Junk Bond Meltdown May Lead to Market Collapse

by Richard Freeman

The highly speculative $670 billion U.S. junk bond (“high-yield bond”) market—more than 15% of all corporate bond financing—is on the verge of meltdown. For the past two months, the market has had virtually no liquidity. Some companies with medium-sized junk bonds have defaulted, and several more companies are on the edge of default. The seizing-up of the “high-yield” junk bond market, is both a reflection of the state of, and a prime driving force behind, the disintegration of the world financial system.

Indicating the advanced stage of the crisis, today’s spread between junk bonds and U.S. Treasury bonds was last equalled only during 1990-91. At that time, the investment firm of Drexel Burnham Lambert, whose team, headed by Michael Milken, had “invented” the runaway junk bond market of the 1980s, filed for bankruptcy, and that market effectively ceased to exist.

What a Junk Bust Means

The junk bond market has a threefold connection to different aspects of the U.S. credit market, and the consequences of its failure are immense. First, junk bonds are used to finance leveraged buy-outs, which is a big part of mergers and acquisitions (M&As). For example, if Company A decides to take over Company B for $2 billion, it may issue $500 million of high-yield junk bonds to pay for one-quarter of the takeover. Mergers and acquisitions have artificially buoyed the stock market. Internet and telecommunications firms, which are a big part of the stock market, have also issued large volumes of junk bonds to expand, or simply meet their financial needs.

Second, junk bonds make up approximately one-sixth of the $4.2 trillion U.S. corporate bond market.

Third, junk bonds figure prominently in the derivatives market. Speculators frequently deal in derivatives contracts, which arbitrage the spread between junk bonds and U.S. Treasury bonds. That is, junk bonds, which are highly speculative instruments to begin with, are packaged and incorporated into
a second-order speculative instrument, derivatives.

Thus, junk bonds are central to the stock, derivatives, and debt markets of the United States, which, combined, have a paper valuation of more than $100 trillion. The junk bond market’s collapse would function as a trigger, both detonating each of the three markets serially, and imploding the financial system as a whole.

Those who are active in the junk bond market are closely looking at the dangers building up. Donaldson Lufkin Jenrette is the largest underwriter of junk bonds in the world, this year, having underwritten more than $5 billion. Donaldson Lufkin Jenrette, which is being bought by the giant Swiss bank Crédit Suisse, is acutely aware of the liquidity shortage. On Nov. 1, a high-yield bond specialist at Donaldson Lufkin Jenrette explained to EIR that there is a growing concern about the riskiness of all financial markets. “There is a worldwide reassessment of risk. This has led investors to stay away from the junk bond market,” one of the riskiest markets of them all, he said. He stated that the only ones speculating and buying junk bonds, “are large institutional investors, who see that the gains in arbitrage in junk bonds is so great, that they’re willing to take the risk.”

“There are two scenarios,” he stated. “First, some immediate benefit to the high-yield bond market. That would mean the oil price comes down and the Federal Reserve loosens the money supply,” pumping funds into the junk bond market. However, “the second scenario is that the oil price does not come down, and the spreads on junk bonds continue to rise to above 1,000 basis points,” which was the level in 1990-91 when Drexel failed. This would cause the economy to crash “into recession, and cause a crisis in the investment-grade bond market,” i.e., all bonds. This is a financial disintegration.

Under the second, more severe development, “The Federal Reserve would have to supply money” on an even larger scale. Yet, it became clear, that the sum total of Donaldson Lufkin Jenrette’s “policy” is to count on Greenspan to intensify the money-printing policies which, in fact, have already put the world onto the path of a Weimar-style hyperinflation.

We will look at the development of the junk bond market, which is an indicator, in microcosm, of the growth of the entirety of speculative markets in the United States, and the high degree of risk. We will then look at the junk market’s current precipitous unravelling.

