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REC'D IN RECORDS SECTION
SEP 15 1958

~~September 11, 1958~~

To Members of the Federal Open Market Committee and Presidents of Federal Reserve Banks not presently serving on the Federal Open Market Committee

From R. G. Rouse, Manager, System Open Market Account

Attached for your information is a copy of a confidential memorandum we have prepared at this Bank on speculation in the United States Government securities market.

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SPECULATION IN THE UNITED STATES GOVERNMENT SECURITIES MARKET 1957 - 1958*

MARKET DEVELOPMENTS

Starting late in 1957 and carrying through the middle of August 1958, the United States Government securities market was subjected to a vast amount of speculative buying and liquidation. This speculation was damaging to market confidence, to the Treasury's debt management operations, and to the Federal Reserve System's open market operations. The experience warrants close scrutiny by all interested parties with a view to developing means of preventing recurrences. The following history of market events is presented in some detail to show fully the significance and continuous effects of the situation as it unfolded.

With the decline in business activity and the emergence of easier Federal Reserve credit and monetary policy in October and November 1957, most market elements expected lower interest rates and higher prices for United States Government securities. There was a rapid market adjustment to these expectations. There was also a gradual shift from the stock market to the bond market by many speculative-minded persons, and especially brokerage houses. While this trend was noticeable in market purchases of outstanding United States Government securities, it was particularly evident in connection with acquisitions of new Treasury issues, both in exchange offerings through the purchase of "rights" (maturing issues) and in cash offerings through subscriptions of a clearly speculative nature. These activities were possible because credit was readily available on advantageous terms.

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* The material presented in this memorandum was derived, to a large extent, from reports received from various elements of the market (dealers, banks, etc.) in the normal course of business. No special investigation or inquiry was made as the Federal Reserve Bank of New York was not authorized to undertake a broad project of this kind. For this reason it was not possible to get to the bottom of all the reported activities nor to verify all the facts. While some of the statements must be accepted as hearsay, most of them were reported by more than one source. There was some confusion over certain facts since dealers do not mention customers' names in their reports to the Federal Reserve Bank. However, the picture presented is believed to be reasonably accurate.

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Build-up

While the problem came to a head after the June 1958 Treasury refunding operation, it had built up in earlier financing operations, principally those in which new cash was borrowed on intermediate and long-term securities. Treasury offerings of longer-term issues over the period from November 1957 were:

Amount (In millions of dollars)	Issues	Offering Dates
650 1,140	3 7/8% bonds of 1974) 3 3/4% notes " 1962)	Offered November 20, 1957 for cash
1,723 3,827	3 1/2% bonds " 1990) 3% bonds " 1964)	Offered February 3-5, 1958 in exchange for various issues totaling $16.7 billion
1,484	3% bonds " 1966)	Offered February 28, 1958 for cash
3,970	2 5/8% notes " 1963)	Offered April 7, 1958 for cash
1,132	3 1/4% bonds " 1985)	Offered June 3, 1958 for cash
7,300	2 5/8% bonds " 1965)	Offered June 4-6, 1958 in exchange for various issues totaling $9.5 billion

Pre-June financing

3 7/8% bonds of 1974 and 3 3/4% notes of 1962

In the first offering of seventeen-year bonds and five-year notes in November 1957, speculative interest was comparatively mild. This was the first cash offering occurring in the bullish market atmosphere following the shift in System policy. The two issues were heavily over-subscribed--the 3 7/8 per cent bonds being allotted $650 million, or 17 per cent of total subscriptions amounting to $3,816, million and the 3 3/4 per cent notes allotted $1,140 million, or 15 per cent of total subscriptions of $7,785 million. Subscriptions received in New York from what appeared to be speculative sources were numerous but the dollar amounts involved were quite modest. Amounts actually awarded to such subscribers were relatively small since the Treasury made a preferential allotment of 26 per cent to savings-type investors, all others receiving only 10 per cent.

