Dow Jones Newswires

Economists Find Some Sense In A Volatile Market

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Of DOW JONES NEWSWIRES
552 words
22 October 2008
11:15
Dow Jones News Service
English

NEW YORK (Dow Jones)--Recent financial turmoil has sent companies and sectors careening up and down indexes. However, a couple of economists say they have developed a method of putting a muffler on all the market noise.

As capital rushes in and out with apparent disregard for fundamentals - largely driven by what traders describe as a volatile mix of irrational fear and blind optimism - economists Hui Tong and Shang-Jin Wei say there is a method to the madness: Companies with less financial flexibility, on average, have declined by twice as much as less-constrained companies as the credit crisis unfolded.

"We were joking about it (that) we could explain the stock market with reasonable accuracy," said Tong of the International Monetary Fund, who coauthored the report with Columbia University economics professor Wei.

To be sure, the credit crisis that erased trillions of dollars in market value appears to be easing and the economy is sliding into what is feared to be a global recession. But financial flexibility will still be a key to future success, the researchers said.

"If you are less financially constrained, you are able to go through the difficult times without suffering too much," Tong said. "You will also be more prepared for the potential recovery."

Wei and Tong analyzed the stock prices of non-financial firms going back to July 2007 using two dimensions: the companies' financial stability based on profitability and size, and their intrinsic demand for external financing. The key in relative performance seemed to be the latter.

For example, tobacco giant Altria Group Inc. (MO), which generates a lot of cash and has few financing needs, has weathered the crisis well, with shares down about 17% this year. Sun Microsystems Inc. (JAVA), on the other hand, is large but is in a capital-intensive business with high intrinsic demand for external financing. Its shares are down about 75%.

Wei said the real power of the model is in showing whether the credit crunch is actually occurring in a given country, and how severe it actually is. In essence, the wider the spread between credit-sensitive companies and less-sensitive companies, the more severe the crisis.

Wei and Tong are in the process of applying their system to countries around the world. Some of the results were not surprising to them: Among the countries most affected in the credit crunch are the U.S., U.K. and Germany. However, the one most affected was a surprise: Greece.

Wei said that Japan and South Korea are also "exhibiting very strong symptoms of a credit crunch," while China and India have so far avoided the worst of it.

Wei said that government measures in the U.S. don't appear to have done much to ease the spread so far, despite a relative ease in credit markets.

"We don't see a response that suggests that the (U.S. Treasury Dept.) rescue package has been considered enough to turn this around," Wei said. "It didn't hurt. There is no evidence that suggests that we're going to get out of this anytime soon."

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Document DJ00000020081022e4am000bj