

# Towards a History of the Junk Bond Market, 1910-1955

Peter F. Basile, John Landon-Lane,  
and Hugh Rockoff, Rutgers University

# Outline

1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit late 1930s
5. Liquidity Trap late 1930s

<b>Table 1. Bond Ratings</b>			
<b>Moody</b>	<b>Poor</b>	<b>Standard</b>	<b>Meaning</b>
<b>Aaa</b>	<b>A**</b>	<b>A1+</b>	<b>Highest Quality</b>
<b>Aa</b>	<b>A*</b>	<b>A1</b>	<b>High Quality</b>
<b>A</b>	<b>A</b>	<b>A</b>	<b>Sound</b>
<b>Baa</b>	<b>B**</b>	<b>B1+</b>	<b>Good Quality</b>
<b>Ba</b>	<b>B*</b>	<b>B1</b>	<b>Fair</b>
<b>B</b>	<b>B</b>	<b>B</b>	<b>Speculative</b>
<b>Caa</b>	<b>C**</b>	<b>C1+</b>	<b>Very Speculative</b>
<b>Ca</b>	<b>C*</b>	<b>C1</b>	<b>Weak</b>
<b>C</b>	<b>C</b>	<b>C</b>	<b>Gambles</b>
<b>D</b>	<b>D</b>	<b>D</b>	<b>Default</b>

Notes: Junk bonds are often defined as those rated Ba or below. Our index is confined to bonds rated B or below. Defaulted bonds are excluded. The verbal descriptions are those used by Moody's during the period 1910-1955. Standard and Poor were merged in 1941. A smaller firm, Fitch, also rated bonds.

Source: Hickman (1958,142)

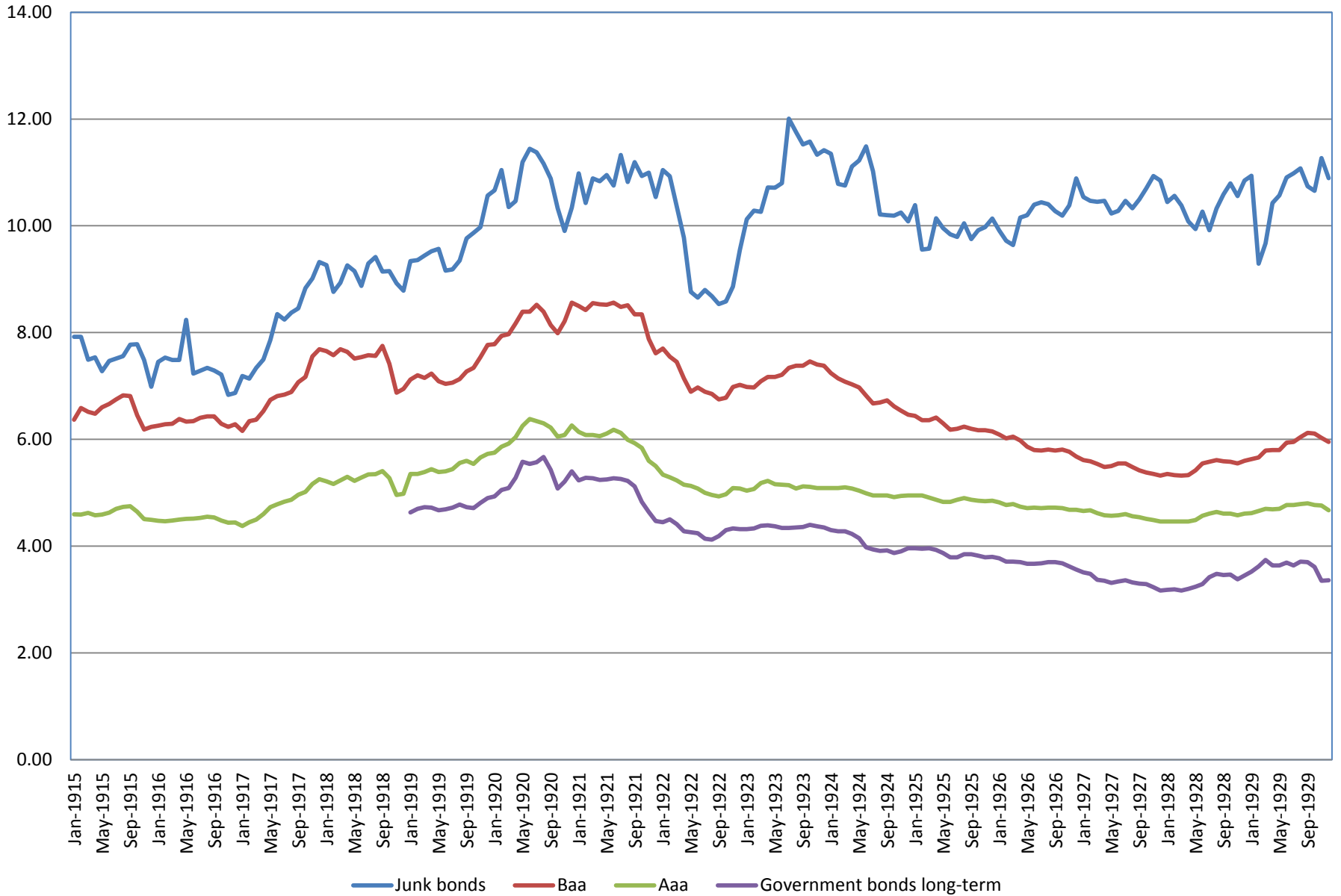
# Building the Index

- Macaulay, Frederick R. *The Movements of Interest Rates, Bond Yields and Stock Prices in the United States since 1856*. New York: NBER, 1938.
- Chain Index
- Short-term to maturity
- Company fails
  - Hickman 1958
  - Michael Milken