**Growth of the Junk Bond Market**

In August 1971, under the advice of the financier oligarchy, President Richard Nixon took the U.S. dollar off the gold reserve standard. This was part of the oligarchy’s imposition on the United States of a “post-industrial society” policy. That policy shut down manufacturing, agriculture, and infrastructure, and built up non-productive services and a speculative bubble. In furtherance of that aim, in October 1979, Jimmy Carter’s then-Federal Reserve Board chairman, Paul Volcker, instituted a severe form of the post-industrial society, called “controlled disintegration.” Volcker raised interest rates, so that by December 1980, the prime lending rate charged by commercial banks had been forced up, to 21.5%. Production shrivelled, yet speculation flourished. Continuing that policy, under the Reagan Administration, in 1981, the Kemp-Roth Act was passed, which benefitted the stock market and speculation in real estate trusts; and in 1982, the Garn-St Germain Depository Institutions Act was passed, which deregulated
the banking system. Financial flows became more and more completely divorced from production processes.

In this environment, during the mid-1970s, the Morgan banking interests, joined by the Rothschild banking interests and the reported drug-trading United Fruit/Chiquita Brands company, financed creation of the Drexel Burnham Lambert investment firm, with Michael Milken inserted into a key operations position. Drexel Burnham Lambert effectuated “leveraged buy-outs” (LBOs) in which Company A would take over Company B, borrowing heavily to do so (hence the term “leverage”). Often, Company A would put up only 10% of the purchase price of Company B in cash and stock, and would borrow the other 90% of the purchase price. In carrying out the borrowing for the LBO takeover, Company A would either borrow money from banks, or issue junk bonds. For example, with Drexel Burnham Lambert as the lead underwriter, and making a market for the junk bond, Company A might issue a $500 million junk bond, bearing a 15% interest rate. With the $500 million received from the junk bond, and other borrowed funds, Company A could complete the takeover.

Against this new mass of debt heaped onto the newly merged company, which required enlarged quarterly debt payments, the newly merged company only had the productive capacities and sales revenues of the original companies, A and B. In turn, the newly merged company gouged itself through asset-stripping—firing workers, reducing capital spending, slashing funds for research and development, and cutting back production—in order to come up with the cash to make the newly enlarged quarterly debt payments. The holders of the junk bonds raked in yields of 15 to 25% per year, with the flow of cash ending only at the point that the depleted underlying company was, frequently, forced into bankruptcy. In February 1990, following the indictment of key figures at Drexel Burnham Lambert, but also because of other reasons having to do with the world financial system, Drexel Burnham Lambert filed for bankruptcy. Drexel had been the key firm for the junk bond sector, often supporting junk bonds with its own cash to keep the overall market up. With the shutdown of Drexel, the market virtually evaporated.

**Figure 1** shows the number of new junk bonds issued, by year. **Figure 2** shows the dollar volume of the annual issuance of new junk bonds, from 1980 to 2000. In 1980, a total of $1.43 billion of new junk bonds was issued. This grew, year by year, under the impress of the growth of LBOs and mergers and acquisitions, so that by 1988, a total of $31.1 billion of new junk bonds was issued that year. In 1989, the total fell slightly, to $28.8 billion in new junk bonds. But, in 1990, the total of new junk bond issues was only $1.40 billion, a fall of 95% from the year before. By 1990, the new junk bond market...
had disappeared.

Figure 3 shows the yield on ten-year U.S. Treasury notes, and the yield on junk bonds, as reported by Merrill Lynch investment bank in its “High-Yield [Bond] Master II Index.” In January 1991, the yield on a ten-year U.S. Treasury note was 8.021%; the yield on a junk bond was 18.11%, giving a “spread” of 10.09% (or 1,009 basis points) between Treasur-
ies and junk bonds. This was the highest spread of the past quarter-century (Figure 4). The very high spread in January 1991 indicates that the junk bond was considered to be ex-
traordinarily risky, and that liquidity had totally fled from the junk bond market.

By January 1991, the default rate on junk bonds rose to 11.37%, which means that of all the junk bonds then outstanding, 11.37% of them collapsed into default. The default rate peaked at 13.08% in July 1991.

1990s Stock Market Boom and Junk Bonds

The financier oligarchy would make the decade of the 1990s, among other things, the era of unbridled stock market speculation, which depended significantly on mergers and acquisitions, which, in turn, depended on junk bonds. After absorbing widespread losses in 1990-91, the oligarchy set about rebuilding and investing in the junk bond market.

