Forbes.com

Credit Crunch

After Bear

Liz Moyer, 03.17.08, 3:11 PM ET

This Author

Liz Moyer

Could Bear Get Another Bid?

Sell first, ask questions later. That was the mood Monday as investors dumped financial stocks in the wake of **JPMorgan Chase**'s $236 million, or $2 a share, fire-sale purchase of **Bear Stearns**.

Bear's stunning collapse over the weekend--it had a market cap of $3.5 billion March 14--is making people think about who is next.

Lehman Brothers (nyse: LEH - news - people) seems to be everyone's answer despite what many analysts say is the company's strong position and relatively unscathed business. In the options market, which last week predicted a precipitous decline for Bear Stearns (nyse: BSC - news - people), Lehman puts (bets the underlying stock price will fall) were triple the number of calls (bets the stock will rise) traded Monday.

Traders were hitting March strike prices as low as $25 and April contracts as low as $10. The stock, which fell 30% throughout the afternoon, is around $26.

"This gives an idea of the kind of move option traders are bracing for in Lehman shares ahead of tomorrow’s earnings, believing the brokerage has the capacity to gain or lose more than one-third of its current valuation on back of the numbers," said Andrew Wilkinson of Interactive Brokers.

Executives are working hard to calm the markets. On Monday, Lehman's chief executive, Richard Fuld, said the Federal Reserve's decision Sunday to lend directly to the 20 primary dealers, which includes the big broker-dealers like Lehman, "takes the liquidity issue for the entire industry off the table."

Lehman is expected to report profits of 72 cents a share Tuesday, but its shares were off 30% in trading Monday. Shares of **Morgan Stanley** (nyse: MS - news - people), seen making profits of $1.03 a share, were off 10%, and **Goldman Sachs** (nyse: GS - news - people), seen with profits of $2.58 a share, was down 8%. Each company faces $2 billion or more in write-offs for the quarter, according to analysts at Credit Sights.

The steep one-day price decline, which is shaving still more off already-weakened capital bases, demonstrate that the Fed's aggressive moves over the weekend haven't alleviated fears.

"We believe any broker could befall the fate of Bear, which had no more credit exposure issues than the other four," says David Trone, an analyst with Fox-Pitt Kelton.

Sure enough, the Fed's actions Sunday, including lowering the rate it charges banks to lend directly from it and opening its discount window to Wall Street brokerages, didn't save Bear Stearns from collapse.

Nor did it save U.K. hedge fund Northern Rock, Netherlands-based hedge fund Carlyle Capital or U.S. subprime lender **New Century Financial** (other-otc: CYFL.PK - news - people). And expectations for more fallout are rippling through the markets.

On Monday, the Bermuda-based clearing company **MF Global** (nyse: MF - news - people) sank 55% in trading on no news. Sure, two weeks ago, the firm disclosed it had suffered $141.5 million in losses because of a rogue wheat trader in its Memphis offices. But there has been no intervening news to spark the Monday freefall.

Again, the options market seems to know more than the rest of the market. There was a rush to buy April puts as low as $10, with a massive $2.15 per share premium. That means the trade won't make money until MF's stock falls to $7.85.

How quickly did MF Global's fortunes change? Before today, investors had twice as many call as put positions.

In a statement, the company said its "clients continue to show strong support, and our counterparty relationships are sound. We are seeing no impact on our repo lines. In addition, MF Global has no exposure to subprime mortgage-backed securities that have been the root cause of the current market environment."

MF Global added that its client funds are higher today than at the end of February and December. And it said Joe Lewis, the billionaire currency trader who lost $1.1 billion on his stake in Bear Stearns and is believed to be liquidating assets to make up for that, is not a client.

Business at the investment banks has certainly slowed in the last six months, apart from the problems with exposure to the credit markets. That is going to make year-over-year earnings comparisons ugly. Wall Street was having a banner 2007 before things headed over the cliff in the summer. If they match consensus estimates for the quarter, Lehman will be down 63% from last year, Goldman down 61% and Morgan Stanley, 59%.

One of the problems is the still-opaque process the banks use to evaluate and mark securities holdings, loans and other assets to market, a process they have to repeat daily because of new accounting rules.

The uncertainty surrounding the true value of mortgage securities, derivatives and other toxic assets is stoking panic in the financial markets. Investors are dumping not only financial stocks but dollars, and they're plowing money into hard assets like gold instead. The price of gold surged past the $1,000 mark last week. It has come down a bit but is still near record highs.

It seems even "sophisticated" trading professionals can panic. Says Tuck School of Business at Dartmouth finance professor Anant Sundaram, "at the end of the day, when they think, despite all fundamentals, that others are starting to head to the door, their panic is no more sophisticated than that of the average Joe cutting in line to get his money out before the bank run."