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Correction or Crash — Wall Street Debate

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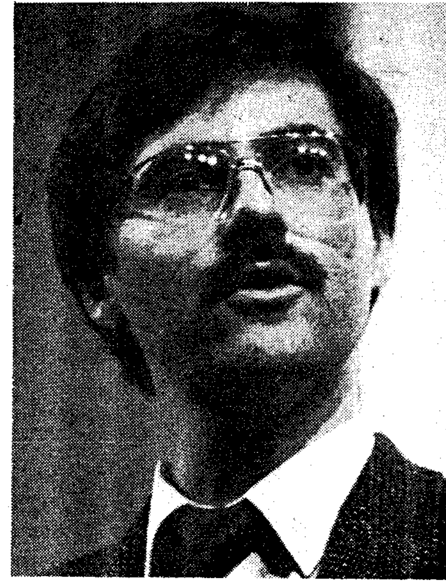
And LISA GOLDEN

Amid the confusion of the stock market instability, Fuqua's Finance Department agreed to assemble a panel to discuss the market activity. Professors Breeden, Cohen, Harvey, Kishimato, Viswanathan, and Whaley participated in presenting their views and answering questions. Not without some debate, this group decided to entitle their presentation, "The Crash of 1987."

Not thoroughly convinced of the use of the word "crash," Professor Robert Whaley opened the discussion with descriptions of some of the mechanisms that have been targeted as being at fault in the market's downturn. He presented the ideas behind both program trading and portfolio insurance. Program trading, he noted, is based on "the relationship that exists between the futures price and the index price. Program traders stand ready every time they see a violation of these two, then they engage in short abitrage or long arbitrage." This arbitraging results in a movement of index and futures prices back into alignment, and thus can be labeled as being a component essential to efficient markets. The program traders, according to Whaley, shied away from the market activity, not knowing what to expect. Instead of being to blame for the extreme market movement, "what you saw," suggested Whaley, "was program trading not taking place rather than taking place."

Breeden: Crash


Harvey: No Crash

In terms of portfolio insurance, specifically dynamic portfolio insurance, inactivity did not seem to be the case. This is a mechanism that is "being ripped in the press (and) justifiably so," said Whaley. This method of protecting monetary investments entails a reblanacing of the portfolio by buying or selling futures contracts for the most benefit given a certain percentage change in the market index (a trigger point). With a significant drop in the market, trigger points were reached on the sell stock side and floods of sell orders hit the floor. This was reflected in a further drop.

These hedging vehicles and their impact on the stock market are likely to be the subject of a number of investigations by Congressional committees and the SEC. Speaking before a Congressional panel last week, SEC Chairman David Ruder said that the blame should not yet be placed on program traders. He added that the mechanism may have increased the liquidity in the market.

Following Whaley, Professor Doug Breeden took the floor. He opened by saying, "I offer no apologies for using the word 'crash.' It was a crash alright. It is my view that there's more going on than program trading. There's more going on than portfolio insurance." He went on to say, "I'm really a gloom and doom person. I really think that this crash will be followed by a recession." Breeden explained that as a leading indicator, the fall in stock prices should essentially foreshadow a drop in consumer spending. These declines, he predicted, would be aggravated by a lack of room for growth of the consumers' debt level. He said that the country could also see a cutback in production, unemployment and a change in the level of borrowing. Citing the lack of Japanese confidence in the American market, Breeden warned that there would be a drop in investment in real estate.

The market freefall, according to Breeden, was largely the result of "optimistic" prices in the market. The P/E ratio was too high, Breeden explained. Profits to earnings ratios, Breeden explained, were at higher levels than ever in the post war market. "The drop was not unfounded," said Breeden, adding that, at this point the ratio "is not at a supercheap level but at a reasonable level."

Professor Campbell Harvey took over the discussion and lightened things up a bit. He said, "at the risk of maybe losing my promotion at Duke, I'm going to disagree with Professor Breeden." Harvey, who didn't see the situation as terribly serious

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argued that the anomaly was the market increase not the market fall. Looking at the market data over a fairly large time frame, "where's the crash?", said Harvey. "It really depends on your horizon." Harvey went on to cite currently strong economic fundamentals as well as regression results that showed the stock market as having generated a lot of false signals in the past. "I really don't think that we're in for a severe recession," he said, "and certainly not a depression."

Unlike the journals widely read, professors Breeden, Harvey, and Whaley did not blame the 508 point market plunge on the lack of Presidential leadership or resolve on Capitol Hill. Characteristics of the market and its mechanisms, they held, are to blame for the volatility.

While the subject of the "twin deficits," accused in the popular press of causing the crash, was only touched upon, Harvey explained that Washington's inability to deal with the problems caused some uncertainty on Wall Street. However, passage of a deficit reduction bill that raises taxes, warned Breeden, could be the worst thing for the economy.,

Regardless of what caused the frenetic trading, whether it was "purely a stock market thing," as President Reagan said following the crash or a result of a perceived lack of leadership on fiscal matters, the implications are now the matter of focus. At any rate, as professor Breeden said at the close of the discussion, "the good news is that (a 500 point drop) can only happen three more times."

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