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3 1/2% bonds of 1990, and 3% bonds of 1964

In the exchange operations in February 1958, the amounts of 3 1/2's of 1990 and 3's of 1964 subscribed for did not appear excessive in view of the potential represented by the $11 billion "rights" held by the public. Presumably, subscribers were cautious since no limit was set on the amount of either issue which might be taken in the exchange. Subscriptions received in New York did not indicate excessive speculative interest in those issues, although there were many small to medium sized subscriptions from speculative sources. The 3 1/2's of 1990 were heavily sold by speculators during the subsequent liquidation in June, July, and early August, 1958, but many of those holdings may have been acquired in the market.

3% bonds of 1966

The 3's of 1966, marketed for cash later in February 1958, were heavily over-subscribed--total subscriptions of $6.7 billion were allotted about $1.5 billion, or about 22 per cent. Speculative subscriptions received in New York appeared to be larger in number and amount than in previous issues, indicating that the speculative fever was building up. This probably reflected the fact that the 3 1/2's of 1990 had risen to a premium of about 2 1/2 points at the time of this cash offering. Nevertheless, later liquidation did not include as many of the 3's of 1966 as of other issues.

2 5/8% notes of 1963

Speculative subscriptions for the 2 5/8's of 1963 offered for cash in April 1958 were even larger, even though it was a shorter-term issue and was the largest Treasury cash offering undertaken in some time. Subscriptions totaled $15.7 billion against which $3.9 billion, or 25 per cent, was allotted. By this time the 3 1/2's of 1990 were selling at a premium of 4 1/2 points and the 3's of 1966 at a premium of 1 3/4 points.

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General Comment

In these earlier operations, the effects of speculation were noticeable principally in the higher premiums emerging in the secondary market for the new issues. During this period, speculators tended either to take their profits early or to wait for six months to take long-term capital gains--the latter course apparently being the most popular. Thus, little pressure was felt by the market which was not fully aware that substantial amounts of United States Government securities had passed into speculative hands. No exact measure of the amount so held is available but, as proven by later events, a significant amount had already been purchased by speculators either in the market or on new subscriptions.

June refunding

As early as March reports were circulated in the market to the effect that large blocks of the securities maturing in June were being purchased as "rights" by speculators. Most of these purchases were made through various brokerage houses for their own account and for individual customers, especially by the firm of Garvin, Bantel & Company which has been active for many years as a money market broker. (Activities of that firm will be described in more detail below). The success of the preceding exchange and cash offerings, and the sizable premiums on the resulting new issues, inspired visions of even greater profits on the new issues arising out of the June refunding, which was expected to include a long-term issue as a means of further extending the maturity of the public debt. Reports were circulated in the market that Garvin, Bantel & Company and other brokerage houses were actively recommending purchase of the June "rights" to their customers as a speculation and as a tax-avoidance scheme. Some individual customers of dealer-banks made purchases direct from the dealer departments of those banks, apparently on advice received elsewhere, since banks and United States Government securities dealers were not actively encouraging that type of activity, so far as can be ascertained.

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As the refunding date approached, reports of sizable purchases of "rights" by speculators became more frequent, and premiums on the recent new issues remained high, though not at the peaks reached in April. On May 29, the 3 1/2's of 1990 were quoted around 106 10/32, the 3's of 1966 around 102 3/4, and 2 5/8's of 1963 around 101 1/4. Although the market was unable to judge accurately the total amount of the "rights" in speculative hands, Government securities dealers were aware of the fact that these holdings were sufficiently large to create problems in the refunding operation, and expressed considerable concern that brokerage houses were encouraging speculation. These comments were passed on to the Treasury Department but there appeared to be no action that could be taken to curb these activities unless the Government securities dealers were to refuse to sell to speculative buyers, or unless banks and others were to refuse to finance these purchases. Competition between dealers and between financing sources appeared to rule out these possibilities.

On the surface, however, the June 1958 refunding proceeded without difficulty and with every sign of being successful. "Rights" commanded a premium of as much as 13/32 until after the offering was announced on Friday, May 29. On Monday, June 2, the premium dropped to 7/32 on the assumption that speculative holders would want to sell inasmuch as they were offered only a seven-year bond rather than a longer-term issue. Selling was very light, however, and when the books opened for the exchange on Wednesday, June 4, a good demand brought the premium back to about 12/32. There was even speculative buying of the new 2 5/8 per cent bonds on a "when-issued" basis.

