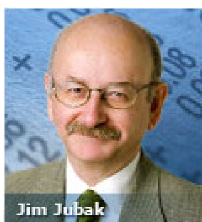

Jubak's Journal 7/27/2007 4:00 PM ET

Stocks feel the pain of a buyers strike

Yes, earnings are decent, and the economy is solid. But many investors fear today's prices will seem way too high tomorrow, so they're sitting on the sidelines.

By Jim Jubak

The stock and bond markets are in the midst of a classic buyers strike.

Investors saw the effects vividly in the 311-point drop on the **Dow Jones Industrial Average** ($INDU) on Thursday, when spreads between what buyers wanted to pay and what sellers wanted to receive widened dramatically -- and when some riskier debt couldn't find any buyers at all.

Buyers strikes aren't one-day phenomenon. But neither do they stretch on for months. The strike ends when buyers think they again know what assets are worth and stop sitting on their hands in fear that any price they pay today will seem like way too much tomorrow.

This one will work itself out over the next couple of months as the asset classes that are the focus of worry right now -- subprime mortgages and the bonds and derivatives based on them, the debt used to finance buyouts and housing prices themselves -- get re-priced.

"Re-priced," of course, is Wall Street jargon for "get sold off until they hit support at a new bottom."

As long as the economy holds up reasonably well -- and it is, according to second-quarter numbers for gross domestic product that put growth at a 3.4% annual rate -- then this will be a painful exercise for holders of assets in those classes while the damage to the overall stock market is limited to the long-awaited 10% correction. In the bond market, there will be a flight to quality that will do wonders for owners of Treasury notes and turn 2007 into a year to forget for anything riskier than that.

Picket lines on stock charts

So what is a buyers strike?

In an orderly market, the price of stocks and bonds may be moving up or down, but the difference at any one moment between what buyers want to pay and what sellers want to receive is relatively small.

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On a very liquid big company stock such as **Procter & Gamble** (PG, news, msgs), the spread can be tiny. At 11:30 a.m. Thursday, the bid buyers were willing to pay was $62.74, and the ask that sellers wanted was $62.75. Even a volatile energy stock with a much smaller market capitalization, such as **Devon Energy** (DVN, news, msgs), which was down $1.15 a share for the day at that point, the spread was still tiny: a bid of $75.27 and an ask of $75.29.

When the market panics, though, that spread can get huge. I remember watching the Dow plunge 508 points on Oct. 19, 1987, and seeing the spread on Procter & Gamble widen to $2, then to $3 and then to $5. Buying Procter & Gamble that day wasn't like trying to catch a falling knife. With the price from one trade to the next falling by as much as $5 a share, buying was like trying to catch a safe dropped from the 25th floor.

Video on MSN Money

Jubak's Journal: A time to buy?

Before you think about buying stocks on the dip, you should avoid companies that plunged on bad news in the home-building, financial and buyout sectors. Instead, says MSN Money's Jim Jubak, buy stocks that fell because of profit-taking.

In a buyers strike, the spreads get even wider, and in some cases the buyers disappear altogether. That was exactly what happened Thursday. Sellers trying to get out of positions in mortgage-backed bonds, in paper backed by bank loans and in derivatives designed to hedge against the risk of default on corporate loans couldn't find any buyers at all. For example, The Wall Street Journal reported the case of one hedge fund manager who wanted to sell just $5 million in bank loans Thursday. He wound up selling just $2 million -- he couldn't find any buyers for the remainder of his position.

Invaluable investments

What causes such a buyers strike? Think of it as a deer-caught-in-the-headlights moment for a financial market. Buyers are so uncertain about the validity of current prices that they freeze into inactivity, buying nothing, until they think they can trust prices again.

Why would anybody buy financial assets having anything to do with subprime mortgages right now, for instance? What prices the market has say that bonds and derivatives based on these mortgages may be worth as little as 45 cents on the dollar. And that the slightly less risky assets based on Alt-A mortgages, those held by homeowners with better credit ratings but with problems such as an inability to document income, might be worth as little as 55 cents on the dollar.

Continued: Few trust prices

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