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Stocks Tumble on Oil Spike, Economic Fears

With oil prices returning to record highs, investors are growing wary of possible rate hikes that would hurt economic growth

by David Bogoslaw

U.S. equities took another beating on Wednesday as oil prices resumed their march toward record highs on supply concerns stoked by a larger than expected drop in crude inventories. Adding to the gloom on Wall Street were worries that the Fed's anti-inflation stance may further impede economic growth and signs of further economic weakening in the Fed's Beige Book report.

On Wednesday, the Dow Jones industrial average finished 205.99 points, or 1.68%, lower at 12,083.77. The blue-chip benchmark closed at its lowest level since mid-March. The broader Standard & Poor's 500-stock index ended down 22.95 points, or 1.69%, at 1,335.49. The tech-heavy Nasdaq composite index fell 54.93 points, or 2.24%, to 2,394.01.

On the New York Stock Exchange, 26 stocks dropped for every six that were traded higher, while on the Nasdaq the ratio was 22-7 negative.

Rumors of big writedowns from Goldman Sachs (GS), Lehman Brothers Holdings (LEH) and Royal Bank of Scotland (RBS) were driving financials lower and boosting short-term Treasury prices, S&P MarketScope said.

Merrill Lynch (MER) reportedly downgraded Lehman Brothers to neutral from a buy rating.

Meanwhile, the Financial Times reported that the bank nearly struck a deal with a group of Korean financial institutions as part of its latest $6 billion capital raising effort and may still reach a strategic arrangement by the end of the year.

The S&P Investment Banking & Brokerage index was down 4.1% Tuesday. Lehman shares tumbled 13.6% Tuesday, their fourth losing session in a row. Merrill shares fell 6.6%. Among other financial names suffering losses Tuesday, Washington Mutual (WM) dropped 9.3%.

On the M&A front, Corporate Express NV (CXP) agreed to be acquired by Staples (SPLS) for 9.25 euros per ordinary share. The enterprise value of Corporate Express on the basis of the offer is about EUR 3.1 billion.

The U.S. Mortgage Bankers Association reported that the Market Composite Index, which measures mortgage loan application volume, rose 10.9% in the week ended June 6. The Refinance Index increased 8.4% from the prior week, while the seasonally adjusted Purchase Index climbed 12.8% from one week earlier.

The Federal Reserve's Beige Book report showed economic activity either weaker or growing at a slower pace in late April and May in the majority of regions across the U.S. Consumer spending slowed since the last report as rising energy and food prices took a bigger chunk out of household incomes, while higher energy prices also seemed to be curbing domestic tourism. Manufacturing activity was generally soft in recent weeks, with weak demand for housing-related and some other products partly offset by higher demand for exports.

The U.S. Treasury budget gap widened sharply to a $165.9 billion deficit in May, above the median estimate of a $110 billion deficit.

The dollar index was down as talk of intervention faded and gold prices were climbing, while bonds were gaining strength with help from comments earlier this week by Jurgen Stark, a member of the European Central Bank's executive board, who told Bloomberg that although the ECB is intent on reining in inflation expectations, "we are not talking about a series of rate increases."

Fed Vice-Chairman Donald L. Kohn, speaking in Boston on Wednesday, said that rising inflation expectations would have "troublesome implications," and reiterated that anchoring expectations is "critical." Still, he noted that the inflationary impact of higher oil prices is less than it was 20 years ago, said Action Economics. That Kohn, who is one of the more dovish members on the Fed's policy committee, seems open to rate hikes to control inflation, suggests the extent of the Fed's about-face on downside risks to the economy.

It's more growing recognition that the Fed's rate-cutting campaign has proven unable to stimulate bank lending -- and hence economic growth -- in the way it once did than the specter of higher interest rates that is weighing on equity markets, says George Feiger, chief executive of Contango Capital Advisors in Berkeley, Calif.

Banks need to maintain certain capital balances in order to keep making loans, but repeated writeoffs of bad loans and unmarketable credit derivatives is drawing down those balances, Feiger says.

"Every dollar of losses that a bank writes off means it can lend $16 less...That’s why the banks are out desperately raising capital," he says. "[The Fed has] run out of options. There’s nothing more they can do."

Any stimulus to the economy, he adds, will have to be on the fiscal side and not through mailing out rebate checks, which are being swallowed up by higher gasoline prices and "going out of country to the Middle East."

Feiger sees the U.S. economy in a state of "volatile suspended animation" for the next year to 18 months until the capital base of the investment banks has been rebuilt. He is urging his clients to stay clear of U.S. stocks, however cheap they may have gotten in recent months.

Oil prices rebounded from two days of selling and were back above $134 a barrel in anticipation of a decline in crude inventories during the week ended June 6. When the Energy Information Administration's report showed a bigger-than-expected drop in crude supplies of 4.6 million barrels, oil prices began to accelerate higher. The government data also showed gasoline stockpiles up 1.0 million barrels and distillates up 2.3 million barrels.

WTI crude oil futures for July delivery settled $5.37 higher at $136.38 a barrel.

Among other stocks in the news on Wednesday, Alcoa (AA) shares fell after JP Morgan downgraded the stock to neutral from overweight, with analyst Michael Gambardella saying he believes the market will be disappointed with both the strategic direction from new CEO Klaus Kleinfeld and the company's near-term earnings due to higher-than-expected input costs. He also doubts the talk of a sale or spinoff and says Alcoa will remain a conglomerate and will grow both its upstream and downstream businesses.

Talbots (TLB) shares rose after the company said it's seeing improving sales trends at both its brands and remains on track to achieve its previously announced outlook for fiscal 2009 earnings from ongoing core operations. The clothing retailer also announced that Aeon Co., Ltd., which through its wholly owned subsidiary is the majority shareholder of Talbots, has agreed to provide Talbots with a $50 million unsecured subordinated working capital term loan credit facility to support its turnaround plan.

Agrium (AGU) shares were trading higher after the fertilizer manufacturer raised its second-quarter earnings forecast to $2.80-$3.00 from $1.92-$2.22 and estimated earnings for the second half of this year of $4.03-$4.23 a share, both excluding items. The company credited the significant increase from its previous guidance to very strong results from both its retail and wholesale operations, with retail expected to account for half of the increase.

Major European indexes continued to lose ground on Wednesday. In London, the FTSE 100 index dropped 1.78% to 5,723.30. In Paris, the CAC 40 fell 2.10% to 4,660.91, while Germany's DAX index was down 1.78% at 6,650.26.

In Asia, Japan's Nikkei 225 closed 1.16% higher at 14,183.48, while Hong Kong's Hang Seng index edged down -0.20% to 23,327.60.

Treasury market

Treasuries were trading higher on Wednesday on weakness in equities and remarks by ECB member Jurgen Stark. The 10-year note moved up in price to 98-12/32 for a yield of 4.07%, while the 30-year bond inched up to 94-28/32 for a yield of 4.69%.