Markets' most volatile week since crunch began

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World markets endured their most volatile week since the credit crunch began more than a year ago, as lending between financial institutions halted and weak economic data foreshadowed a hard landing for the US and Europe.

Stock markets suffered steep losses, while sharply lower government bond yields reflected the expectation of interest rate cuts from the US Federal Reserve, European Central Bank and the Bank of England in coming months.

Yesterday, while the US Congress passed legislation that will facilitate the purchase of toxic assets from banks, the economy took centre stage. The US labour market lost 159,000 jobs in September, the largest decline since March 2003.

"The economic data are just starting to show clearly an acceleration in the weakening of activity," said Stephen Stanley, chief economist at RBS Greenwich Capital. "Since mid-September, there has been a regime change in the credit status for everyone, not just financial firms but households and especially businesses of all sizes."

The seizure in bank lending and breakdown in trust between banks and investors came as a number of institutions were rescued by governments and regulators in the US, UK, Ireland, Iceland and Europe. Central banks pumped large amounts of liquidity into **money markets** but that only lowered overnight London interbank offered rates (Libor), which had soared on Tuesday when the third quarter ended.

In contrast, three-month sterling, dollar and euro Libor rose further and as benchmarks for floating rate home and company loans they impose a higher cost for the broad economy.

The spread between three-month dollar Libor and three-month US Treasury bills reached record levels as investors sought the safety of US debt and shunned lending in the money market. The so-called Ted spread stood at 380 basis points yesterday.

Strains across cash and derivative markets for interest rates and credit were not alleviated by the completion of the third quarter.

"As our most liquid of global debt markets ceases to function normally, trading volumes have begun to decline notably as traders put down their phones and slowly creep away from their desks," said William O'Donnell, strategist at UBS.

Hedge funds also face a rising tide of redemptions from investors.

Hennessee Group expects the average hedge fund will post a return of between negative 5 and 9 per cent for September. The breakdown in lending between banks has ensnared companies, as US commercial paper issuance fell a record $94.9bn for the week ending on Wednesday. The market has contacted $208bn in the past three weeks.

Against that backdrop, **volatility** across equity and debt markets soared. US equity volatility as measured by the Vix rose to a record on Monday after the Treasury's $700bn bail-out plan was rejected by lawmakers and sparked the biggest slide in the S&P 500 since the crash of 1987.

Yesterday, Wall Street's fear gauge remained elevated and the S&P 500 reversed early gains, for a decline of 9.4 per cent since Monday, its worst weekly performance since September 2001. Elsewhere in **equity markets** , the FTSE 100 fell 2.1 per cent, while the FTSE Eurofirst 300 fell 1.4 per cent.

Asia suffered a large fall-out on Tuesday after Wall Street's big stumble, and the pain continued for much of the week. Japan's Nikkei 225 index fell 8 per cent, Hong Kong lost 5.4 per cent and Australia fell 4.3 per cent.

Trading was volatile in **credit markets** . Yields on cash bonds set record highs, but trading and new issuance was limited. Credit derivatives were marked by large swings in credit insurance for financials.

Emerging market bonds, currencies and stocks were roiled by risk aversion. India's Sensex fell 4.4 per cent for the week and closed at a new low for the year. Brazil's Bovespa lost 12.3 per cent this week.

Big gains for **government bonds** were led by the two-year sector as investors bet on rate cuts. The ECB signalled that fighting inflation was being eclipsed by the banking crises in the US and Europe. Also this week, bond market volatility exceeded the record peak of 1998.

The yield on the two-year German Schatz fell to 3.25 per cent from 3.66 per cent over the week. UK Gilt yields dropped 27bp to 3.96 per cent, while the US two-year note had fallen 51bp to 1.59 per cent.

Risk aversion and global weakness hit the euro and benefited the yen and the dollar in **currency trading** . The euro fell to its lowest level against the dollar in a year and set a two-year low against the yen.

In **commodities** , gold rallied to a peak of about $925 an ounce on Monday, only to slide to a low of $820 yesterday. Oil was also volatile and after crude traded near $107 a barrel at the start of the week, it set a low of $91.30 yesterday.