The opening of the books on the cash offering of 3 1/4 per cent bonds of 1985 on June 3, apparently had little effect on speculative holders of the "rights", who seemed to believe that the premium on the new seven-year issue offered in exchange would warrant their retaining the speculative position in

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the "rights" and the new 2 5/8 per cent bonds. While considerable speculation appeared in the cash offering of the 3 1/4 per cent bonds, subscriptions received in New York did not indicate any overwhelming excesses in that issue--undoubtedly because of the Treasury requirement of a 20 per cent down payment on subscriptions received from others than banks. Despite the announcement on Thursday, June 5, of a somewhat larger-than-expected allotment on the 3 1/4's, the exchange "rights" and the new "when-issued" 2 5/8 per cent bonds were not adversely affected, and enthusiasm for the exchange continued through the closing of the books on June 6.

Some suspicion of the precarious technical state of the market arose with the announcement on Tuesday, June 10, that $7.3 billion of the total $9.5 billion of refunding had gone into the 2 5/8 per cent bonds; the market had previously estimated that about $4 billion of 2 5/8's would be issued. It was evident that excessive amounts had been taken by speculators, and also, very surprisingly, by corporations which normally would have exchanged for the one-year 1 1/4 per cent certificates. However, the price of the 2 5/8's held at premiums of as much as 10/32 through that week. Another suspicious sign developed at the end of the week when the brokerage firm of Garvin, Bantel & Company tried to persuade various Government securities dealers to postpone delivery on June 16 of 2 5/8 per cent Treasury bonds purchased on a "when-issued" basis, evidently because of difficulties encountered in financing these purchases.

Liquidation Phase

Up to this time, any real difficulties had been prevented by the strong underlying bullish market sentiment, based on anticipations of a continuing business recession, maintenance of credit and monetary ease, and falling interest rates. The market was obviously vulnerable to the shift in these expectations which was touched off on Monday, June 16, the effective date of

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the exchange, by the appearance of press articles reporting improvement in business conditions and suggesting that a prolonged downward movement in bond prices might soon begin. This development immediately resulted in selling by speculative holders of the new 2 5/8 per cent bonds who became increasingly nervous as the price of that issue approached par. At this stage, there was little selling by speculators of other Treasury bonds, such as the new 3 1/4's of 1985 and 3 1/2's of 1990 which issues later came into the market. By Thursday, June 19, another press report along the same lines indicated that the Federal Reserve saw a turning point at hand and was shifting its policy away from easier credit. There followed greater waves of selling not only of the 2 5/8's but of other Treasury issues, producing price declines of as much as 1 1/8 points, so that the new 2 5/8's quickly dropped below par.

The implications of these events for the Treasury were extremely disturbing in view of the necessity of carrying out the refunding of the August maturities in mid-July and a further borrowing of cash shortly thereafter. The Treasury, therefore, set out aggressively to purchase the 2 5/8's on a declining price scale in an effort to cushion the downward price movement and to achieve more stability in the market. At the end of the June 25 statement week, the Treasury had purchased a substantial amount of that issue, as well as smaller amounts of other issues which were pressing on the market. Prices of the 2 5/8's declined to as low as 99 6/32, the new 3 1/4's to 99 18/32, and the 3 1/2's of 1990 to 103 14/32, about 3 1/4 points below the high reached in April. Market confidence was badly shaken by the continued offerings, and buying, aside from the Treasury's purchases, was very light in relation to the supply; dealers were reluctant to make markets in the issues under pressure, bids being almost non-existent. It was evident from reports by dealers that most of the selling came from brokerage houses; individuals were being forced to sell out, at least in part, because they could not meet calls for additional margin as prices declined.

