foreshadowing more layoffs and plant closures. J.D. Powers & Associates issued a forecast putting US industrywide sales of light trucks and cars at 14.95 million, the lowest level since 1994.

In yet another report pointing to a continuing slump in the housing market and rise in home loan defaults and foreclosures, the US Census Bureau said the national homeowner vacancy rate rose to 2.8 percent in the fourth quarter of 2007. That was up from 2.7 percent in the previous quarter and equaled the record set in the first quarter of 2007.

The global impact of the US financial crisis and recession was indicated by a report showing a virtual standstill in world trade over the new year. The Bureau for Economic Policy Analysts, a Dutch research institute, reported that in the three months to January, world trade in goods rose at an annualized rate of 0.2 percent over the previous three months.

"This is a substantial deceleration," the institute said. "World trade volume growth is on a downward trend."

The growing signs of economic slump, combined with the impact of the credit crunch and investor fears about new bank failures, sparked the broad sell-off on commodity markets that began on Wednesday and continued Thursday. Crude oil and gold prices nosedived from record highs set at the start of the week.

Oil prices fell by 6.9 percent over the two days, while most other commodities fell by 7 percent. Wheat prices plummeted by 15 percent. Overall, the decline in commodities prices for the week was the biggest in a half-century.

The sell-off was evidently sparked by the decision of the Fed, announced Tuesday, to cut its federal funds target interest rate by 0.75 percent, rather than the 1 percent expected by commodities speculators. That bolstered the US dollar on world currency markets and led to a sharp decline in the euro, the yen and the Swiss franc from record highs recorded earlier in the week. The British pound, Australian dollar and Canadian dollar also fell sharply.

Big investors, including hedge funds, which had bid down the value of the US currency and bid up the price of key commodities, in part to recoup losses on stock, bond and derivative investments, panicked and began unloading their commodity holdings. But the commodity sell-

© World Socialist Web Site

off was also fueled by fears of a global recession, which would deflate commodity prices.

Since the beginning of 2008, demand for oil in the US has fallen 2.4 percent compared with the same period last year.

The commodity plunge is also the result of increasing demands from hard-pressed creditors for commodity speculators to increase their margins in collateral and cash.

The *Wall Street Journal* on Friday described the mechanism as follows: "Investors with losing trades in credit markets—mortgage bonds or collateralized debt obligations, for example—are being required by banks and others to set aside more cash to cover the money they borrowed to make trades, a process called 'deleveraging.' To raise the cash, some investors and hedge funds have sold some of their commodity winners."

The *Journal* went on to explain that the process is an expression of the generalized crisis of the financial system, centered in the big banks and investment houses. It quoted Rich Feltes, director of commodity research at MF Global Ltd. in Chicago, as saying, "This is all related to the liquidity crisis. As assets at banks are written down, they need to shore up their portfolios by bringing in more cash from hedge funds that are trading in commodities."

Heavily leveraged hedge funds and other investors also dumped commodity holdings because they were compelled to sell liquid assets in order to make up for losses from bad bets on other forms of speculation.

As Mark Wilson, vice president and senior credit officer at Moody's Investors Service, put it: "We are in an environment where there is uncertainty all around."

In an attempt to fend off a financial meltdown, the Fed has taken unprecedented measures, including pumping hundreds of billions of dollars into credit markets and taking onto its own balance sheet mortgage-backed securities, loans used to finance leveraged corporate takeovers and other failing assets that are weighing on commercial banks and investment houses and threatening them with bankruptcy, a la Bear Stearns.

This can only weaken global confidence in the Fed's own solvency and further undermine the position of the US dollar. Ultimately, the cost will be born by the US government, either in the form of curtailed remittances from the Fed to the US Treasury, as a result of losses suffered by the US central bank, or a direct government bailout of Wall Street.

The US government took another step in this direction on Wednesday when the regulatory body that oversees Fannie Mae and Freddie Mac, the government-chartered mortgage finance firms, agreed to allow the two companies to reduce their capital requirements from 30 percent to 20 percent. This move, reportedly taken under intense pressure from the Bush administration, will enable the two mortgage finance companies to pump an additional $200 billion of liquidity into the US mortgage market. The aim is to bolster the distressed market for so-called "jumbo" mortgages greater than $417,000 and increase the firms' capacity to refinance more subprime home loans.

Since the US government ultimately stands behind Fannie Mae and Freddie Mac, both of which recorded record fourth-quarter losses, the expansion of their lending facility represents yet another step toward a direct government rescue of the banking and mortgage industries.

The loosening of capital requirements for the two firms helped spark the stock market rally on Thursday, raising hopes that it will help stanch the fall in home prices and the spread of mortgage defaults and home foreclosures, thereby shoring up the balance sheets of the banks and investment houses.

That the fallout from the US housing collapse and failure of mortgage-linked investments continues was underscored by the announcement Thursday from Credit Suisse, the Swiss Banking giant, that it was likely to record a loss for the first quarter of 2008. The bank also admitted that it had mispriced the value of some of its securities and said it would write down its assets by $2.83 billion and cut its profit results for 2007 by 6 percent, or $7.8 billion.

Another ominous sign was the announcement from CIT, a major lender based in New York, that it had drawn down its entire $7.3 billion line of backup credit because it could not get credit from its usual sources. CIT stock plunged by 17 percent on Thursday. "It's a ripple effect," said Michael Taiano, an analyst at Sandler O'Neill & Partners. "CIT gets squeezed, the people they lend to get squeezed and end up maybe defaulting on their loans. It kind of goes down the food chain."

Comparing the current crisis to the process that produced the Great Depression, economist and *New York Times* columnist Paul Krugman wrote Friday: "The financial crisis currently underway is basically an updated version of the wave of bank runs that swept the nation three generations ago. People aren't pulling cash out of banks to put it in their mattresses—but they're doing the modern equivalent, pulling their money out of the shadow banking system and putting it into Treasury bills. And the result, now as then, is a vicious circle of financial contraction."

Former Federal Reserve Board Chairman Paul Volcker suggested in a television interview that the Fed was taking inordinate risks and cautioned that its policy of cutting interest rates could lead to an explosion of inflation. He said on PBS's Charlie Rose program: "We have seen the Federal Reserve take more extreme measures in some respects than any that have been taken in the past to deal with the financial crisis."

He went on to say that the Fed was not a place "where you put in bad assets, possibly bad assets," and warned that the weakening of the dollar "begins to raise questions" as to its role as a world currency.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site