# Outline

1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit
5. Liquidity Trap

# The Bond Market 1925-1929



# Outline

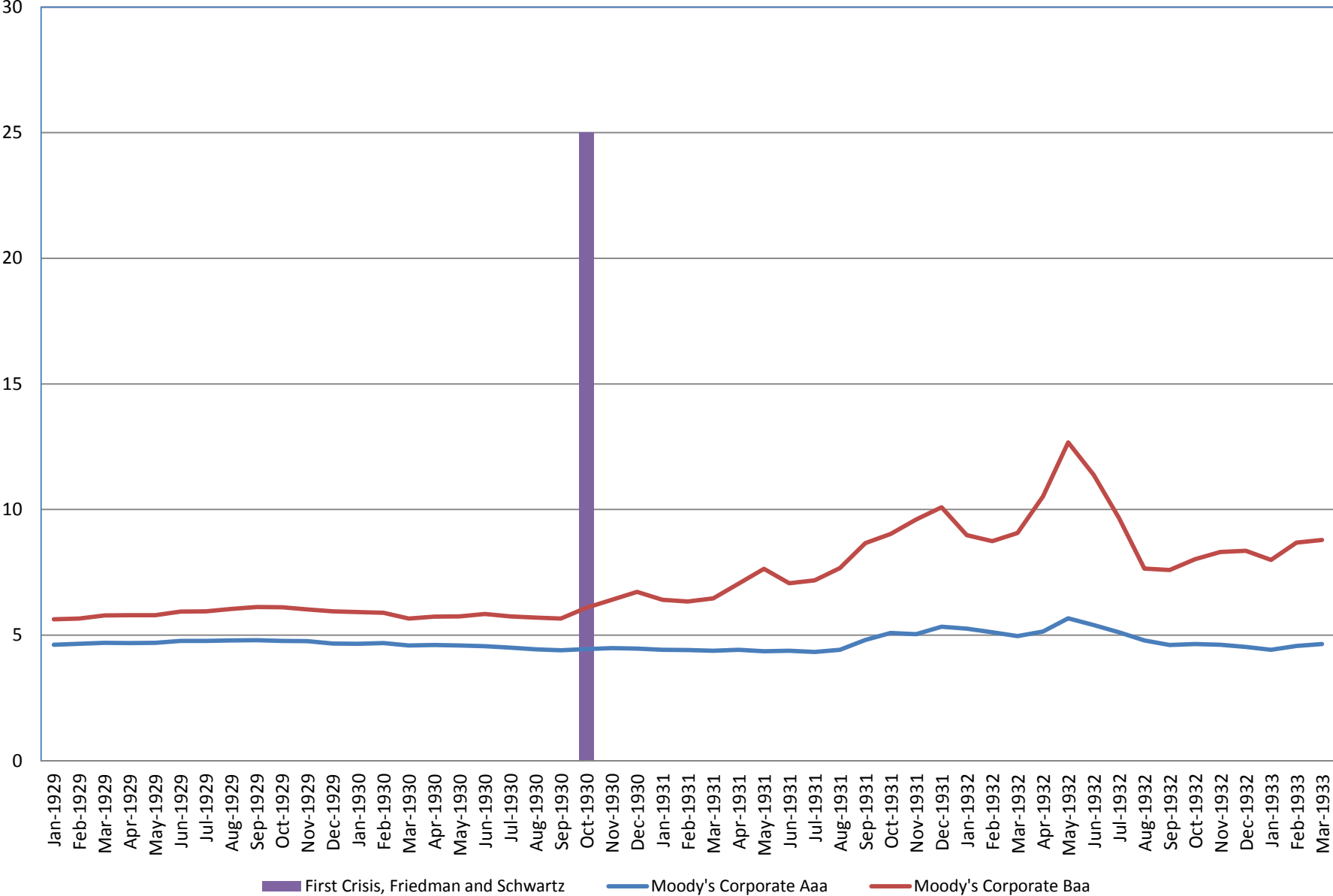
1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit
5. Liquidity Trap

# Outline

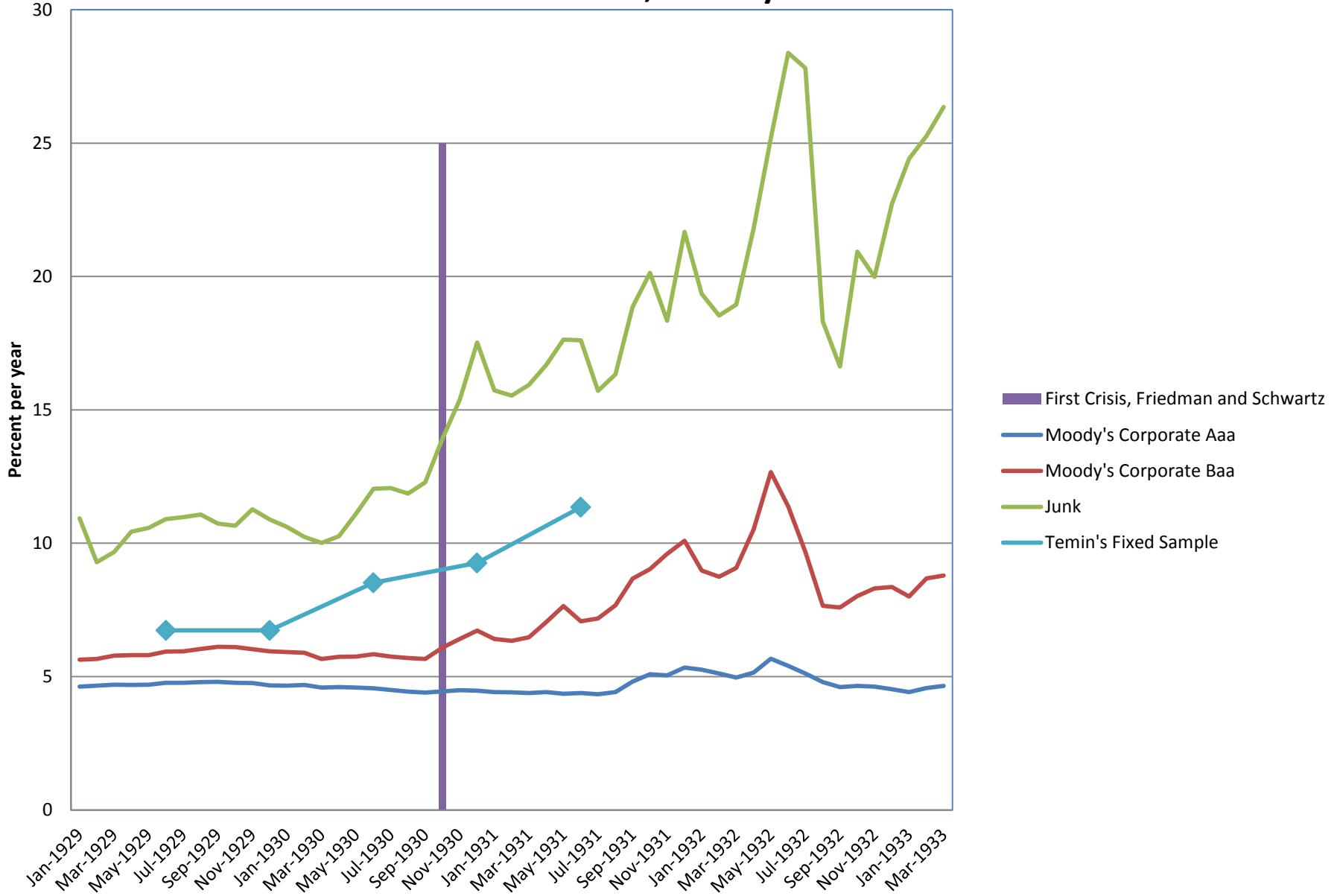
1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit
5. Liquidity Trap



