

Investors Fear Growth Will Fail To Revive Stocks

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A new fear is helping fuel the latest stock-market rout: that booming global growth -- for years the engine of the world's financial markets -- may have trouble pulling U.S. markets out of their swoon this time around.

Over the summer, when shaky credit markets first sent U.S. stocks lower, strong economic growth in China, India and Europe, together with intervention by the Federal Reserve, reassured investors and sent them back into stocks, pushing U.S. market indexes to new highs.

Now, big financial companies like [Citigroup](#) Inc., [Merrill Lynch](#) & Co., [Morgan Stanley](#) and [Wachovia](#) Corp. are taking multibillion-dollar write-offs linked to the credit-market turmoil. The Fed, meanwhile, is warning that the nation's economic growth is likely to slow. Europe's growth prospects have weakened, and oil has continued to climb toward \$100 a barrel.

Those factors have left investors to wonder whether the Fed's skill in adjusting interest rates and China's economic power will be enough to save U.S. stocks from a steeper selloff.

Money managers overseeing billions of dollars at hedge funds, pension funds and mutual funds have been hunkering down. Their pullback helped send the Dow Jones Industrial Average down 4.5% in the final three days of last week, to 13042.74 -- the sharpest three-day plunge since 2002.

In New York, Richard Rosen, who oversees \$3.5 billion at a subsidiary of New York Life Investment Management, has been trimming his holdings not only in Merrill Lynch and [Wells Fargo](#) & Co., but also in oil-related stocks he once favored. In Washington, Wayne Wicker, whose Vantagepoint Funds oversee \$33 billion, launched a new investment fund -- which immediately used futures markets to bet that the Standard & Poor's 500-stock index would continue to fall. In Chicago, Jack Ablin, whose Harris Private Bank oversees \$52 billion, has been shifting some money out of U.S. stocks and into commodities like oil and copper.

Growth Slowing

Fears are spreading that more bank write-offs could be in the offing as the nation's housing market continues to weaken and securities based on low-quality mortgages keep going bad. The Fed, which has cut interest rates twice since mid-September, is signaling that it mightn't be comfortable cutting rates every few weeks to maintain order. Growth in Europe and Japan is slowing, and fears are spreading that investors in China and India may be contributing to stock bubbles in those markets.

"We have been relying on global growth to pull us along, but that was in the face of mild head winds. Now the head winds seem to be getting stronger," says Ethan Harris, chief U.S. economist at Lehman Brothers.

For this year's third quarter, economists had expected to see annualized U.S. economic growth of a little more than 3%. Instead, initial government estimates showed a 3.9% expansion rate as booming global growth offset the initial effects of U.S. credit-market woes. American multinationals including [Coca-Cola Co.](#), [Procter & Gamble Co.](#), [Intel Corp.](#) and [Cisco Systems Inc.](#) benefited from strong global demand. Meanwhile, dollar-rich Middle Eastern and Asian investors were big buyers of U.S. securities, helping keep U.S. markets afloat.

As this year has progressed, however, Lehman Brothers has cut growth projections not only for the U.S., but also for Europe and Japan. "There are more countries in the caboose now than the engine," Mr. Harris says.

Technology companies have also sounded alarms. Cisco has warned that flagging demand for its networking equipment from big financial companies could hold back sales growth.

Last week, Allen Sinai, chief economist at research firm Decision Economics Inc., concluded that the risk of a U.S. recession has risen to 50% from 40%. He doesn't foresee recessions in China or India, but he thinks their stock markets have "gotten ahead of themselves." Mr. Sinai sees China's economic growth slowing to 9% or 10% next year from 11% this year, India's to 8.5% or 9% from 9.5% and Brazil's to 3.5% from as much as 4% this year.

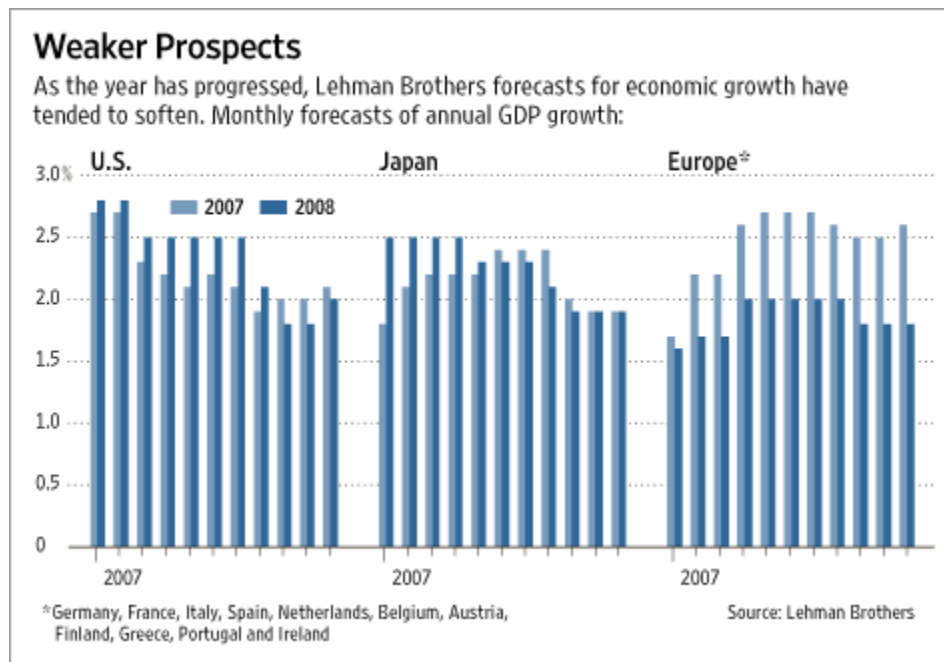
Some economists now fear a recession in Japan, where the economy contracted in the second quarter. Most projections are for a return to growth in the third quarter but domestic demand remains weak, leaving Japan dependent on exports to the uncertain global economy.

