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## Behind the Selloff: Stocks Are Pricing 'Worst Case Scenario'



On Thursday August 18, 2011, 1:12 pm EDT

Fears of a global banking crisis swept across markets, driving stocks sharply lower, Treasury yields to record lows, and gold to record highs.

The dramatic reflex to run for safety also propped up the U.S. dollar, which was stronger against a whole group of currencies.

The yield on the U.S. 10-year note fell below the psychologically key 2 percent level temporarily, a level it has not seen since possibly the Eisenhower era. The Dow tumbled more than 500 points at the day's lows, and the industrial and commodities stocks that rely on global growth fell the hardest.

Like an out-of-control cyclone, speculation that Europe's banks are beginning to suffer the contagion of Europe's sovereign debt crisis ripped across global markets, taking bank shares and equities markets lower. That speculation, collided in a perfect storm, with a string of weak U.S. economic reports, which helped fan worries about waning global growth.

But the drama started with fears about Europe, reignited just two days after the leaders of France and Germany tried to calm markets by pledged to create a more unified fiscal structure for the euro zone and other measures, including a bank transaction tax, left markets concerned about the lack of resolution for the debt crisis.

Thursday's disclosure from the European Central Bank that a single bank borrowed \$500 million for a week spooked markets, recalling for some the memories of the 2008 financial crisis. The report also came at the same time the Wall Street Journal reported that the New York Fed has been engaging more with the European banks operating in the U.S. to see whether they have access to reliable funding.

"The fact that the New York Federal Reserve is actually talking to the U.S. operations of some of these European banks is in the course of business," said Art Hogan of Lazard Capital Markets.

"What's pointed out in the Wall Street Journal is what's obvious to us. We are concerned about European banks, sure. Are they going to need to raise capital? Will they all be solvent at the end of the day? These stories go back and forth, and until we know the answers to that, we're going to try to price worse case scenarios into stocks. Right now the markets are going through the process of concerns."

A source close to the Fed said is routinely in contact with banks.

"Because there is stress in the markets, there are more regular interactions," with European and U.S. banks, the source said.

Hogan said the "muscle memory" of the Lehman failure is adding to the anxiety in markets.

"People waiting for the Lehman moment probably will be disappointed," he said. "The psychology of the market is such that we have a very recent memory of calamity."

The markets have been quick to respond to negatives in U.S. data, and Thursday's Philadelphia Fed survey gave it plenty to be concerned about.

The index, which measures factory activity in the Mid Atlantic region, fell to negative 30.7 from a positive 3.2 in July, its lowest reading since March, 2009.

"Today's data is consistent with lower yields. It is consistent with that we get a sub-50 reading on ISM in August, and it does confirm some of the bullishness in the Treasury market," said Ian Lyngen, senior Treasury strategist with CRT Capital.

The ISM manufacturing survey, expected in early September, is a measure of U.S. manufacturing activity, and a reading below 50 would signal a contracting economy.

Lyngen said the 10-year note, while close in 2008, did not dip below 2 percent then, as it did today.

At one point Thursday, the yield was 1.973 percent, and the 30-year was at 3.340 percent.

Hogan said the real worries of the markets are the two barrells of Europe's debt problems and the struggles to contain the U.S. deficit, which resulted in a downgrade of the U.S. credit rating by Standard and Poor's.

"What's difficult for us to contemplate is just how much the cure for the two major issues affecting the markets are going to cost in terms of growth," said Hogan.

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