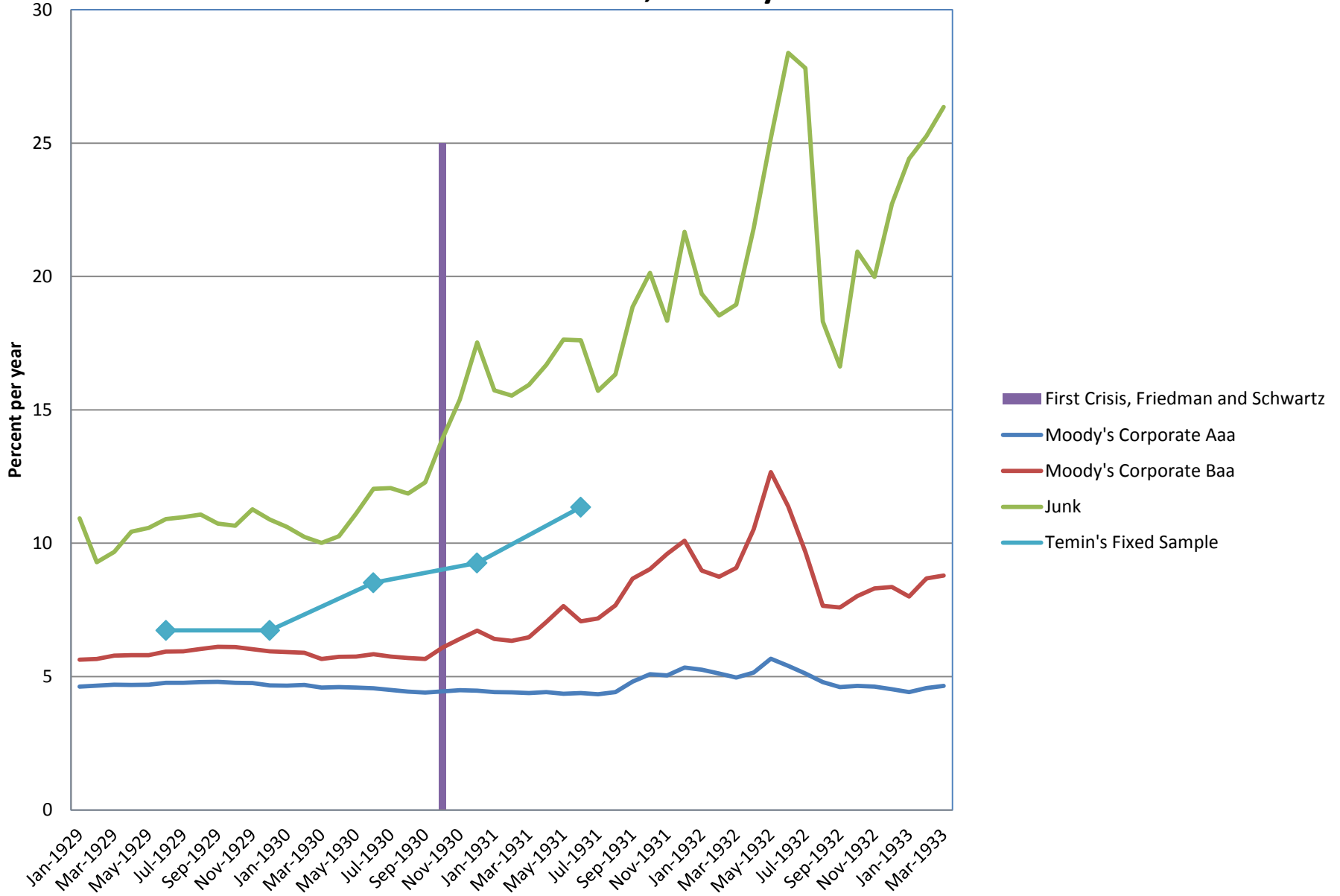
# Yields on Selected Assets, January 1929 - March 1933



# Yields on Selected Assets, January 1929 - March 1933



# Yields on Selected Assets, January 1929 - March 1933



**Table 2. The Response of Country Banks to the Great Contraction (Garlock's Select Sample of Rural Wisconsin Banks)**

	High Grade	Medium Grade	Low Grade	Total
Securities held in 1929	38	37	25	100
Securities sold 1929-32	25	17	10	52
<i>Proportion sold (percent)</i>	66%	46%	40%	52%
Securities remaining in portfolio	13	20	15	48
Change in ratings of securities held 1929-32	0	-11	+11	0
Securities held from 1929 to 1932 at 1932 ratings	13	9	26	48
Securities acquired	6	5	14	25
<i>Proportion of initial holdings replaced (percent)</i>	16%	14%	56%	25%
Securities Held in 1932	19	14	40	73

