Crisis is a study in the power of fear

Investors, seized with panic, sell first and ask questions later

By Vikas Bajaj

NEW YORK: The technical term for it is "negative feedback loop." The rest of us just call it a panic.

How else to explain yet another plunge this week in global stock markets — particularly in the absence of another nasty surprise?

On Wednesday, central banks in Europe and North America jointly cut interest rates to jolt the markets out of their panicked state and to encourage banks to start lending more freely. The Federal Reserve, the European Central Bank and the Bank of England, along with others, all cut their benchmark rates by half a percentage point.

"What the central banks are trying to do is inject some confidence in the marketplace," said Michael Darda, chief economist at MKM Partners, a research and investment firm. "There is a lot of liquidity but there is absolutely no confidence. There is no trust."

The joint action appeared to have a positive impact at first and stocks moved higher at the open of trading in New York. European markets briefly recouped nearly all of their losses for the day. But the rally quickly faded on both sides of the Atlantic on worries that the interest rate cuts would not be enough to fix the problems in the financial system and forestall a global recession.

"Unfortunately, there is no silver bullet here, and that's really what the markets are telling us," Darda said. "After all these extraordinary actions, we still haven't seen much traction in the credit markets or the equity markets."

Indeed, anybody searching for cause-and-effect logic in the vertigo-inspiring gyrations of the market will be disappointed — even if the overarching problem of a crisis of confidence in the global economy is now becoming clear.

Instead, the market has become a case study in the psychology of crowds, many experts say. In normal times, it runs on a healthy mix of fear and greed. But fear now seems to rule, with investors often exhibiting a Wall Street version of the fight-or-flight mechanism: They are selling first and asking questions later.

"What's happening is people are crawling into a bunker and pulling an iron sheet over their heads because they think the sky is falling," said William Ackman, chief executive of Pershing Square, a hedge fund firm in New York.

And that bunker is getting very crowded, so much so that some analysts are starting to suggest that the markets are showing signs of "capitulation." This is another term of art to describe what happens when even the

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bullish holdouts, the unflagging optimists, throw up their hands and join the stampede out of the market.

Fear can be seen at every turn: in headlines raising questions about another 1930s-style Depression and in the crowds gathered around office televisions to track stocks or to parse the latest pronouncements from the Federal Reserve chairman, Ben Bernanke, or Treasury Secretary Henry Paulson Jr.

To some, signs of capitulation can be read as an indicator that the bottom may be near.

Sam Stovall, chief investment strategist at Standard & Poor's Equity Research, is among that group. In addition to his fundamental analysis suggesting that stocks are reaching bargain levels by traditional measures, he was swayed by the numerous telephone calls he has received in recent days from professional acquaintances and his sister-in-law, all saying they are getting out of stocks.

"More and more people are doing that and selling out," Stovall said.

The opposite of capitulation, of course, is investing at the height of a bubble. One oft-cited sign of the housing market's top: when dinner parties are dominated by stories about fast profits on flipped condominiums.

During the dot-com boom in the late 1990s, it seemed that everybody and their grandmothers were piling into stocks. Now they are bailing out.

Another barometer of panic: volatility, reflected in the so-called Fear Index (or the VIX), which tracks options trades that investors use to protect against future losses. On Tuesday, it climbed to its highest level since the 1987 stock market crash.

Fear is an immensely powerful force, perhaps more so than greed, said Andrew Lo, a professor at the Massachusetts Institute of Technology who has studied investor behavior.

Scientists who have studied the brain function have found that the amygdala, the part of the brain that controls fear, responds faster than the parts of the brain that handle cognitive functions, he said.

"Fear is a much stronger motivational force," Lo added, saying that several real life experiments have found that actual behavior reflects the biological evidence. "The loss of $1,000 has a much bigger impact than the gain of $1,000."

Those instincts seem to be taking over.

"With negative emotions, we tend to have a desire to change the situation," said Ellen Peters, a senior scientist at Decision Research in Eugene, Oregon. But "when things are good there is not much desire to change."

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That perhaps explains why investors are willing to earn virtually no return in Treasury bills just to be assured that they will get their money back, rather than investing in short-term corporate debt that offers a better return but carries some risk. Investors were re-

Timothy A. Clary/Agence France-Presse

Passers-by watching the news through the Nasdaq window in New York on Wednesday.

minded of that risk after Lehman Brothers sought bankruptcy protection in September.

Even banks, which make money by lending to businesses, consumers and each other, are hoarding cash. That is why the Federal Reserve said Tuesday that it would buy commercial paper, the short-term loans issued by companies and banks.

If the market is indeed close to the bottom, history suggests that any rally in the next few weeks will probably be big. Stovall, the S&P strategist, estimates that since World War II, stocks have recouped about a third of their bear market losses in the first 40 days after the market hits bottom.

But enough investors have to first be persuaded that the economy and housing market will begin recovering soon. Another major test will be third-quarter corporate earnings reports that will trickle out in the next three weeks.

Perhaps the most important indicator will be the credit markets: Investors will regain confidence when they believe financial firms are adequately capitalized and money is flowing more freely through the financial system.

Ackman, the hedge fund manager, who has been vocal about his bearish views of some financial companies in recent years, said it was hard to precisely time the market. But, he added, "I do think that stocks are getting extremely cheap."

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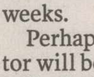

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