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While the market became steadier up to July 1, the underlying tone was weak and another sharp wave of liquidation hit the market on July 1 and 2, resulting in further Treasury purchases of the new 2 5/8 per cent bonds in the amount of $233 million on those days, together with small amounts of other intermediate issues. The market was seriously upset by further discussions of the market implications of better business conditions and by the growing realization of the size of the speculative interest in the market. After the extensive liquidation which had already taken place, selling by speculators continued unabated and the market was convinced that large amounts of bonds were still in speculative hands. Investment buying was almost entirely absent in the light of these expectations. Despite temporary rallies, the market declined further through July 9 and the Treasury purchased another $146 million of 2 5/8 per cent bonds, making total purchases of $589 million in this issue.

On Thursday, July 10, the market rallied strongly and signs of confidence began to return after the Treasury announced that it had purchased the $589 million of the new Treasury bonds, of which $456 million would be redeemed in recognition of the fact that the Treasury had over-issued these bonds. The market welcomed that announcement as an indication that bonds in the hands of speculators had been substantially reduced, and that the Treasury probably would confine its August refunding to a short-term issue. The market held quite firm until July 14, when the news of the Iraq coup d'etat set off another sharp decline, resulting in mark-downs for the day on longer-term issues of as much as 1 22/32 points. Selling was light, however, until late the next day when a further decline developed, featured by sales from speculative sources and apparently forced by margin calls resulting from the previous day's price declines. Small amounts of 2 5/8 per cent bonds were again purchased by the Treasury but these purchases appeared futile in view of the weight of speculative holdings apparently still overhanging the market.

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After brief rallies on July 16 and 17, the market again declined sharply on Friday, July 18, despite the Treasury's announcement of the terms of the August refunding, which was confined to a one-year certificate. Speculative selling was again a major factor in producing sharply lower prices, but this time it was accompanied by sales by institutional investors who were becoming increasingly alarmed over the state of the market. Bids for securities disappeared almost completely. The market felt that if the $600 million Treasury purchases had not cleaned up these holdings, the amounts of securities still in speculative hands must be immense.

These developments brought the Federal Reserve into the market on July 17 and 18 as a buyer of long-term issues, including those issues which had been under pressure of speculative selling. This move quickly turned the market around and temporarily dried up the selling waves. System purchases of the longer-term issues and the new 2 5/8 per cent bonds were not as extensive as the earlier purchases by the Treasury. However, a sizable amount of the new 1 5/8 per cent certificate offered by the Treasury in the August exchange was purchased by the System on a "when-issued" basis to assist the Treasury's refunding operation. Market interest centered in the exchange while the subscription books were open from July 21 through July 23 and prices of long-term issues remained fairly steady during that period. However, earlier market declines and speculative selling had weakened confidence in the future of the market to the point where the Treasury's refunding operation could have been almost impossible had the System not stepped in. The relationship between speculative excesses in the longer-term issues and the refinancing of the short-term issues was, of course, not direct, and the refunding difficulties reflected in large part, expectations of improved business conditions and more credit restraint resulting in higher short-term rates. But there is no denying that the whole market had been badly upset by behaviour of the long-term market over the preceding month.

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On Friday, July 25, when the Treasury announced a cash offering of $3.5 billion 1 1/2 per cent Tax-Anticipation Certificates due in March 1959, the market was fairly steady, but on Monday, July 28, the long-term market fell sharply--a most disturbing development coming just before the opening of the books on July 29 for the Treasury's new cash offering. Prices continued to drop on that day and the situation again became close to being demoralized. Offerings again came largely from speculative sources, although some institutional liquidation showed up on July 29; there was a virtual absence of buying. No action was taken by either the Treasury or the Federal Reserve System to stabilize the market, despite the current financing operation, and the sharp decline at this point developed partly because of a growing awareness of the System's withdrawal from the longer-term market.

Another short period of relative stability followed, although it was tempered by the belief that large amounts of bonds might still be in speculative hands.

