Stresses as U.S. nears debt brink

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Confidence is eroding, but market for Treasury securities holds ground

BY LOUISE STORY AND DAVID KOCIENIEWSKI

As the U.S. Congress and President Barack Obama failed yet again to break their stalemate over the U.S. debt limit, Wall Street and Washington turned their attention to a critical question: How long will investors give them?

"We may have a few stressful days coming up — stressful for the markets of the world and the American people," William M. Daley, the chief of staff for Mr. Obama, told CBS television Sunday.

Early reaction to the gridlock indicated that there were worries in global markets, with stocks off and the price of gold, deemed a safe investment during times of uncertainty, rising.

For weeks, the market for U.S. Treasury securities — long considered the world's ultimate haven — has held relatively steady.

The U.S. Treasury Department has said that the government must reach a deal by Aug. 2 or risk temporarily being unable to meet all its obligations, like interest payments on debt, pensions or paychecks to government workers.

Few investors believe that the United States will renege on its debt. Analysts point out that the government has neared the brink on reaching crucial financial agreements in the past without marketwide collapse. Still, the greatest anxiety in the markets is that investors will lose confidence in Treasury securities and move toward selling them, which would drive their value down and their rates up.

John Canavan, a market analyst at Stone & McCarthy Research, a firm in Princeton, New Jersey, said that he thought investors might sell some U.S. bonds to buy German bonds or assets in Asia and emerging markets. Foreign investors, he noted, own a far greater share of U.S. debt than was the case several decades ago.

"They don't hold them because they have any patriotism or anything else, and they're going to be quick to unload them if they feel there is danger to hold them," Mr. Canavan said.

Mr. Canavan did not miss a beat when asked when investors would become more nervous.

"Now," he said. "There has been this expectation that at some point, they'd come up with a deal, but given the failure this weekend, I think market confidence is eroding."

The reaction in Asian markets on Monday was fairly muted. The Nikkei 225 index in Japan closed 0.8 percent lower, and the S.&P./ASX 200 index in Australia declined 1.6 percent. The Shanghai composite index sagged 3 percent, but mainly because infrastructure stocks fell after a major train crash in eastern China over the weekend.

The dollar gained modestly against some major currencies, but fell against the haven currencies of the Swiss franc and the yen on Monday.

Gold rose to another nominal record high level of $1,622 an ounce and was trading at $1,612 by early afternoon in New York.

European markets mostly closed slightly lower, while in the United States, the Standard & Poor's 500-stock index was down 0.12 percent in afternoon trading on Monday.

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It is often difficult to contemporaneously pinpoint when a panic begins. The financial crisis of 2008, for instance, is often dated to the summer of 2007, but it did not result in full-fledged market chaos for more than a year. During that time, many government officials said the situation was under control.

The situation in the United States does carry some of the classic ingredients for flurries of selling, financial historians said.

Panics sometimes occur when an asset that had been considered perfectly safe comes into question. Other conditions for financial mayhem include excessive speculation in one kind of investment — often one thought to be very safe — and sometimes low interest rates.

Some financial historians also say the markets have become more panic-prone than they once were, in part because of the mass of cash that has poured in recent decades into short-term investments like money market funds.

The current situation is unusual, though, in an important way, said David A. Moss, an economic policy professor at Harvard Business School. Treasu securities, he said, are the typical safe investment during a panic, so peo might not run away from them.

Mr. Moss said that the outcome cou be that there is a "mad rush" out Treasury securities, or it also might b that "people aren't sure what to do, s they just stay there."

Treasury securities have been at th center of panics in the United States be fore, though far earlier in U.S. history.

Richard Sylla, a finance professor at the Stern School of Business at New York University who has written about panics, pointed to 1792, when one Treasury trader ran into problems and sent the market into a spiral in which it lost 25 percent of its value.

About 100 years later, Congress had to call an emergency session because the Treasury was running out of gold reserves as foreign investors redeemed dollars for gold, Mr. Sylla said.

"Today we talk about what happens if the Chinese sell all the U.S. securities; in 1893, foreign investors were doing just that," Mr. Sylla said.

Mr. Sylla's initial assessment of the present situation was, "They're playing with fire in Washington, D.C., right now."

Or as the chief of fixed income at Morgan Stanley Smith Barney, Kevin Flanagan, said: "When you're a bond guy, the thought of default is like kryptonite. It's a word you just don't want to hear."

Still, perhaps because no one likes to talk in earnest about possible panics, Mr. Moss, Mr. Sylla and Mr. Flanagan said they did think a deal would be reached in Washington before Aug. 2.

That would avoid even a technical default, which is a short-term, nonpermanent default that could occur if the government had to delay some payments temporarily while it wrapped up a budget deal.

In addition to watching market signals like the rates on Treasury securities, traders said that they were eager to see whether the Treasury Department would announce on Monday that it would decrease the size of an auction o new Treasury securities this week.

The department has been decreasin the size of its weekly auction over th past month, to give it more flexibility the debt limit is not increased by nex week.

Bettina Wassener contributed reporting from Hong Kong, and David Jolly from Paris.