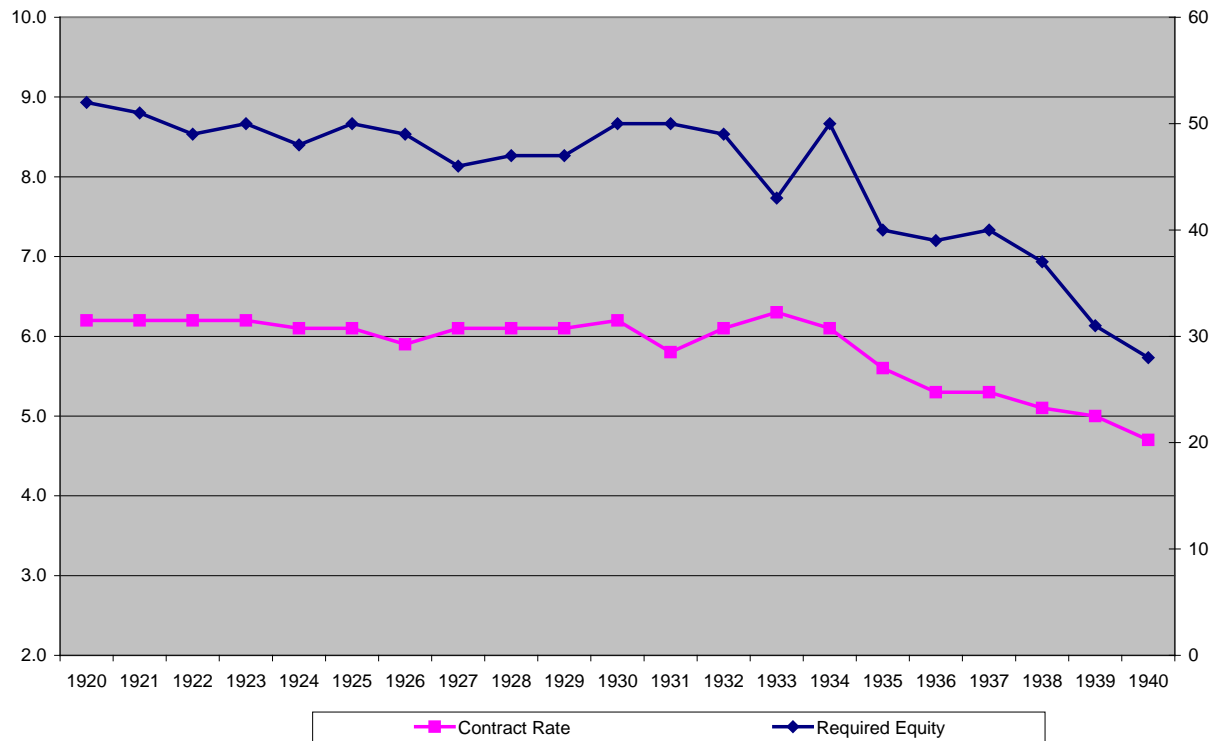
Note: All securities are valued at book value (acquisition price) and measured as a percentage of total security holdings in 1929. The definitions of the grades are as follows. High grade: U.S. Government Securities, Federal Land Bank Bonds, Aaa and Aa Corporates, and State and Municipal Bonds not in Default. Medium grade: A and Baa Corporates. Low grade: All others including defaulted and not rated.

Source: (Garlock 1941, 49-50). The figures were read from a chart. So there is a small margin of error, perhaps one percent, around the figures.