Late on Monday, August 4, the Board of Governors of the Federal Reserve System announced an increase in margin requirements from 50 to 70 per cent, and the United States Government securities market dropped sharply on Tuesday, August 5, as this action was widely interpreted as an initial move by the System to tighten credit. Speculative offerings, including several large blocks of the 2 5/8's of 1965, came into the market and quotations fell rapidly as bids became scarce. Prices declined as much as 7/8ths of a point on that day and continued through the following Monday under pressure of speculative sales, a large part of which again resulted from margin calls; some investment selling also developed. Losses in the longer-term bonds over this week ranged up to 3 3/4 points. An unusually sharp drop on Monday, August 11, brought the 3 1/2's of 1990 to a low of about 95 14/32, the 3 1/4's of 1985 to 92 2/32, and the

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2 5/8's of 1965 to 94 30/32. It is noteworthy that pressures on the 2 5/8's of 1965 were less extreme in this decline, indicating that the speculative holdings were substantially reduced.

A substantial rally developed on Tuesday, August 12, when prices rose, in some instances, by more than 1 1/2 points. During the course of this rally reports circulated that some speculators were beginning to buy back the issues they had sold earlier in an effort to average out their losses. There had been occasional reports of this tendency on early upswings, but buying of this type appeared to be in small lots.

From this point on, the market swung quite widely with price gains and losses ranging to as much as 1/2 point, but the speculative influence was gradually diminishing--dealers reported that speculators were generally either sold out or had large margins against their remaining holdings. There have been some reports of sizable blocks still in the hands of speculators but this has not been disturbing to the market. It is also reported that large corporations are still substantial holders of the 2 5/8 per cent bonds acquired as a speculation in the June exchange, but that these holdings are well frozen by the low market price of the issue.

In the two-month period from the middle of June through August 11, prices of long-term bonds declined more than 10 points, a rise in yield from about 3.20 per cent to 3.70 per cent. This is probably the sharpest price decline over such a short period in the modern history of the Government securities market. The washing out of 10 per cent of market values in such drastic declines, with the market practically non-existent, was bound to undermine investor confidence.

FINANCING

A key factor in this speculative episode, in addition to market expectations of continuous rising prices, was the ability of speculators to

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finance their purchases readily at advantageous rates, and particularly on small margins. This type of financing was obtained from banks, and even from corporations. Most of the borrowing from banks was placed outside of New York since only two of the larger local banks made loans or repurchase agreements, and these in moderate amounts, for that purpose. Banks and corporations all over the country became involved as loan brokers and many stock brokerage houses made strenuous efforts to find financing for speculators. Stock brokerage houses apparently put their customers into Government bonds and either found financing themselves or placed the financing through loan brokers. Some of the large New York City banks discovered that their customers were taking speculative flyers, but the banks had little or nothing to do with financing the purchases. It is impossible to measure the part of the various participants in these activities. Available evidence, however, indicates that impetus to the speculation arose, to a large extent, from firms who were in the business of placing financing or who were in a position to do so readily. It was reported that such firms were actively soliciting that type of business on the ground that the business promised sure profits and, in may instances, tax advantages.

Much of the financing by banks was on a collateral loan basis, with margins running from as much as 5 per cent down to 1 per cent, and even with no margin at all, in some cases. One small New York City bank was reported as having required no margin.

One of the complications connected with the financing of "rights" in the June refunding arose from the fact that many lenders required only small margins against the June "rights"--as would be expected on such a very short-term obligation. However, when borrowers exchanged the "rights" for the new 2 5/8 per cent bonds on June 16, the lenders immediately called for more margin on that seven-year obligation. Apparently, the borrowers and loan brokers had

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not anticipated this development which was a factor in aggravating the market decline at that point. Calls for additional margin by financing institutions represented a major aggravation in numerous later waves of selling. A sharp decline in the market on one day was frequently followed on the next day by margin calls which caused more selling in a secondary wave since borrowers were unwilling or unable to supply additional margin.

