The New York Times
nytimes.com

January 26, 2008
TALKING BUSINESS

Hate to Spoil a Weekend, but ....

By JOE NOCERA

Back in his mid-1980s heyday, when he was America's most famous investor, managing America's most famous mutual fund, Peter Lynch used to hate Mondays. Monday, you see, was the day the market was most likely to go down; according to research Mr. Lynch had compiled, from 1955 to 1985, it dropped by a cumulative 1,500 points just on that one day.

Mr. Lynch, who for 12 years ran Fidelity's Magellan Fund, had a simple theory as to why this was the case: negative thinking. "The reason for the Monday decline," he once told me, "is that on the weekend everyone becomes an amateur economist." Investors, he believed, would read the weekend newspapers, filled with their articles of doom and gloom, and become filled with doom and gloom themselves. Naturally, their first instinct was to sell when the market opened on Monday.

Sigh. This is a weekend newspaper. You may want to stop reading now, Peter. I don't see how you can avoid a certain amount of gloom given the week we've just had — and its implications for the future. Yes, things were a little less crazy on Thursday and Friday, but the early part of the week was just awful. On Monday, our markets were closed for Martin Luther King's Birthday, but all over the world, stock markets were in free fall. On Tuesday, the Dow Jones industrial average dropped 464 points at the open, and closed with a loss of 128 points. On Wednesday we had the so-called whiplash rally — from a 300- point morning deficit, the market swung to a nearly 300-point gain. Even with the gain, a 600-point swing doesn't exactly inspire confidence. It inspires fear.

Meanwhile, the Federal Reserve announced an emergency rate drop of three-quarters of a point, in a move that smelled an awful lot like panic. Economists were debating whether the economy was nearing a recession — or was already in one. The New York State Insurance superintendent sought a bailout plan for the major bond insurers, fearing disaster if they failed. Housing prices continued to drop. Further write-downs by the major financial institutions seemed all but certain. All the things that the bears have been predicting were coming to pass, and it was hard to know when — or how — it would end.

"This is nothing like I've ever seen," said Peter Bernstein, the author and market sage — and a man who has pretty much seen it all. Normally, he said, bear markets set in when stock values get out of hand, as was the case when the tech bubble burst in 2000. But not this time. The market is in trouble because the larger economy is in trouble. "The collapse of credit is what is driving this recession," he said. Mr. Bernstein added: "Unsnarling the financial system and getting back to a vibrant risk-taking financial system is going to take time. If people have to start borrowing the old-fashioned way — that is going to be an adjustment. I have no sense of how bad it is going to be, but I think it is going to last beyond 2008."

Daniel Alpert, a managing director of Westwood Capital, wrote: "In past debt debacles, and other market crises, the affected assets have been things like commercial real estate, farmland, tech stocks and bank shares. This time around, along with the stock market, it is people's homes, the repricing of which literally hits us where we live." Mr. Alpert made the point that in just the first six years of this decade, mortgage debt and consumer debt have both doubled; indeed, he predicted that credit card debt will be the next shoe to drop.

Stephen Roach, Morgan Stanley's former chief economist — he is now chairman of its Asia division — told me that private consumption in recent years amounted to 72 percent of gross domestic product, far higher than the 66 percent it had been just a few years before.

David A. Rosenberg, the North American economist for Merrill Lynch and the author of a devastating report on the state of the economy, said, "When you look at private-sector debt that was over and above what can be explained by G.D.P., you are talking about $6.5 trillion beyond the economy's capacity to handle that debt."

That debt will have to be either written off or paid back. People will have to stop spending, he said; they'll have no other choice. "The problems are deep, widespread and intense," he said.
Is that gloom and doom enough for you? More to the point, are you ready to face a world in which your two biggest assets, your retirement account and your home, don't automatically go up? Just as individuals assumed their homes could only go up, the larger society has, over the past few decades, been built around the idea that rising asset values will always take care of our financial problems. What the events of this week suggest is that maybe they won't.

If you're a middle-aged baby boomer like me, you probably first got interested in the stock market — and real estate, for that matter — in the early 1980s, when the great bull market began. The era before then, from 1969 to 1982, when the market did nothing, and BusinessWeek could write its infamous cover line, "The Death of Equities" — is not really part of our collective memory.

Starting with the crash of 1987, every time there has been a market break, it always snapped back, usually sooner rather than later. Every time housing prices faltered — as they did in the early 1990s — they quickly snapped back as well. As a result, those twin engines, stocks and homes, became the assets we absolutely came to depend on to live the life we wanted. Our employers made the broad transition from pension plans — where the risk was spread broadly and the companies were responsible for their employees' retirement — to 401(k) plans, where the risk was shifted entirely to the employees. But we were O.K. with that, weren't we?

We were happy to assume that risk because the market's inevitable rise would secure for us a decent retirement. Similarly, our home offered us the ability to buy things we wanted — vacations, for instance, or second homes — because we learned that we could borrow against the equity. The rise in the value of that asset made the prospect of repayment relatively painless. It also allowed us to avoid facing the fact that our incomes weren't keeping pace with our desires.

But the crazy run-up in home prices since the new century began was unsustainable, and the trillions borrowed against home equity that has since vanished has now become the great overhang in our economy.

Consumer spending will slow because people need to pay off that debt instead of taking another vacation. It will also slow because it scares people to know that their chief assets are no longer doing what they are "supposed" to be doing. "Their strategy of borrowing against their homes has left them vulnerable," said Jacob S. Hacker, the author of "The Great Risk Shift."

As for the stock market, it really can't handle much more bad news. Yet Charles R. Morris, a writer steeped in the details of the derivatives and credit default swaps that have caused so much trouble, believes that there are plenty more write-downs yet to come — and that the era that began in August 1982, when the bull market began in earnest, is winding down. "I view this as an end to a 25-year cycle," he told me. He's titled his new book "The Trillion-Dollar Meltdown."

I don't claim to know where the stock market is going in the near term. Nobody with a brain can claim to know that. What I do know is that the events of this week — and the past few months — have

served as a painful reminder of how dependent we have become on a rising stock market and an ever-appreciating home.

If we ever get back to an era like the one that took place from 1969 to 1982, it's not going to be fun. It's not just that we were younger back then. America was a different place, and Americans didn't need the stock market, or home appreciation, to live the way they wanted.

Now we do. Let's see what happens on Monday.