of the buyout firm, reported that it could lose more than $200 million on its holdings of mortgage-backed securities. Highbridge Capital, a unit of J.P. Morgan, saw its Statistical Arbitrage fund fall 18% in the first eight days of August. A raft of private equity deals are on hold or being renegotiated, including Home Depot's sale of its building-supply subsidiary to Bain, Carlyle, and Clayton Dubilier & Rice. There have been signs that even supersafe vehicles like money market funds may not be immune. The Federal Reserve has made extraordinary injections of more than $62 billion into the financial system to keep credit flowing. The European Central Bank has pumped in almost $300 billion.

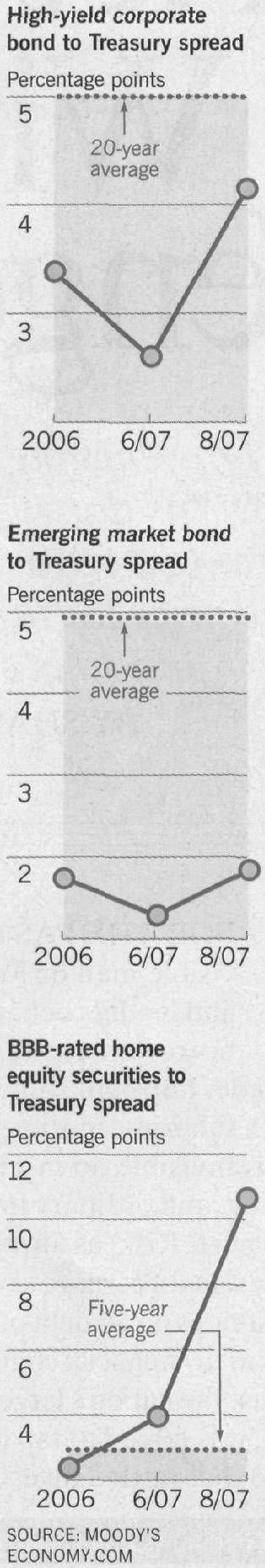
Tight money isn't just a problem for Wall Street heavyweights. The stock market, spooked by the prospect of bankruptcies and defaults, has fallen 8% since mid-July, dinging ordinary investors and taking a bite out of their 401(k)s. Volatility is becoming a way of life. Investors who had grown accustomed to a smooth upward climb in stock prices are numbly witnessing downward swoons of 200 or 300 points a day as rumors about this hedge fund or that mortgage lender set off waves of selling.

The credit crunch has raised the cost of mortgages even for borrowers with pristine credit and put further downward pressure on home prices. David Adamo, CEO of Luxury Mortgage, a mortgage banker in Connecticut, says that three months ago he could sell a high-quality $3 million mortgage to 20 different banks at an interest rate of 6.75%. Today only two will even consider buying the loans, and they want 10%.

The real worry is that a more drastic meltdown may lie ahead. It might begin, for example, with the collapse of a marquee hedge fund. The banks that extended billions of dollars in loans to the fund would suffer deep losses. Other lenders, girding for a wave of defaults, would turn off the tap. "A big problem is that lenders don't know which of their clients is likely to default because the system is so opaque," says Mark Zandi, chief economist at Moody's Economy.com. "So they would stop lending to everybody." Even rock-solid companies like Procter & Gamble or IBM will have to pay more to borrow money to build new plants or make acquisitions. That's when the crisis could jump from the markets to the economy at large—crimping business investment and consumer spending and bringing on a painful recession, with job losses, sharper stock market drops, and even steeper declines in home values.

For the moment that's still the worst-case scenario, not the most likely one. No one knows when the market turmoil will end or where it will lead, but in this special report we'll tell you everything you need to know to understand the market shock and its potential consequences. We'll examine the origins of the crisis and explain what the return of risk means—to the markets and individuals. A gallery of market veterans, including legendary investors Warren Buffett, Bill Miller, and Bill Gross, assess the turmoil and advise investors in their own words on what to do about it. Further on, we'll look at how the subprime mess ensnared a German bank, and we'll show its impact on that most precious of assets, your home.

Investors are demanding higher yields on risky paper.



SOURCE: MOODY'S ECONOMY.COM

PUT SIMPLY, what we're seeing is a massive repricing of risk in every asset class, from mortgages, junk bonds, and high-grade corporate debt to office buildings and equities. Suddenly investors have recognized that they weren't getting paid nearly enough for the perils of owning securities backed by dubious mortgages and low-rated bonds. The root cause of the current problems, says Jeremy Grantham, chairman of investment company GMO, "is that risk was mispriced on an extensive basis globally." Now investors are demanding far bigger compensation for putting their money on the line.

The compensation they want is higher interest payments on debt and increased returns on stocks and real estate. And in the inexorable mathematics of the markets, for investors to get better returns in the future, asset prices have to drop substantially. Fortunately, this upheaval is taking place at a time when the basic economic outlook remains sound, bolstered by low inflation and strong growth around the globe. The best bet is that asset values will settle at a level higher than their long-term averages, reflecting the generally balmy climate. The rub is that prices have been bid so high that in many cases they still have quite far to fall; we'll give our estimates of how much a bit later. One hint: Stocks still look overvalued by at least 10% or so. "The prices of stocks, bonds, buildings, and the like were bid extremely high," says Yale University economist Robert Shiller. "That's why we could be near a major inflection point."

THE FAILURE OF A MARQUEE HEDGE FUND OR PREMIER MORTGAGE LENDER COULD SPARK A MAJOR MELTDOWN.