Financing by means of repurchase agreements was supplied by banks and corporations, corporate lending being confined solely to repurchase agreements. In most cases, the agreements were reported to have been made on an open basis, that is, they could be terminated at any time after June 16 at the option of either party. It is difficult to understand why corporations would enter into this type of business but it was probably the result of high-powered salesmanship by loan brokers and lack of awareness on the part of corporations of the risks involved. In addition, as money became easier in the first half of 1958 and Treasury bill rates declined sharply, corporations found it increasingly difficult to place repurchase agreements and to make other short-term investments at advantageous rates. In many cases, the repurchase agreements offered by loan brokers against speculative holdings allowed the corporation to earn the coupon on the underlying securities rather than to be paid interest by the speculator probably at a much lower rate; such arrangements were thus very attractive to corporations on a rate basis. Corporation activity in this field had the additional effect, at times, of reducing the availability of repurchase agreements to United States Government securities dealers.

The financing of speculators by corporations probably was an important factor in aggravating the initial market declines on and after June 16. The Treasury had issued no tax-anticipation obligations which corporations could use to pay June taxes and, because of the premium of several 32nds on the June

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"rights", corporations were reluctant to buy these maturing issues for redemption to pay their June taxes. Corporations thus found it advantageous to make repurchase agreements maturing on June 16, and were willing to do this against bonds involved in speculative operations. However, when these agreements matured, on June 16, speculators either had to find other financing or sell out. Efforts to work out these situations pointed up the vulnerability of the market and were an additional disturbing influence at this critical point.

TAX CONSIDERATIONS

According to reports by dealers, many wealthy individuals in the higher-income brackets purchased "rights" to the June refunding for tax reasons. Several tax advisers were said to be widely recommending this move and were making the necessary financing arrangements through loan brokers. Apparently, several different schemes were devised in order to gain tax advantages but details of these various methods were not clearly discernable.

The weakness in all these schemes was that participants expected the securities involved to remain at a premium--none of them suspected that prices could drop as low as was the case; in fact, some may have expected a substantial profit as well as a tax advantage. This points up the difficulty of trying to separate tax angles from speculative considerations. Thus, it probably would not be possible to spot certain transactions as being effected strictly for tax purposes and others for pure speculation.

Furthermore, tax considerations clearly influenced the timing of sales, even where holdings were acquired for strictly speculative purposes. Dealers reported that holders of securities purchased around the end of the year, tried to hold them for six months if they still had a profit, in order to take a long-term capital gain. On the other hand, holders of 3 1/2's of 1990, acquired in the exchange offering made in February 1958, were inclined to sell before August 15

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in order to achieve short-term capital losses. Similarly, those who made speculative purchases of other issues in the market also moved to sell within the six-month holding period when faced with unavoidable losses.

ROLE OF GARVIN, BANTEL & CO.

According to reports from banks and Government securities dealers the firm of Garvin, Bantel & Co., a member of the New York Stock Exchange, was the most active of the firms acting as money brokers in arranging financing for speculative purchases of United States Government securities. Other firms reportedly were conducting a similar business on a smaller scale, but apparently did not get into such an unbalanced position as Garvin, Bantel & Co. Many of them acted more as securities brokers, with the placement of loans a secondary activity.

During the early part of 1958 reports were circulated that Garvin, Bantel & Co. was extremely active in the United States Government bond market, trading in bonds in the same manner as a United States Government securities dealer. In fact, in one of the earlier cash offerings during the year, that firm quoted the new securities on a "when-issued" basis before the subscription books were open; at our request it ceased that practice. However, it became evident to the dealers that Garvin, Bantel & Co. was purchasing sizable blocks of various Government security issues, particularly "rights" to the June refunding, as early as three months before that refunding. These purchases of "rights" continued at rising prices as the refunding date approached, and premiums of as much as 13/32 were paid. The market generally was well aware of that firm's activity but it had no conception of the overall size of its operations.

