Wall Street falls reflect concerns over bailout and fears for US economy

International tensions

Peter Symonds
24 September 2008

US stocks suffered their worst two-day slump in six years this week, amid concerns in financial circles about any obstruction or delay to the Bush administration's massive $700 billion bailout announced last Friday as well as its adequacy and long-term consequences. This market volatility will undoubtedly be exploited to push the plan through Congress as rapidly as possible and on the most favourable terms to Wall Street. There could even have been an element of market manipulation on the part of major investors who stand to profit from this unprecedented government handout to the banks and financial elite.

All of the US share indexes fell sharply on Monday and Tuesday, wiping out gains last Friday when investors enthusiastically greeted the initial bailout announcement. The Standard & Poor's 500 fell by 1.6 percent on Tuesday on top of 3.8 percent on Monday. The Dow Jones Industrial Average was down by 4.8 percent over the two days. The banking sector was hard hit with the S&P banks index falling 3.1 percent yesterday, on top of a 12 percent plunge on Monday—the largest fall since the index was created in 1989.

Global stock markets followed suit yesterday, negating most of the gains made since Friday. The MSCI Asia Pacific index—a composite indicator of Asian shares—dropped 2.1 percent. All of the region's markets fell except for South Korea, Taiwan and Vietnam. Japan was closed for a holiday. China's CSI index slid 3.8 percent, Hong Kong's Hang Seng fell 3.2 percent and the Australian benchmark S&P/ASX 200 closed 1.9 percent lower. The story was similar in Europe. The French CAC-40 was down 2 percent, the German DAX fell by 0.6 percent and the FTSE-100 in London dropped 1.9 percent.

Increased purchases of US treasury notes sent yields falling yesterday for a second day, after a sharp rise on Friday. The yield movements are another indicator that after initially welcoming the bailout package, investors are seeking safe havens. Commentators have pointed to the widening gap between the three-month lending rate to banks and to the US Treasury as evidence of the continuing credit crunch—an unwillingness to lend to banks when their debts and solvency remain in question. Yesterday the Ted Spread—one measure of the gap—was 2.50 percentage points, the highest level since prior to the bailout on September 18, when it was 3.13 percentage points, the most since the index started in 1984.

Oil prices shot up by $16.37 a barrel in New York on Monday—the largest ever one-day gain—before falling back by $2.76 yesterday. While not all of Monday's rise can be attributed to investors looking for a safe haven, it is certainly a factor driving the market volatility.

All eyes have been on the discussions underway in the US Congress. One factor in the falls over the past two days is uncertainty over the terms of the bailout package. Amid widespread popular disgust and anger over footing the bill for the orgy of speculation on Wall Street, Congress may be compelled to add some caveats to what at this stage is an open-ended handout with virtually no regulation or oversight. As one commentator put it, investors are still waiting to see "what decorations are on the Christmas tree" before assessing the full benefits of the handout.

Other concerns, however, are of a more fundamental nature. A number of analysts have warned that the package will simply not resolve the deep-going crisis of the American economy. David King, money manager at Putnam Investments in Boston, told *Bloomberg.com* that the bailout was "helpful, but it's not going to prevent a recession if we're in one, or cause people to pay back loans that they couldn't otherwise pay back."

Also speaking to *Bloomberg.com*, Oppenheimer & Co. analyst Meredith Whitney said the plan held "little hope of improving core fundamentals over the near and medium term.". She has already lowered her earnings estimates for US banks, predicting US home prices may fall an additional 25 percent. While providing a massive boost for Wall Street, the package will do nothing to assist the hundreds of thousands of Americans faced with the grim prospect of losing their homes.

In comments to the *Australian Financial Review*, Merrill Lynch's chief North American economist David Rosenberg was even more pessimistic about the bailout. "We do not think it seriously changes the endgame—the US economy is in recession and likely to remain so. At best it merely removes what was looking like the worst case scenario: the entire collapse of the global financial system and a deep global depression," he said.

