Junk bond panic signals new stage in crisis of world capitalism

Barry Grey
14 December 2015

There are many indications that last week's selloff on stock and bond markets signifies a new and explosive stage in the world capitalist crisis.

Amid plunging prices for oil and other basic commodities (the US oil benchmark sank below $36), a further contraction in trade by China and worsening economic conditions in the "emerging markets," stock prices in the US, Europe and Asia fell sharply. The major US stock indexes declined by more than 3 percent, bringing the Dow and the S&P 500 into negative territory for the year.

Even more ominous was the continued rout of US high-risk, high-yield corporate bonds, or "junk bonds." In the course of the week, investors removed $3.8 billion from junk bond funds.

Prices of high-risk securities fell to levels not seen in six years—in the aftermath of the 2008 Wall Street crash. The yields on these low-rated bonds, which move in the opposite direction of price, continued to soar, as did the cost of credit default swaps purchased to hedge against bond defaults.

Further roiling the markets was the prospect of the Federal Reserve raising interest rates for the first time in nearly a decade when it meets this week. Even though Fed Chair Janet Yellen has repeatedly assured the markets that any increase will be small and rates will remain well below normal for an indefinite period, any increase will tend to further depress junk bond prices.

Jeffrey Gundlach, head of the Doubleline Total Return Bond Fund, expressed the fears on Wall Street, declaring, "We're talking about raising interest rates with the credit markets in corporate credit absolutely tanking. They're falling apart."

The most threatening development was the collapse Thursday of Third Avenue Management's Focused Credit mutual fund, which invests in energy-related junk bonds. Facing mounting debts, declining revenues, rising borrowing costs and a wave of redemption orders by clients, the fund suddenly announced that it would not redeem customers' withdrawal orders and would block them from getting access to their money.

This follows Stone Lion Capital's suspension of redemptions in its credit hedge funds and the partial suspension of redemptions by a Carlyle Group asset management fund. Black Rock's junk bond exchange-traded fund, the largest of its kind, fell Friday to its lowest level since 2009.

This is merely the tip of the iceberg. Standard & Poor's Rating Service recently warned that 50 percent of energy junk bonds could default, along with 72 percent of bonds in the metals, mining and steel industries. Distressed debt in the US is at its highest level since the official end of the recession in June of 2009. Corporate defaults have topped 100 this year, nearly one-third being oil, gas or energy companies. There have been 40 bankruptcy filings by North American oil and gas producers this year, and more than $1 trillion in US corporate debt has been downgraded.

The mounting crisis in the junk bond market has profound and convulsive implications for the entire credit system, in the US and internationally, because these bonds, particularly those tied to the oil and energy industry, have mushroomed in volume since the collapse of the subprime mortgage bubble in 2007-2008.

High-yield bond assets at US mutual funds hit $305 billion in June 2014, triple their level in 2009. Outstanding debt in the US junk bond market has soared to more than $1.2 trillion from less than $700 billion in 2007—an increase of 71 percent.

This massive growth in the US junk bond market is an expression of the ever more pervasive role of speculation and parasitism in the US and world capitalist economy. Far from reining in the socially destructive and semi-criminal activities of banks and hedge funds that triggered the financial disaster and resulting depression, the US Federal Reserve and the government—first under Bush and then under Obama—rewarded the "banksters" with trillions in taxpayer bailouts and virtually free cash in the form of zero interest rates and Fed bond purchases ("quantitative easing"). The same policies were pursued by central banks and governments in Europe and Asia.

In an environment of super-low long-term interest rates, suppressed by the Fed in order to push money into the stock market and increase the wealth of the financial elite, finance capital, having crashed the housing market, had to find new outlets to realize high returns on its speculative bets.

Banks and corporations spurned investment in the productive forces and the creation of decent-paying jobs because the returns were too low. Instead, money flooded into the junk bond market, which paid high returns precisely because the companies issuing the bonds had doubtful or poor credit, or were involved in highly volatile economic sectors, such as energy.

This new wave of parasitism was accompanied by a ruthless attack on the working class. Wage-cutting and austerity became universal, and they continue unabated throughout the world.

Corporations with bad credit, however, enjoyed voracious demand for their bonds. They borrowed hand over fist, especially energy and other commodity extracting companies seeking to take advantage of $100 a barrel oil prices and ever-rising demand from China and the emerging market countries. They and the rest of the corporate world used their vast hoards of cash not to invest in production, but to further enrich the CEOs and billionaire investors by indulging in dividend increases, stock buybacks and a frenzy of mergers and acquisitions.

It is no accident that the inflation of the junk bond bubble has coincided with a record level of mergers and acquisitions, set to hit more than $4.38 trillion this year. Last week, even as stocks and bonds were plummeting, chemical giants DuPont and Dow announced a $120 billion merger—yet another job-slashing, cost-cutting exercise in parasitism.

But the slowdown in China and the mounting crisis in the once-booming emerging market countries—Brazil, Argentina, Turkey, Russia, South Africa, Indonesia, etc.—have pulled the rug out from under the junk bond house of cards.

The collapse of Third Avenue's junk bond fund eerily recalls the collapse in July 2007 of two subprime mortgage hedge funds owned by the late investment bank Bear Stearns. Eight months later, Bear Stearns itself collapsed, and six months after that, Lehman Brothers went bankrupt and the insurance giant AIG was bailed out by the Federal Reserve.

The decay of American and world capitalism that underlies the mounting crisis is reflected in the rise to the top of an underclass of financial parasites. One representative is the founder of Third Avenue Management, Martin Whitman, revered on Wall Street as the dean of "vulture investors." Whitman has assembled a multi-billion-dollar fortune by gambling on distressed assets.

The junk bond crisis exemplifies the diseased state of capitalism that finds expression in the political superstructure in the ever-rising tide of militarism and war, the drive toward dictatorship and the relentless assault on the living conditions of the broad mass of working people. The tectonic shifts at the economic base of society sent shockwaves throughout the political system, intensifying class tensions and conflicts between the major powers.

But these shockwaves also thrust ever-broader layers of workers into struggle against the system. The claims of economic "recovery" are being shattered by the reality of ever deeper and permanent crisis and slump. The turn is to the working class and the struggle to put an end to the capitalist system and replace it with socialism.