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To Some, the Widening Crisis Seems Driven by Fear, Not Facts

By LANDON THOMAS Jr.

The fear is spreading.

For months now, investors have been lured to overseas markets with the promise that surging growth and solid economic fundamentals in Asia and the Middle East would insulate them from the credit squeeze plaguing the United States market.

But the broad international sell-off on Monday — and the prospect of a steep market decline in the United States on Tuesday — raised fresh concerns that a looming recession and the fallout from subprime mortgages could have global repercussions.

Some analysts saw the sell-off, with leading indexes off 4 percent to 7 percent worldwide, as being driven by fear more than by fact.

“I don’t think it’s warranted by the fundamentals,” said Edward Yardeni, an independent strategist. “The resilience of the global economy in the face of a credit crunch has been impressive.”

Mr. Yardeni warned, however, that in a time of panic and fear, less attention is paid to fundamentals, like a fairly tight United States job market and strong growth and the extraordinary buildup of foreign exchange reserves in emerging markets. The result is panic selling and the prospect of a global recession. “People are creating the financial violence that they hoped to avoid,” he said.

More could be in store on Tuesday. Markets in the United States were closed on Monday in observance of Martin Luther King’s Birthday, but futures for the Dow Jones industrial average traded 500 points down in a stark indicator that the main indexes could face a sharp drop, adding to one of the worst-ever starts to a year.

Other analysts point out that the overseas uncertainty reflects the unpleasant if not devastating reality that the excesses of the long-running credit boom will not go away soon.

What makes this correction more dangerous, they say, is that the selling is not being driven by panicky retail investors, as it was in the collapse of the technology bubble, but by hedge funds and investment banks that find themselves saddled with illiquid securities backed by an array of valueless assets.

“What you see is not a panic of the public. This is a panic of the sophisticated,” said James Sinclair, a well-known gold trader who oversees a financial Web site and who has warned investors for years about the dangers of derivatives. “But this will have a tremendous impact on the public. In the end, this will hit Joe Sixpack. It’s very serious, and drastic emergency economic action is needed.”

Indeed, according to research on liquidity flows by Thomas McManus, an equity strategist at Bank of America, net inflows to domestic stock-oriented mutual funds through the first nine days of the year were positive, albeit off from higher levels in previous years.

Most retail investors have not invested directly in the complex securities that have ruined the reputations of some of Wall Street's best-respected minds. But their exposure to plummeting companies like Citigroup and Merrill Lynch, and now a broader basket of stocks affected by the market malaise, will add to the sense of wealth erosion that many are already feeling from the declining values of their houses.

On his blog, JSMineSet, Mr. Sinclair has told his readers that as much as $450 trillion worth of derivatives could disintegrate, leading to a far greater, and in some ways unpredictable, calamity. He argues that compared with the savings and loan crisis in the late 1980s, when the formation of a trust company for beaten-down institutions established a floor for sinking assets, the inability of the government to form a similar entity for suffering securities has heightened investors' unease.

While the views of Mr. Sinclair, a gold bug who expects the price of gold to go to $1,650, up from about $870 now, might be taken with a grain of salt, other experts have also begun to warn of the dire consequences of the credit market collapse.

Christopher Wood, a strategist based in Asia who publishes a widely read newsletter called Greed & Fear, pointed out in a note published this weekend that the potential insolvency of bond insurers like Ambac, MBIA and ACA Capital speaks to a larger market correction that has not yet been grasped by policy makers. "Greed & Fear's view is that with the bond insurance business model fast unwinding, a full-scale crisis could be coming," he wrote.

The international selling has also stoked a long-held fear that flush Asian and Middle Eastern central banks and government-backed investment funds will cut back on their dollar-based investments — like Treasury bills and stakes in troubled investment banks — in the face of another round of interest rate cuts and continued weakness in the dollar.

These flows have represented a crucial font of liquidity for an economy that produces little of its own domestic savings, and they have been lifelines for capital-starved banks. But no money manager, regardless of the time frame, likes to invest in a falling market, and analysts fear that a spate of additional write-downs and market turmoil will signal to foreigners that the markets here have not yet found their bottom.

One large investor, who asked not to be identified because he did not want to tip his hand, said that the sell-off on Monday was a direct response to the stimulus package proposed by the Bush administration — not so much a judgment that the proposal was inadequate as a reflection of the weakness and drift of the world's largest economy.

"It is one thing to see the market go from 14,000 to 12,000," he said. "But when the president of the United States says we are sick, you can't ignore that."