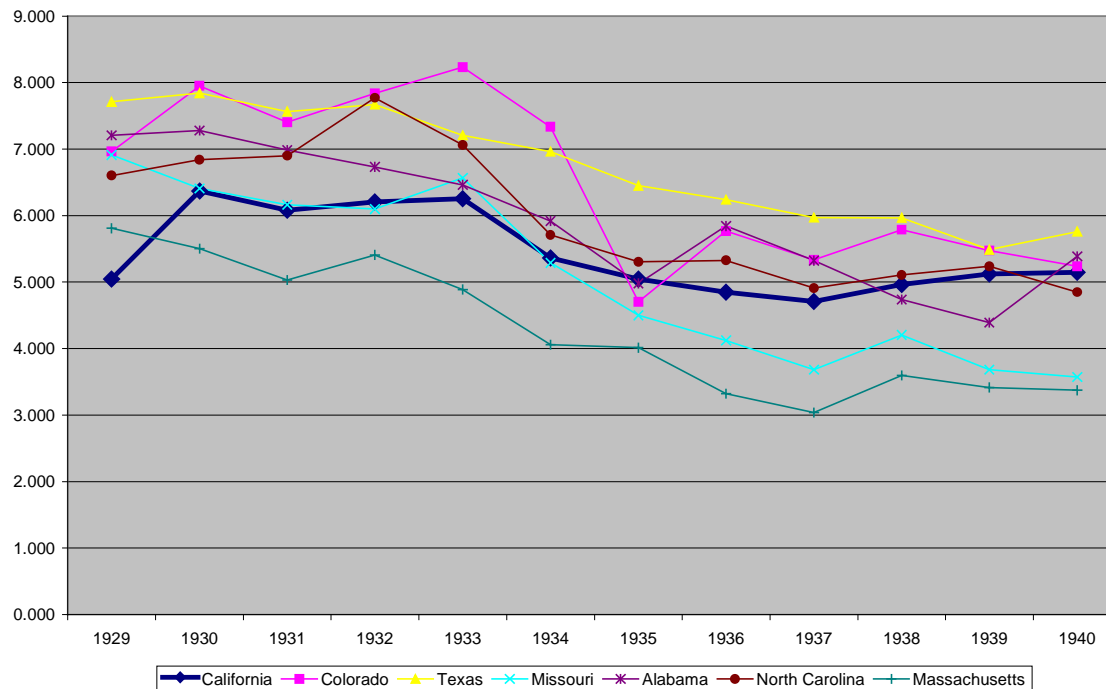
# Outline

1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit
5. Liquidity Trap

# Mortgage rates suggest that cost of capital was low in late 1930s



# Measured Bank Lending Rates also suggest that the cost of capital fell

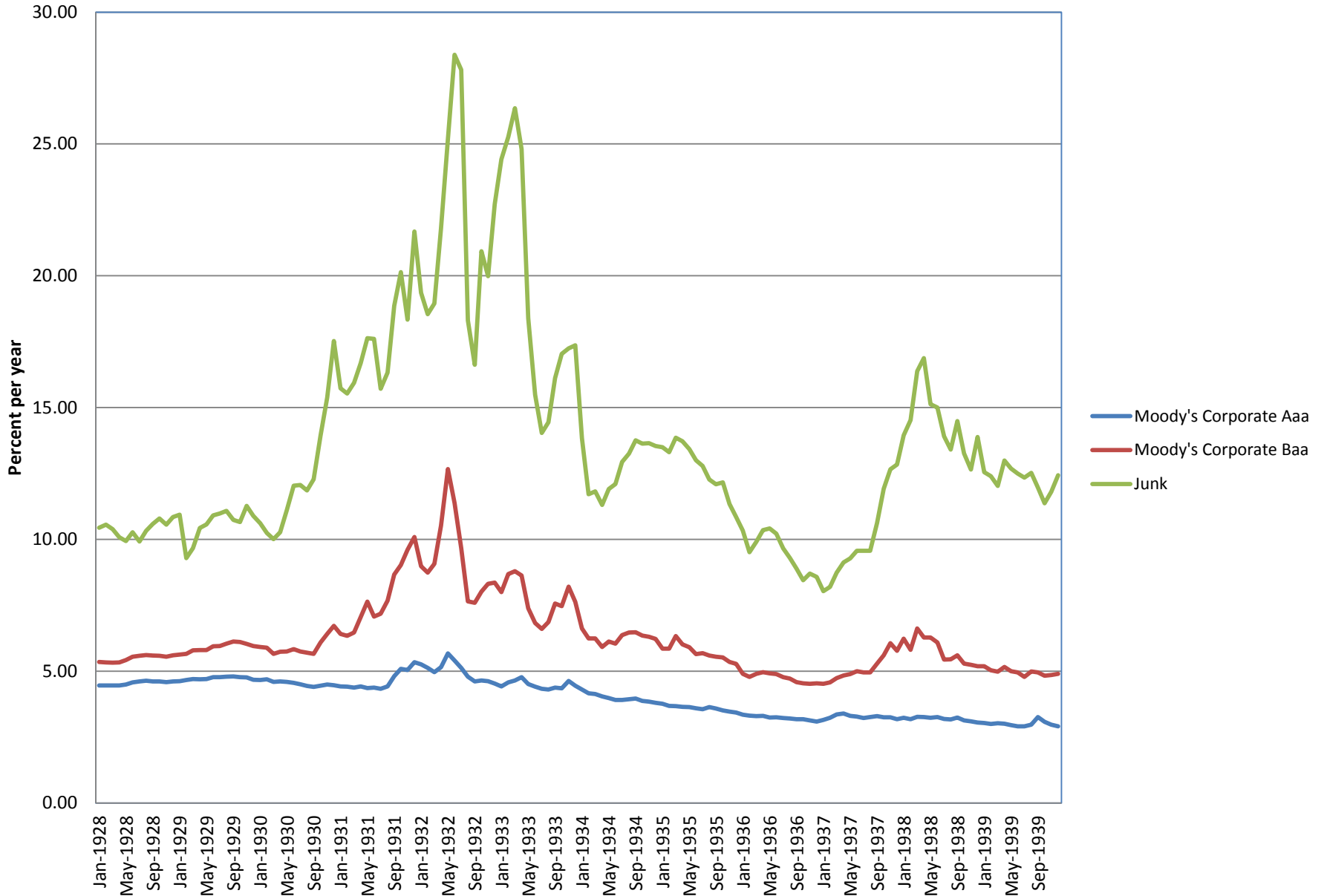


# Yield Aaa Corporates, January 1928 - December 1939





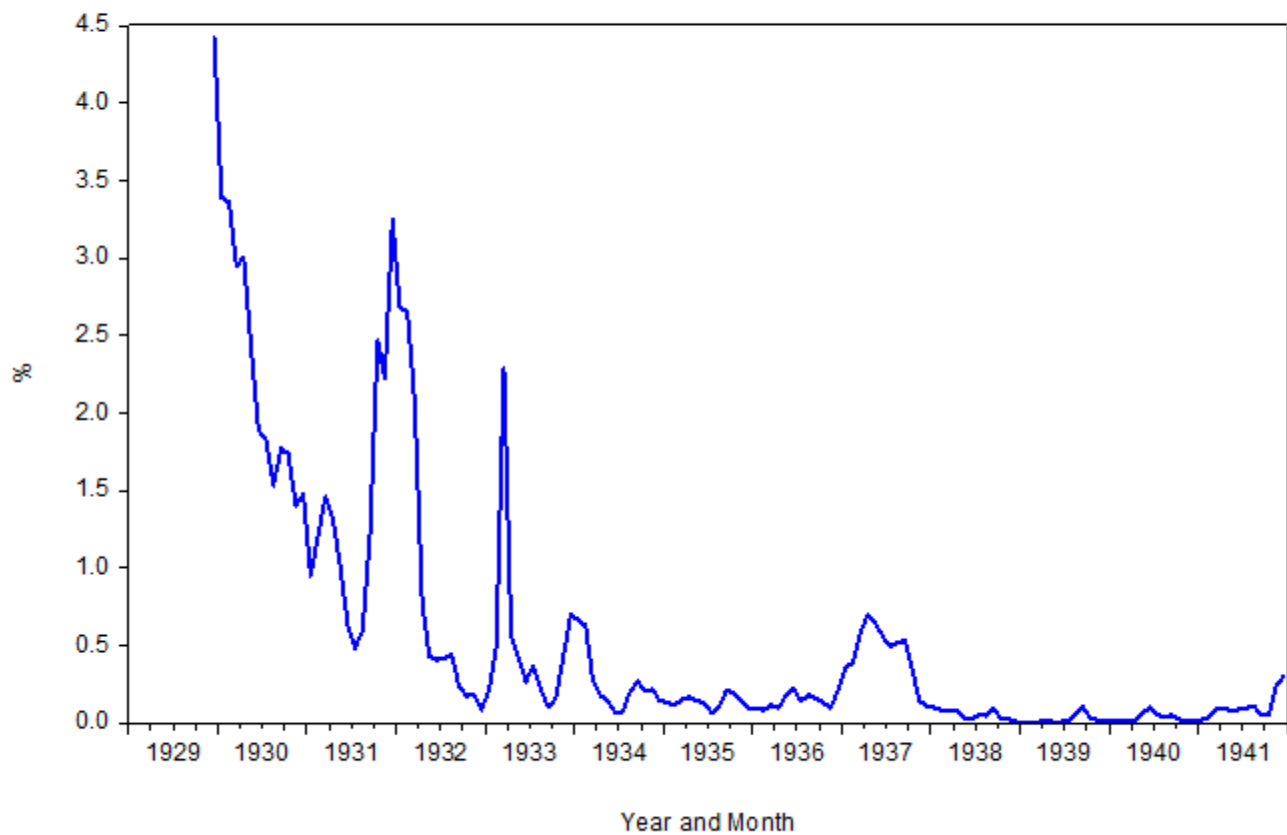
# Yields on Selected Assets, January 1928 - December 1939