Well-known Japanese analyst Kenichi Ohmae dismissed the package as "a joke". Speaking this week at an investor forum in Hong Kong, he declared that the world financial system confronted a liquidity crisis and called for the establishment of a $5 trillion "international facility" for financial institutions. He insisted that the facility had to be "so big that people won't get panicky" and suggested that the foreign currency reserves of China, Japan, Taiwan, the Gulf states, the European Union and Russia could be used to set it up.

International tensions

However, the major European and Asian economic powers have already been resistant to US calls for a coordinated effort. A statement from the G-7 industrialised countries on Monday formally welcomed the Bush administration's bailout, but effectively rejected Washington's proposal for all G-7 members to establish a similar plan. While declaring a commitment to further action, the statement added that any steps would be "consistent with our respective domestic circumstances".

As Christian de Boissieu, chairman of the French prime minister's council of economic analysis, bluntly explained: "The US must take charge of the budgetary costs of the crisis. I'm all for trans-Atlantic solidarity, but this doesn't include financing the bailout." The Bush administration's plan had already put European governments offside by initially not including foreign banks operating in the US. "Who would open a bank again in the United States?" one European bank executive asked the *New York Times*. US Treasury Secretary Henry Paulson was forced to amend his proposal over the weekend to include all banks.

Already concerns have been raised over the Washington's ability to fund the plan. The $700 billion package, on top of other bailouts including $200 billion for mortgage giants Fannie Mae and Freddie Mac, will send US public debt soaring to over 70 percent of Gross Domestic Product—a level not seen since 1954. Several analysts estimate that the budget deficit could hit a new high next year of $1 trillion or 7 percent of GDP.

Already pressure is being exerted for savage cutbacks to government spending that would gut what remains of social services and infrastructure. Speaking to the *Washington Post*, Peter Schiff, president of Euro Pacific Capital, declared: "Where's the tax increase to fund this bailout? Where is the cut in programs? The government's not doing either—they're just going to print money. And if you think inflation is the answer, take a trip to Zimbabwe and see how it's working for them."

A sharp fall in the value of the US dollar on Monday also reflects concerns about the viability of mounting US debt. While it recovered somewhat yesterday, the dollar plunged by 2.2 percent against the euro on Monday—its biggest one-day fall since January 2001. The massive debt also raises a question mark over the US government's credit rating. The credit rating agencies Moody's and Standard & Poor's reassured investors that the rating was stable. But Pierre Cailleteau, managing director of Moody's sovereign risk unit, did acknowledge to the *Washington Post* that it was "a critical question given that the US Treasury's Aaa rating acts as a cornerstone of risk pricing in the global financial system."

Referring to the falling dollar, C. Fred Bergsten, director of the Petersen Institute for International Economics and former Carter administration treasury official, told the *Washington Post*: "This is a revaluation of the US. Growth is going to be slower, the budget deficit higher, but mostly, the whole US financial system has been thrown into question. People around the world are looking at this and saying, 'Holy Toledo'."

While most commentators are offering rather empty reassurances, Nouriel Roubini, writing in Monday's *Financial Times*, warned that the financial meltdown was far from over. He traced out what he believed would be the next stages in the financial crisis which will hit hedge funds and private equity firms. "We are observing an accelerated run on the shadow banking system that it is leading to its unravelling... Of course this severe financial crisis is also taking its toll on traditional banks: hundreds are insolvent and will have to close," he wrote.

Turning to the broader ramifications, Roubini ominously added: "The real economic side of this financial crisis will be a severe US recession. Financial contagion, the strong euro, falling US imports, the bursting of European housing bubbles, high oil prices and a hawkish European Central Bank will lead to a recession in the eurozone, the UK and most advanced economies." After listing the weaknesses of the European financial system, he concluded: "Thus the financial crisis of the century will also envelop European financial institutions."