Garvin, Bantel & Co. apparently had several methods of transacting this business. Since the firm had conducted a money broker business for many years, it was normal for it to act strictly as a broker in many transactions,

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merely placing the financing in the customer's name where it was feasible to do so. However, where repurchase agreements were placed with corporations, the customer would be unknown to the corporation. Thus, the firm would buy the securities, place the repurchase agreement with the corporation, and contract to repay it, all without revealing for whom the firm was acting. Tax considerations may also have required that the contracts be made in the firm's name. At one point, we inquired of Mr. George Garvin as to his firm's status in these transactions since we had heard it was purchasing bonds in its own name. He informed us that his firm had no position, but this proved to be misleading since the firm had commitments both to buy and sell in connection with the repurchase agreements described above. These consisted of commitments to buy back securities, from the lenders, and commitments to sell to the firm's customers who were to take up the securities at the termination of the financing. Sizable amounts of such repurchase agreements were apparently placed with corporations. It may well be that the corporation treasurers considered the contracts as equivalent to the financing of dealer portfolios, since the contracts were in the firm's name, and did not realize the overall size of the operation and the seriously extended position of the firm as a principal in these transactions.

Mr. George Garvin told this Bank that all his commitments represented tax transactions and not speculative operations; this may have been true when many of the commitments were made, but the speculative factor assumed importance as the opportunity for profits became more apparent. Mr. Garvin also claimed that no risk was involved for the firm because of the offsetting commitments; later developments proved otherwise. Shortly after the first market break in mid-June, Garvin, Bantel & Co. was reported as attempting to sell large blocks of the new 2 5/8's and as being disturbed because a market could not be found for those blocks. Mr. Garvin even called the Federal Reserve Bank to complain

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about the lack of a market. Several dealers were asked to sell large blocks of those bonds and the firm continually pressed the dealers for progress. At this point, the liquidation came from situations where the commitments were not in Garvin Bantel's name, and where the customers decided to sell on their own initiative.

Subsequently, around the first of July, the firm undertook to terminate the commitments in its own name, in order to relieve itself of the excessive liabilities involved. The firm requested each customer to take up the commitment, to purchase the securities, or to finance the contracts separately. The customers' decisions on how to handle their commitments were made over a number of days, and were governed by their willingness and ability to find financing and to put up additional margin in many cases. In those cases where customers were willing to take over the bonds and hold them, financing presumably was obtained in the customer's name, but aggressive attempts to find such financing spread the word among banks that Garvin, Bantel & Co. was in trouble and raised estimates of the amount of bonds still in speculative hands. We understand that of some $500 million bonds involved in such contracts, nearly $200 million were sold through Garvin Bantel & Co. for account of customers who did not take up or finance the bonds. The firm did not take any losses on these sales as it apparently had the right to sell the customers out under the contracts, although some of the transactions are still in dispute between the two parties.

The firm's attempt to sell the bonds involved in these and other financing arrangements through a number of dealers greatly increased the pressure on the market. The large amounts of bonds offered for sale by Garvin, Bantel & Co. late in June were a major factor in inducing the Treasury to start its large-scale purchases of the new bonds, a substantial amount of which undoubtedly came from or through Garvin, Bantel & Co.

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Efforts to liquidate speculative holdings were frequently complicated by the inexperience of the individuals who actually owned the bonds. This fact was particularly true in some of the large transactions in which Garvin, Bantel & Co. was involved. That firm was itself over-aggressive at times in showing blocks around the market and appeared to have little control over the owners. In one instance late in July, a block of $30 million 2 5/8 per cent bonds of 1965 which had been financed on bank loans was shown for sale simultaneously to three different dealers as well as through Garvin, Bantel & Co. This situation greatly confused the dealers, who were not sure of the actual amount of bonds for sale, and there were rumors of a much larger amount of bonds overhanging the market than was actually the case at the time.

Although not directly related to Garvin, Bantel & Co., another tendency which aggravated price movements was the inclination of speculators to sell regardless of price. It made no difference whether the price represented the current market bid or 1/4 or 1/2 per cent lower--their only interest was in getting out. Most professional investors in United States Government securities would be much more cautious in attempting to liquidate in a weak market. Pressure of margin calls probably made it more difficult for speculators to be cautious, but panic psychology was undoubtedly a major factor in producing the extreme price declines. The developments mentioned above reveal the unfamiliarity of speculators with the functioning of the United States Government securities market and their unawareness of the probable consequences of their actions.