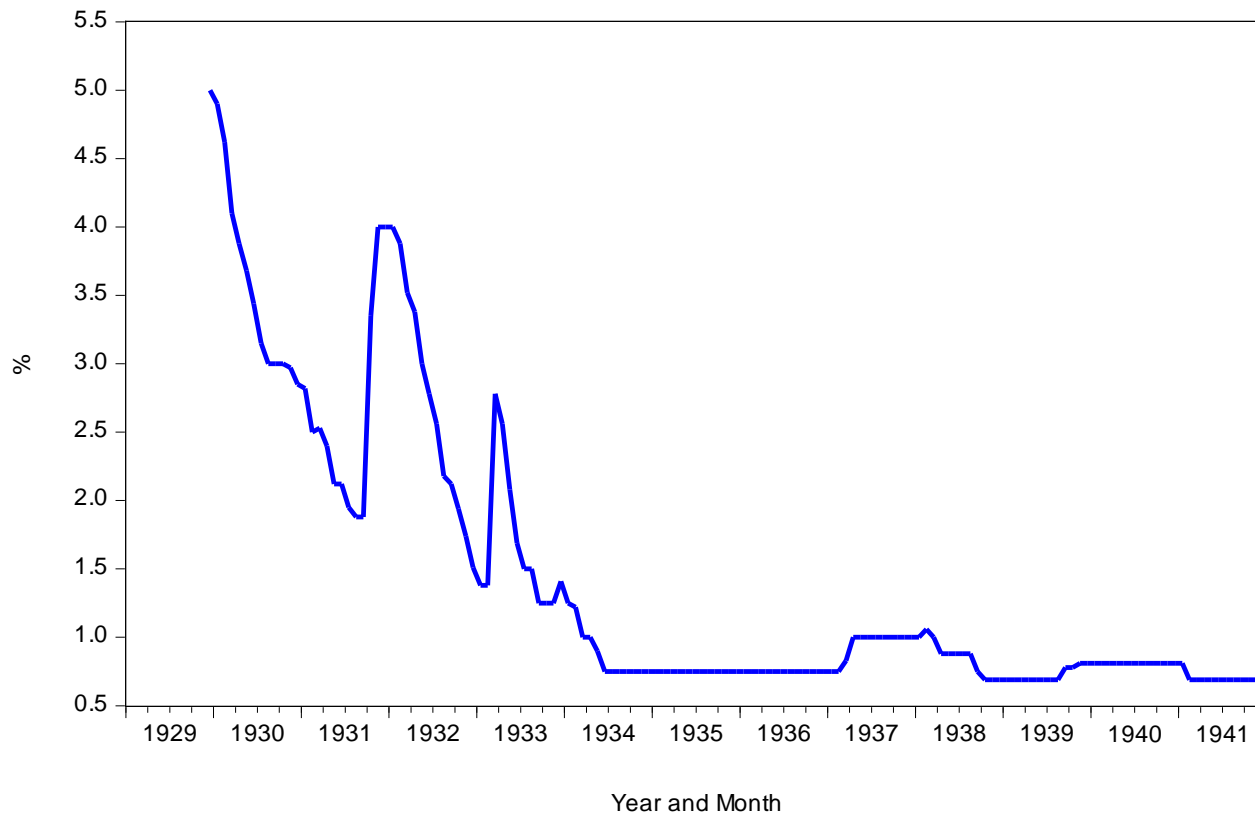
# Outline

1. Index of Junk Bond Yields
2. Lending Standards in the 1920s
3. The Banking Crises and the Rise in Risky Rates in the 1930s
4. Risky rates as proxies for the cost of bank credit
5. Liquidity Trap