Figure 2 shows that the level of new junk bond issuance fell to $1.40 billion during the crash of 1990. This was raised to $72.3 billion in 1993, and finally, in 1998, the level of new junk bond issuance hit a record $140.9 billion.

Figure 5 represents the broadest level of junk bonds, the value of the principal amount of all junk bonds outstanding. Whereas Figure 2 represents only the amount, however sizable, of junk bonds issued in a single year, Figure 5 presents...
the cumulative value of all junk bonds (each year, to arrive at this sum, the value of new junk bonds issued is added in, and the value of the principal amount of existing junk bonds that has been retired, is deducted). In 1992, the value of the principal amount of all junk bonds outstanding had fallen to $205 billion. Then, with the heavy issuance of new junk bonds each year, it exploded, particularly during 1995-99, which is when the “high-tech”-based Nasdaq stock average surged. From a level of $205 billion in 1992, the principal amount of all junk bonds outstanding rose to $652 billion in 1999, more than tripling in only seven years.

Junk bonds were a key underpinning of the stock market, particularly the Nasdaq “high-tech” stocks, in two ways. First, particularly the Internet and telecommunications companies engaged in a wild spree of mergers and takeovers, with often a single company buying as many as two dozen or more other companies, to bulk itself up. Junk bonds played an important role, though by no means providing all the financing, in those takeovers.

Second, in addition to financing LBOs, the Internet and telecommunications companies also used a significant portion of the proceeds realized from the sales of junk bonds, as operating cash to live on. Since many Internet and telecom companies were starting out and did not have investment-grade credit ratings, to the extent they issued bonds to tap the credit markets, they were below-investment-grade bonds. The Internet and telecom companies used the money from the bond sales to buy some equipment, but also, because they are losing money, in many cases the money was used to pay common operating expenses.

Simply put, without the cash raised from junk bonds, many of the high-flying “high-tech” companies and their vastly overinflated stocks, would have gone under. Thus, the junk bonds played a dual role: The junk bond-funded LBOs helped artificially bull up the stock prices, and the junk bonds also helped keep several “high-tech” companies alive; if, instead, they had crashed, their stocks would have crashed, and this would have pulled down the stock market.

The dual role of junk bonds contributed mightily to the fact that the market valuation/capitalization of all the stocks traded on the Nasdaq shot up from $615 billion in 1992, to $5.20 trillion in 1999. If the junk bond market goes under, so does the Nasdaq.

Yet, junk bonds finance more than just Internet and telecommunications firms. According to a spokesman for Donaldson Lufkin Jenrette, as of Nov. 1, approximately one-third of all junk bonds outstanding are from the Internet and telecommunications sector. This means that $450 billion of junk bonds are issued by other sectors, including energy, shipping, autos, health care, and clothing. A collapse of the junk bond market will have effects in these sectors of the economy too.

**Junk Bonds and Derivatives**

Junk bonds also play a role in the derivatives market. In September 1998, the Long Term Capital Management hedge fund went under. LTCM had been making derivatives bets, not on a single instrument, but on the difference between two or more instruments. LTCM had made derivatives bets on the spread between the yields on U.S. Treasury bonds on the one side, and the yields on U.S. corporate bonds, on the other side; and bets on the spread between the yields on U.S. Treasury bonds on the one side, and the yields on junk bonds on the other. Earlier in 1998, the spread between the yields on U.S. Treasury bonds and on junk bonds was, by historical standards, high. Using its Black-Scholes model, LTCM bet that the yields would narrow. LTCM bet wrong.

