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Panic grips credit markets

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The panic in world credit markets reached historic intensity on Wednesday, prompting a flight to safety of the kind not seen since the second world war.

Barometers of financial stress hit record peaks across the world. Yields on short-term US Treasuries hit their lowest level since the London Blitz, while gold had its biggest one-day gain ever in dollar terms. Lending between banks, in effect, stopped.

Speculation mounted that the Federal Reserve, which refused to cut rates on Tuesday, could be forced into an embarrassing U-turn or might further expand its market liquidity operations.

The $85bn emergency Fed loan for the troubled insurance group AIG, announced on Tuesday night, failed to curb the surge in risk aversion. Instead, markets were hit by a fresh wave of anxiety.

One cause for fear came when shares in a supposedly safe money market mutual fund fell below par value – or “broke the buck” – owing to losses on debt in Lehman Brothers, which filed for bankruptcy protection on Monday. This raised the risk that retail investors in other such funds could panic and pull out their money.

All thought of profit was abandoned as traders piled in to the safety of short-term Treasuries, with the yield on three-month bills falling as low as 0.02 per cent – rates that characterised the “lost decade” in Japan. The last time US Treasuries were this low was January 1941.

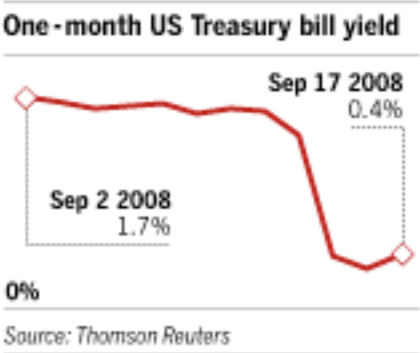
Shares in the two largest independent US investment banks left standing – **Morgan Stanley** and **Goldman Sachs** – fell 24 per cent and 14 per cent, respectively, as the cost of insuring their debt soared, threatening their ability to finance themselves .

Morgan Stanley was holding preliminary merger talks with **Wachovia**, a troubled regional lender, and could approach other banks and look at other options in the coming days, people familiar with the situation said. Washington Mutual, another regional lender, has hired Goldman Sachs to contact potential buyers.

HBOS, a leading UK mortgage lender pressed into sales talks by the government after its share price halved this week, agreed to a £12bn takeover by Lloyds TSB.

A key measure of fear in the fixed-income markets - the so-called Ted spread, which tracks the difference between three-month Libor and Treasury bill rates - moved above 3 per cent, higher than the record close after the Black Monday stock market crash of 1987.

US authorities fired back with the Treasury announcing it was borrowing $40bn to give to the Fed to use for its emergency lending – in essence removing balance sheet constraints on the size of this assistance.



The Securities and Exchange Commission announced new curbs on short selling.

Some analysts have criticised US authorities for adopting an arbitrary approach to rescues - saving AIG, but not Lehman - that was impossible for investors to predict and therefore did not boost confidence.

The S&P 500 fell 4.7 per cent, led by a 8.9 per cent slump in financials. Equity volatility was near its highest level since March. The dollar fell against other major currencies.

Gold benefited from safe-haven buying, with prices rising 11.2 per cent to a three-week high of $866.47 a troy ounce.

Andrew Brenner, co-head of structured products and emerging markets at MF Global, said: “It feels like no one wants to take anyone’s credit...it feels like we are on a precipice.”