## Treasury Bills



## Commercial Paper

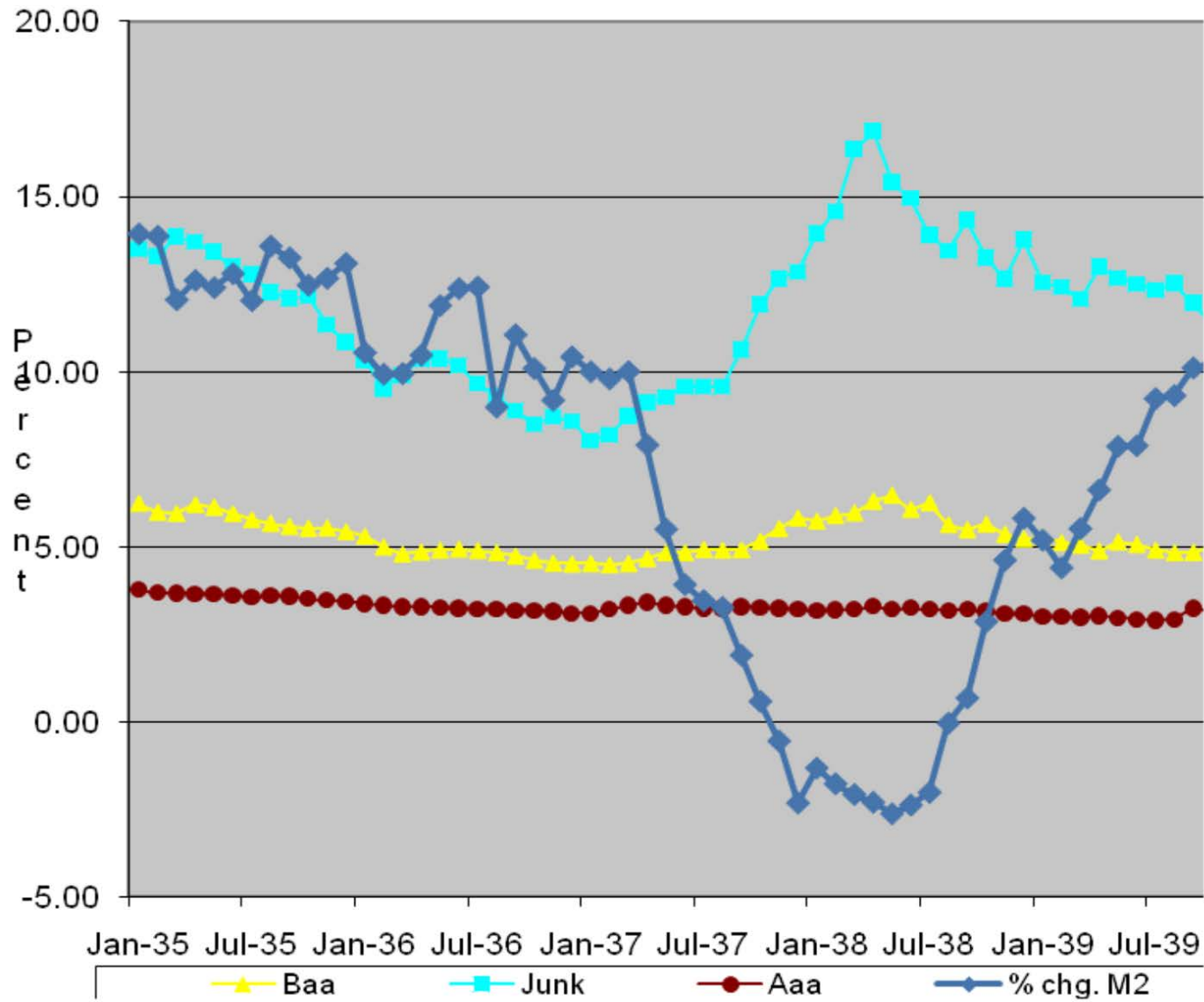


# The Liquidity Trap

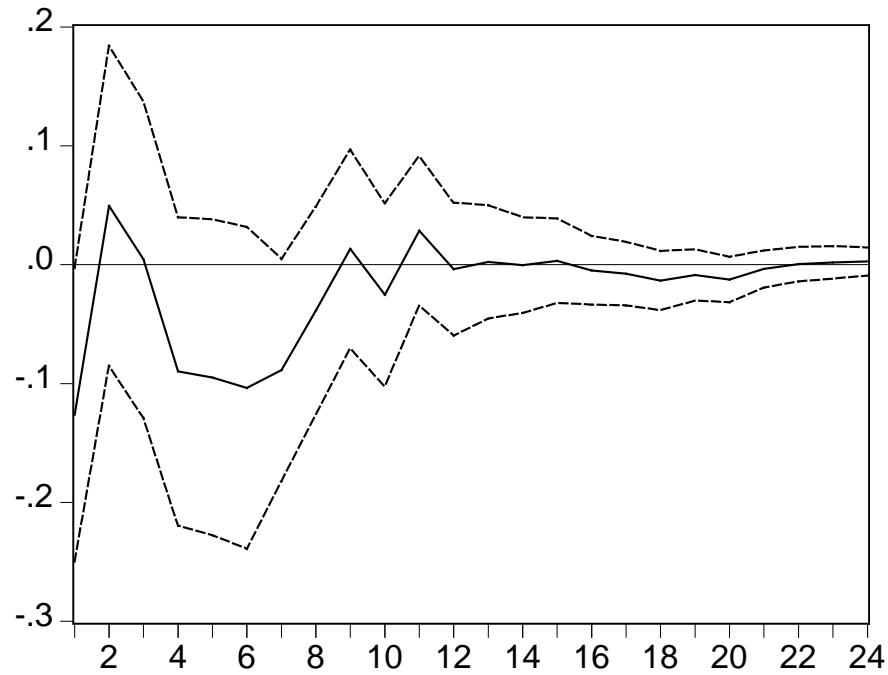
- Alvin Hansen – *Guide to Keynes*
- "In fact, the United States during the thirties (especially from 1934 on) was a good example [of a liquidity trap]."
- Paul Krugman – *Its Back*
- "in the late 1930s and early 1940s it seemed quite natural to assume that money was irrelevant at the margin."

# Keynes – *The General Theory*

“There is the possibility, for reasons discussed above, that, after the rate of interest has fallen to a certain level, liquidity-preference may become virtually absolute in the sense that almost everyone prefers cash to holding a debt which yields so low a rate of interest. In this event the monetary authority would have lost effective control over the rate of interest. But whilst this limiting case might become practically important in future, I know of no example of it hitherto. Indeed, owing to the unwillingness of most monetary authorities to deal boldly in debts of long term, there has not been much opportunity for a test.”



