Investors Assess the 'Nightmare' Scenario

INVESTING, FAST MONEY, MARKETS, STOCK MARKET, CORRECTION, S&P

Posted By: John Melloy | Executive Producer, Fast Money

CNBC.com
| 25 May 2010 | 02:24 PM ET

The **S&P 500 Index** is in the midst of its first official 10 percent correction since this bull market began in March 2009. Selloffs like these tend to keep going after passing such a widely followed threshold as more and more investors begin to ask themselves, "What exactly is the stock market telling us that we don't already know?" That's why the S&P during bull markets doesn't just turn on a dime after dropping a clean 10 percent.

It's not helping things that right now U.S. investors are flying blind on the data front, with no substantial economic releases this week and the next earnings season seven weeks away. This is increasing the chatter of more and more nightmarish scenarios.

"Things really start to get scary if not only do the European and U.S. economies turn down, but also China's real estate bubble and its expansion collapse and Japan slumps on falling exports and another misguided deficit reduction program," wrote economist David Levy of the Jerome Levy Forecasting Center. "To turn this situation into a full nightmare scenario, suppose — and it is not too difficult — that policy responses necessary to contain the global depression are delayed or bungled in much of the world, causing serious disruptions in major developed economies and allowing financial sector collapses in parts of Latin America, Asia, Eastern Europe, and Africa."

Today, the S&P 500 extended its drop from the index's 2010 high in late April to as much as 14.7 percent as concern increased that Spain would be the next European country needing emergency assistance. U.S. stocks kept falling even after Federal Reserve Bank of St. Louis President James Bullard said, "there are several reasons why this new threat to global recovery will probably fall short of becoming a worldwide recessionary shock."

"Two weeks ago I would give the global depression scenario a one percent chance, but the chances have increased to 10 percent today," said Brian Kelly, founder of Kanundrum Capital, who has navigated his clients nicely through the volatility of the last five weeks. "But the tails are getting fatter these day," said Kelly, echoing the "White Swan" comment from economist Nouriel Roubini last week.

The worst-case scenario laid out by Levy could put the S&P 500 on course for its credit crisis low of 666 reached in March 2009 when the fate of the U.S. financial system hung in the balance. The majority of traders and investors still believe that is very unlikely. But when does the stock market turn from a predictive mechanism into a panic inducer?

“For the most part, recent moves appear to be a correction, not the start of a more protracted bear market,” wrote the UBS Global Investment Strategy team, led by economist Larry Hatheway, in a note to clients today. “There is little evidence that growth is rolling over,” wrote the team, adding “the risk is that asset market corrections become self-fulfilling and lead to weaker demand in coming weeks and months.”

That’s the problem. We are in an environment of an interconnected global financial system still clogged by IOUs to each other, where fear can become reality very quickly.

The global depression theory from Levy “is not probable, but if you’re a money manager, you have to factor that into your thinking,” said Gary Kaminksy, former money manager for Neuberger Berman and now a CNBC contributing editor. “Investors are going to therefore pay less for earnings and you’ll see multiple compression.”

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