When Fed Chairman Greenspan, assisted by U.S. Treasury Secretary Lawrence Summers, began turning on the printing press full throttle in September 1998, one of Greenspan’s principal aims was to bail out and liquefy the derivatives market. But within this context, Greenspan had to, and did, bail out the highly speculative junk bond market, which had seized up. The reason is that Greenspan could not unwind LTCM’s derivatives contracts, if some of those contracts had two parts—U.S. Treasury bonds and junk bonds—and the second part of the contract, the junk bonds, were illiquid. So, Greenspan poured money out to liquefy the junk bond market, so that LTCM derivatives contracts involving junk bonds could be unwound.
Today, many banks and hedge funds are still addicted to the derivatives contract based on the spread between U.S. Treasury bonds and junk bonds, as one of the most profitable, and play it in considerable quantities. Undoubtedly, the current turmoil in the junk bond market has had, and is likely still having, a disruptive effect on the derivatives market, although it is not being reported publicly.

There are other ways that the junk bond market impacts the derivatives market, with potentially fatal consequences should the junk bond market fail.

**Junk Bond Disintegration**

The junk market is very illiquid, and is showing signs of unravelling.

**Figure 6** shows that through the first three quarters of 2000, the dollar value of junk bonds which defaulted reached $24.9 billion. Were that trend to continue, and were the fourth quarter of this year to be as wild as the first three, the year 2000 would have the highest level of junk bond defaults ever. Already, there are developments in the last weeks of the third quarter and the beginning of the fourth, which show that not only will the defaults increase, but even the business of bringing out new junk bond issues has been severely impaired:

- During the week of Oct. 16, Levi Strauss & Co., maker of Levi and Docker jeans, shelved a $350 million junk bond issue, because of “poor market conditions,” i.e., interest rates on the bonds are too high and there is a lack of liquidity. Earlier in the month, Linc.net, an optical telecommunications company, shelved a $175 million junk bond issue, and two companies cancelled junk bond issues, also in October.
  - Owens Corning, Warnaco, and Champion Enterprises, all of whose bonds had been rated investment grade, either had serious business reverses or filed for bankruptcy, and their bonds were downgraded to junk bond status in late August through October. Further, on Oct. 24, Xerox Corp., the world’s largest photocopier company, reported third-quarter losses of $128 million, as part of its worsening business conditions. On the same day, Standard & Poor’s rating service downgraded Xerox’s bonds to a “BBB−,” just one notch above the level of junk bond.

- During October, ICG Communications, a seller of telephone and Internet Services, announced further deep troubles. Its stock shares, which had been trading at $39 per share in March, are now trading at about 18¢. ICG has a few hundred million dollars worth of junk bonds, which it likely will soon have to declare in default. Also during October, another “high-tech” company, Viatel, came very close to default. Morgan Stanley Dean Witter investment firm underwrote the junk bonds issued by both ICG and Viatel, and owns some of them. On Oct. 10, Reuters news service reported that Morgan Stanley may have lost $1 billion on its junk bond portfolio, including ICG and Viatel. Within days, Morgan Stanley issued a denial, saying it had lost “only” $90 million. On Oct. 10, it was reported that Deutsche Bank, one of the world’s largest banks, had lost $1 billion on its junk bond portfolio. On the same day, one of Deutsche Bank’s board members issued an internal e-mail to managing directors, denying the report.

Thus, the effect of the junk bond meltdown is reaching into the world’s largest banking institutions, whose denials of losses may not be credible.

On Oct. 12, Moody’s Investors Services reported that for the third quarter of this year, the rate of default of all junk bonds outstanding was 5.4%, but that this would rise to 8.4% by the end of September 2001.

It would appear that the rate of default will be larger and occur much sooner. Revisit Figure 2. It shows that the level of new junk bond issuance fell from $140.9 billion in 1998 to $99.7 billion in 1999. So far, through the first ten months of this year, it has been $47 billion, but the level of new monthly issuance is so low, it may not reach $50 billion for the year.

Then revisit Figure 4. By October 2000, the spread between a ten-year Treasury bond and a junk bond, 777 basis points, had become higher than the spread that existed at any point after the September 1998 failure of the LTCM hedge fund, when the junk bond market seized up. Due to extreme illiquidity, it is now escalating toward the level of 1,009 basis points that existed in January 1991, which accompanied the disintegration of the junk bond market then.

The meltdown of the speculative junk bond market is gathering force; it has the potential to collapse the U.S. stock, bond, and derivatives markets.