# The response of the junk bond yield to a one standard deviation innovation in M2, Cholesky decomposition.





**Figure 6. The Response of the Junk Bond Yield to Money, 1934-1941, Quarterly Data**

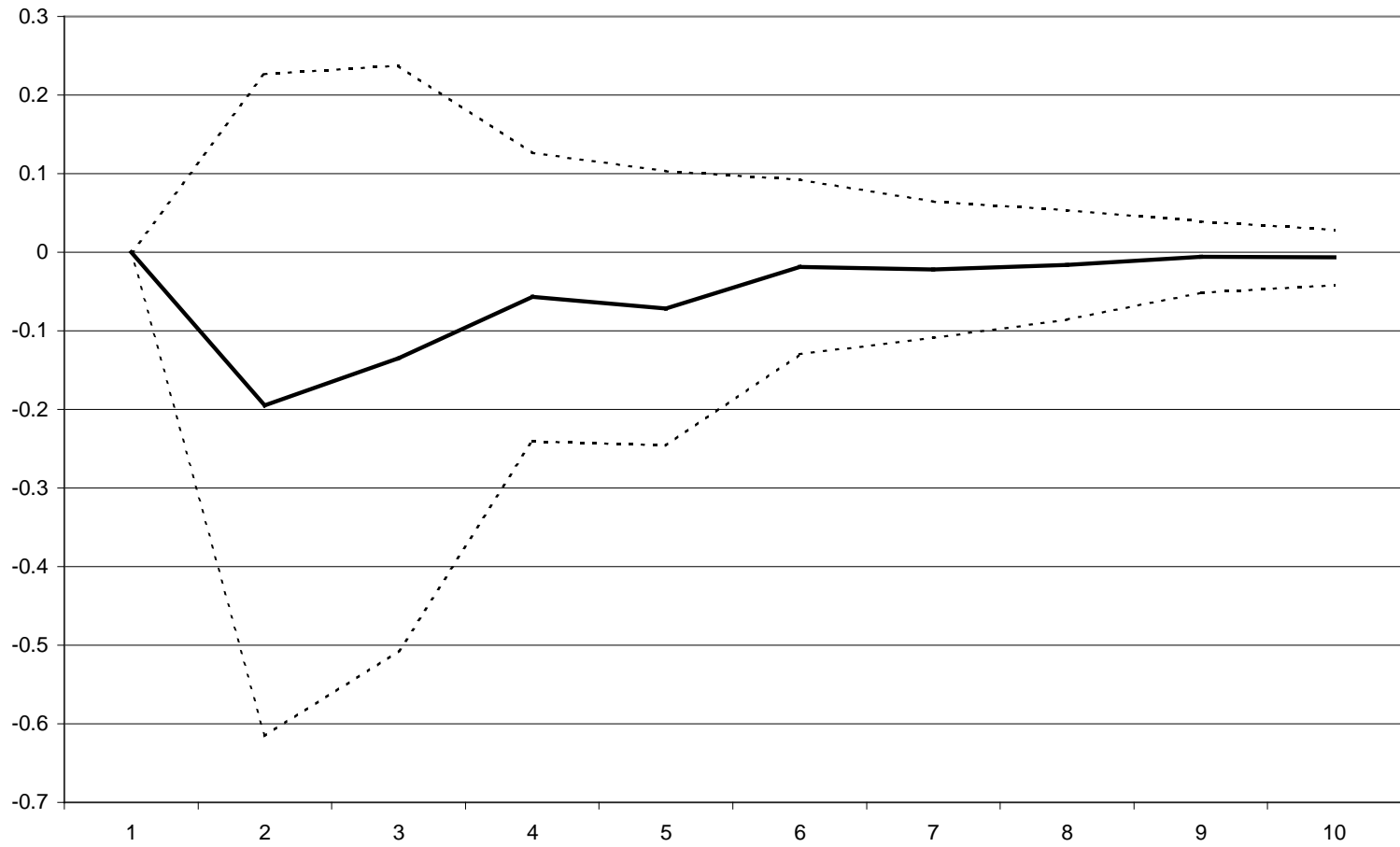
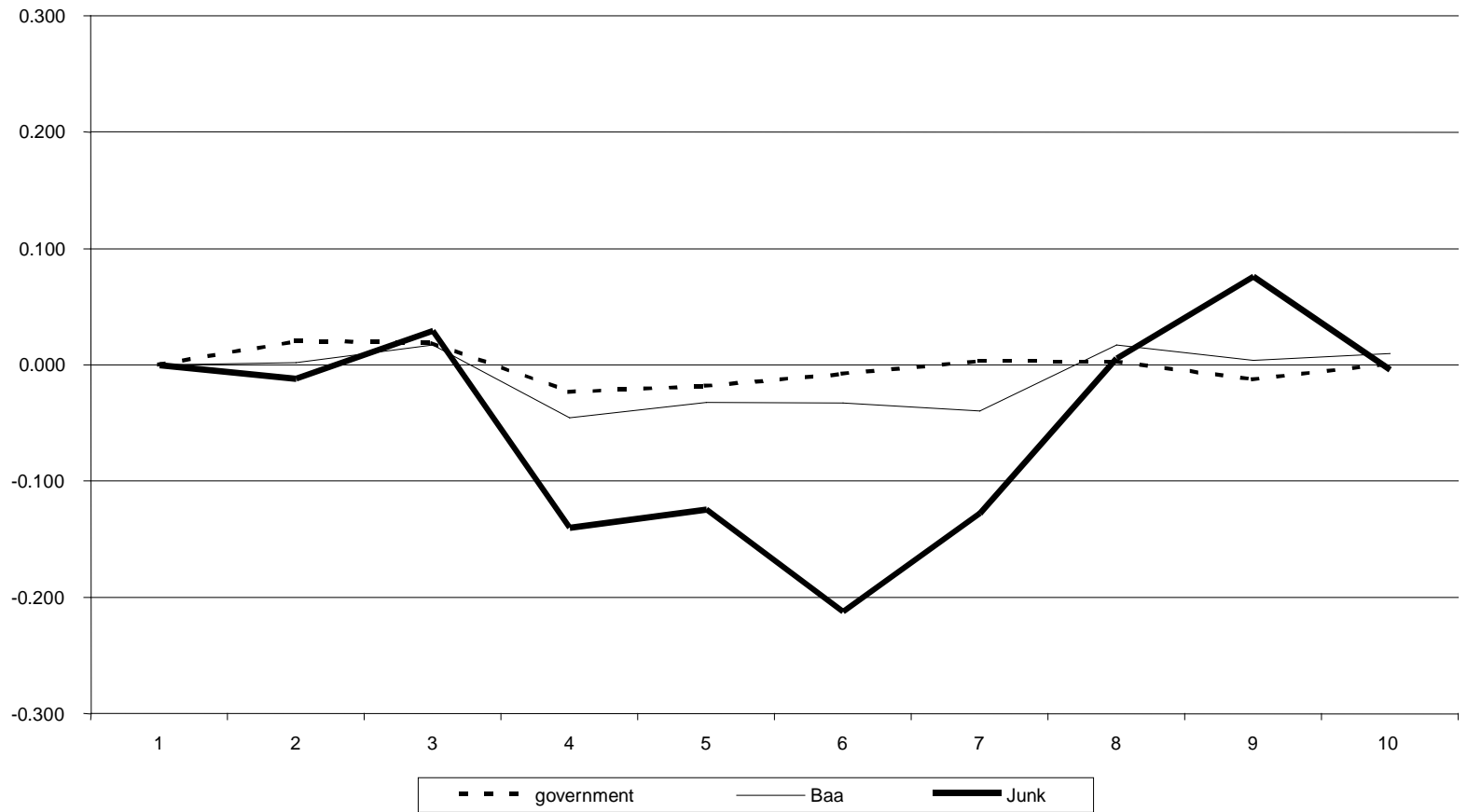


Figure 5. The Response of Selected Yields to Changes in M2 Growth, 1934-41



# Pebble in the Pond or a Tsunami?

- Pebble in the Pond?
  - Big impact where the pebble lands initially
  - Effect on short-term governments is the whole story
- Tsunami?
  - Small impact on the ocean, big impact when it comes ashore
  - Impact is greater the farther away the asset is on the quality spectrum
    - Aaa bonds look similar to T-bonds
    - Baa respond more than T-bonds
    - Junk-rated bonds on average 3 times more than T-bond