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Another big drop: Dow down 508; Fed efforts, rate hint fail to stem massive losses

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Stocks tumbled again Tuesday, despite efforts by the Federal Reserve to keep credit flowing to businesses and word from Fed Chairman Ben Bernanke that the central bank could soon cut interest rates to re-energize the economy.

The Dow Jones industrial average, down nearly 370 points Monday, sank another 508 points, or 5.1%, to 9447. It was the Dow's fifth-consecutive drop, during which it slid more than 1,400 points, or 13%. The Standard & Poor's 500 tumbled 61 points, or 5.7%, to 996. It was the first time the S&P 500 -- the index to which trillions of dollars of investors' money is linked -- had closed below 1000 since Sept. 30, 2003. The S&P 500 has now fallen 36.3% from its October 2007 high, outstripping the average 31.5% decline in the typical post-World War II bear market.

Stock market losses continued to accelerate after passage of Friday's \$700 billion rescue plan for the financial industry, which was supposed to restore investor confidence. Tuesday, investors bailed even after the Fed made one of its most dramatic moves yet to help corporations through the global credit crunch. The Fed said it would buy corporate commercial paper -- a way to lend short-term cash directly to creditworthy companies that need funds for payroll and other immediate needs.

Money market and mutual funds are the biggest buyers of commercial paper. The Fed said the market for short-term loans fell \$52.1 billion to \$1.8 trillion the week ended Sept. 17.

The Fed's Commercial Paper Funding Facility can buy up to \$1.3 trillion in three-month corporate IOUs until April 30, 2009. The program is expected to lead to much lower interest rates and more credit availability -- although details, including when the Fed will start buying, are still being worked out.

Bernanke noted credit has tightened even for the worthiest business and consumer borrowers. That was underscored by a report Tuesday from the Fed that showed consumer borrowing fell in August for the first time since January 1998, reflecting both a tight credit market and a spending slowdown. Borrowing fell for both revolving loans, which include credit cards, and non-revolving, which includes borrowing to buy big-ticket items.

"People don't want to borrow if they can help it. People can't borrow even if they want to," says David MacEwen, chief investment strategist of fixed income at American Century Investments. Credit markets across the board remain "seized up," he says, and the market for debt sold by companies is "completely illiquid." When companies are able to borrow, the terms are very onerous, he says. "If Corporate America cannot finance itself from credit markets, we're in for a world of hurt," he says.

President Bush said the financial rescue plan enacted last week offers a "range of tools" to stabilize markets but could take time to work. Thawing the freeze in the financial system is not going to happen overnight," the president told workers at an office-supply business in the Washington suburb of Chantilly, Va. These are urgently needed steps," he said.

In what could be one slightly positive sign, investors sold short-term government Treasuries, which have been a favorite spot to hide. Investors sold three-month Treasury bills, pushing the yield up to 0.70% from 0.45%.

The Fed is positioned as a backup player, not a source of cheap money, and its program may become critical to companies near the end of the year when the commercial paper market is typically tighter.

"We may use this as a fallback," says Helen Shan, treasurer of Pitney Bowes, a document-management services company. "But right now, I'm not sure it makes much sense for us."

Confidence missing

The Fed's move and Bernanke's comments failed to have a positive impact on Wall Street.

"There's just no confidence, and it's terrible," says Envision Capital Management President Marilyn Cohen, adding that companies won't use the Fed's cash for growth. "They use it while they're in the foxholes ducking the next bullet."

Signs that the credit crisis had spread outside the USA rattled most markets Monday. But Tuesday, overseas markets closed mixed. In London, stocks ended up 0.4%, despite banking jitters surrounding the Royal Bank of Scotland, whose shares tumbled 40% amid solvency concerns. In Paris, stocks gained 0.6%. German stocks dropped 1.1%. Japan's benchmark Nikkei 225 average fell 5% in early trading today, its lowest level in nearly five years.

Lyle Gramley, a former Fed governor now at Stanford Financial Group, says there is a contagion of fear as people realize it's not just the U.S. economy that is in trouble, but economies around the globe. "People are calling me up and asking me, 'Is this the Great Depression all over again?'" he says. "We need to calm people down. What will do that, I don't know."