"Falling U.S. home prices and asset values mean consumer psychology will weaken and consumer spending will weaken" in the U.S., Mr. Sinai says. As write-offs eat into banks' capital, "they will have to cut back on lending," meaning companies will cut back on investment. "This looks like, feels like, smells like a bear market" for stocks -- meaning the start of a decline of 20% or more -- Mr. Sinai adds.

For now, at least, stocks are far from such a severe slump. The Dow industrials are down 7.9% since finishing at a record 14164.53 on Oct. 9, just one month ago. Broad indexes still haven't fallen as heavily as in the summer and aren't back to their summer lows, although they are getting closer.

Many investors remain hopeful, recalling other sudden swoons over the past two years. Each time, U.S. stock markets bounced back and hit new highs, as low interest rates and global prosperity generated huge amounts of money that found its way into shares.

But a growing number of investors are hedging their bets, fearing there is no guarantee that stocks will bounce right back this time.



"The combination of Merrill Lynch and Citigroup both announcing write-downs that were more than expected was an eye opener," says Mr. Rosen of New York Life's MainStay Funds. "Most

of Wall Street expected that when Chuck Prince, Citigroup's chief executive, left the company, "the stock would go up a whole lot," he adds. Instead, the stock fell heavily.

Mr. Rosen didn't sell Citigroup shares, though he says he wishes he had, at least in the short run. But he scaled back his holdings of Wells Fargo, a major mortgage lender, and Merrill Lynch, as well as [Fannie Mae](#) and [Freddie Mac](#), which invest in mortgage loans. He invested some of the proceeds in companies without mortgage exposure, such as drug stocks. He says he also pulled back from stocks in general, boosting his cash holdings by tens of millions of dollars, to a range of 5% to 7% of the money he manages, up from between 3% and 5%.

"It just seems like [the rout] can't be concentrated just on financials," he says. "It feels like it is going to start spreading into other areas." That feeling helped him decide to trim his holdings of oil drillers and big integrated oil producers, which have been riding the world economic boom and whose stock prices have approached his target levels. He says he also is considering cutting back on stocks of raw-materials producers, which have soared along with Chinese demand for their products.

Gasoline Prices

Apart from the bank write-offs, Mr. Ablin at Harris Private Bank says he was disturbed to see retailers reporting last week that October was one of their worst months in recent years, suggesting that rising gasoline prices and trouble getting loans may finally be hitting consumer wallets. Most big chains, from [Wal-Mart Stores](#) Inc. to [J.C. Penney](#) Co. to upscale [Nordstrom](#) Inc. missed Wall Street's modest sales expectations, and major chains overall reported a sales gain of just 1.6% for the month, down from 3% a year earlier.

The Nordstrom news "was an ominous sign," Mr. Ablin says, because it implied that even the wealthiest consumers were less eager to spend. On top of that came a warning to

Congress from Fed Chairman Ben Bernanke that the U.S. economy is likely to slow further before it recovers.

"It seemed like a turning point," Mr. Ablin says. "It showed this is not just a subprime phenomenon," limited to those who invested in securities backed by low-quality mortgages.

Mr. Ablin says Harris is shifting some money out of U.S. stocks across the board and moving into commodity index funds. He hopes to take advantage of rising oil prices and protect clients from a weakening dollar, since the price of oil and other commodities tend to rise when the dollar declines.

Vantagepoint Funds in Washington, which invests money for city and county employees' retirement plans, launched a new global fund on Oct. 30. The fund invested \$475 million in the ensuing days. It bought Swiss and German stocks but sold futures contracts on the S&P 500, betting on more U.S. stock declines. It also sold the dollar, betting it will keep falling, and bought U.S. Treasury bonds, a common refuge in times of trouble.

On Wednesday, Vantagepoint's chief investment officer, Mr. Wicker, visited colleagues in Minneapolis who manage some of his firm's investments. That day, the Dow industrials plunged more than 360 points.

"As the selloff was gaining momentum in the afternoon, I showed up in the office. Some folks were saying, 'We ought to re-evaluate the portfolio,'" Mr. Wicker says.

Credit Crunch

They discussed the risk that the Fed could be caught between the need to cut interest rates, to protect the economy and ease the credit crunch, and the need to avoid rate cuts, in order to prevent oil-fueled inflation and support the dollar. Reducing interest rates by another half- to three-quarters percentage point, Mr. Wicker told the others, might help the economy, "but it would put the dollar in an even worse position."

Mr. Wicker says the conversation reinforced his pessimism and his desire for the fund to bet against U.S. stocks.

While most people's worries now focus on U.S. markets, Fred Dickson, chief market analyst at brokerage firm D.A. Davidson & Co. in Great Falls, Mont., has begun to worry that countries that rely heavily on exports to the U.S. could suffer from cooling U.S. demand. Roughly one-quarter of China's exports are shipped to the U.S., according to Moody's Economy.com. Mr. Dickson also worries that U.S. investors' risk aversion could make them trim holdings of high-flying foreign stocks.

For most of the year, Mr. Dickson advised the brokerage firm's clients, who have total investments of about \$24 billion, to put 10% of their portfolios in developing-country stocks. In late October, he sent out a note to about 20,000 clients recommending that they cut their allocation to those stocks in half.

--Anita Raghavan and Scott Patterson contributed to this article.