"People are panicked, and they want out no matter what," Moody's Economy.com chief economist Mark Zandi says. "Ultimately, the policymakers are going to win the day," he says. "Given everything that the Fed and the Treasury are doing, we're going to get to a point where people are going to say, 'Ah ha, the U.S. government is going to backstop the financial system' ... and the sentiment will shift."

Rate cut imminent?

Bernanke suggested the central bank may cut interest rates to shore up a rapidly deteriorating economy and address a credit crisis of "historic dimensions."

The Fed "will need to consider whether the current stance of monetary policy remains appropriate," Bernanke told members of the National Association for Business Economics in a relatively gloomy speech that offered the clearest sign yet that the central bank was considering a rate cut amid the financial turmoil.

"Economic activity is likely to be subdued during the remainder of this year and into next year," he warned. "The heightened financial turmoil that we have experienced of late may well lengthen the period of weak economic performance and further increase the risks to growth."

In a market where participants bet on future Fed moves, investors Tuesday were pricing in a half-percentage point cut this month, according to Action Economics. Although rate cuts usually stimulate spending, and therefore the economy, it's unclear how much short-term good one would do while banks are so unwilling to lend.

"The Fed chairman just gave the green light for a rate cut at the October meeting, if not before," Christopher Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi, said in a note to clients.

The Fed next meets Oct. 28-29, but can change rates at any time. The central bank has held its target for short-term interest rates steady at 2%, the lowest in nearly four years, since April.

But James Paulsen, chief investment strategist at Wells Capital Management, says cutting interest rates could backfire.

"The policymakers need to stand down now and stop reacting to every move in the markets," he says. "The thing that is driving this is fear, and they are contributing to it."

What's left in the Fed toolbox?

The Fed still has a number of tools at its disposal, given its Depression-era power to lend to a range of businesses in unusual and exigent conditions. A seemingly arcane change this week allowing the central bank to pay interest on bank reserves could have a big

impact by making it easier for the Fed to flood markets with needed cash without undercutting its interest-rate policy.

But to put a floor under falling home prices, Gramley and some other economists say, the federal government needs to play a more direct role in aiding homeowners in danger of foreclosure.

Part of the reason Bernanke's comments on interest rates didn't cheer markets is that his counterparts overseas haven't been singing from the same songbook.

There had been hope for a global plan to cut interest rates, says **Joe Saluzzi**, a trader at **Themis Trading**. But those hopes were dashed as European leaders failed to come to agreement for an orchestrated action to address the gummed up credit markets.

Credit woes squeeze stocks

The declines on Wall Street are adding up to historic losses for investors. The Dow's losses the past five days represent the worst five-day percentage loss since Sept. 21, 2001, and the largest five-day point loss in history. The dollar losses are brutal. More than \$700 billion in shareholder wealth was wiped out Tuesday and \$5.7 trillion this year, according to the DJ Wilshire 5000 index. Investors have lost \$7.2 trillion since the market topped on Oct. 9, 2007. Year to date, the S&P 500 is down 32.2%. If it ended 2008 down this much, it would be the largest annual loss by the stock market since 1937.

In testimony Tuesday to the House Budget Committee, Peter Orszag, director of the non-partisan Congressional Budget Office, said data suggest that private and public pension plans, because they invest in stocks and other financial instruments, took a combined hit of \$2 trillion -- or 20% of their assets -- in the past 15 months.

Real pain is expected to be reflected in the third-quarter earnings that firms are beginning to report. After the market closed Tuesday, Alcoa, the aluminum producer whose quarterly earnings report typically kicks off the earnings season, reported a 52% drop in quarterly earnings, to \$268 million, which included a \$31 million one-time charge.

That's a big reminder that quarterly earnings reports are not expected to be rosy. Analysts are calling for an 8.1% decrease in profits for companies in the S&P 500, and that estimate is likely too optimistic, says Dirk van Dijk, director of research at Zacks Investment Research.

"The expectations are clearly too high," he says. "The numbers are not picking up just how bad things will be." The only sector of the economy expected to post higher earnings is energy, he says, and that's because oil prices only really started to fall in September.

The credit crunch "is spreading to the real economy, and you'll see it in corporate earnings -- and it's not going to be a pretty picture," he says.