Losses of speculators probably were substantial--the $30 million of 2 5/8 per cent bonds, referred to above, was sold at a price of around 95, which represented a loss of at least 5 points, or $1.5 million, assuming the bonds were acquired at par or above. This particular block was reported to be owned by a group of very wealthy individuals. Losses of this magnitude should

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have been a severe deterrent to further speculation in United States Government securities, but dealers reported that speculators were buying back the Government securities they had previously sold. Most of these purchases were apparently small and were reportedly designed to average out losses, as might be done in the stock market.

We understand that all of the repurchase agreements in which Garvin, Bantel & Co. was principal have been terminated. A fair guess would be that the bulk of other speculative holdings financed through that firm also have been liquidated. Those blocks which remain probably are so heavily margined at this point as to present no immediate threat to the market, and the same probably applies to speculative holdings not connected with Garvin, Bantel & Co. However, since it is difficult to believe that values will be restored within the near future to a point where these holders can recoup their losses, one is forced to conclude that even the well-margined holdings might eventually be liquidated. As such a development would probably be a gradual process, it presents no immediate threat but it cannot be ignored as a possibility.

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ROLE OF UNITED STATES GOVERNMENT SECURITIES DEALERS

As far as is known, none of the United States Government securities dealers actively recommended speculation in Government securities for individuals--some say they tried to discourage it. However, practically none of the dealers refused to sell "rights" or other securities to Garvin, Bantel & Co. or to any of the other firms involved in the speculative activities, (at least until close to the end of this episode) even though the dealers were fully aware of the intent of those purchases. The dealers repeatedly commented that these people should not be in the market and expressed fears for the long-run welfare of the market under the circumstances.

On balance, dealers had large long positions in Treasury bonds through May and into June 1958, since they were still thinking in terms of a continuing demand for securities. With the development of heavy selling and rapidly declining prices, dealers retrenched by cutting down their long positions until they were close to even in the longer maturities. Their efforts to protect themselves tended to aggravate the price declines and resulted in a reluctance to make markets when the pressures were extreme.

The question might be asked whether dealer short selling added to the downward pressures generated by liquidation of speculative holdings. There is no evidence that dealers sold short for more than brief periods as a means of improving their ability to take on additional securities which were pressed on the market at declining prices. Most of the short sales were made to retail buyers as prices reached levels attractive to bona fide investors. Some of these transactions represented hedges against long positions, a normal dealer function.

As to short sales by others, there is no direct evidence that this was taking place. Reports indicated that selling by speculators through the two-month period starting in mid-June was entirely actual liquidation of speculative

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holdings. It seems unlikely that individuals would sell short because of the interest loss involved and because of their unfamiliarity with the Government securities market. Brokerage houses might conceivably have made short sales, but only one report of such sales was made during that period. A small investment dealer in Boston telephoned to this Bank in early August and said he was certain that some of the brokerage houses, which had been active in putting customers into Government securities, were selling short in order to take up bonds cheap from some of their customers. He asserted that he was interested only because this practice was hurting "his friends" and not because he had a direct interest in the matter. However, it was learned that this dealer had been active in encouraging customer speculation.

In the early stages of the speculative boom some Government securities dealers were reported to be selling bonds to speculators on a delayed-delivery basis. The dealer would sell at a price near the current market price for delivery several weeks, or even months, in the future and would simultaneously buy the bonds in the market to hold until the delivery was to be made. The speculator thus expected to take up the bonds at a future date and to resell them at a substantial profit. The dealer would, of course, earn the coupons on the bonds as long as they were held in his position, and had the protection of the purchaser's commitment to take delivery and pay for the bonds on the specified date, so that there was no market risk to the dealer, assuming that the purchaser's credit was good. However, it is questionable whether dealers did much of this type of business, especially after they became aware of the extent of the speculative interest in the market. Most larger dealers would not normally trade with individuals and would not want to rely on the commitment of an individual to take future delivery, particularly where the transaction was an obvious speculation. Some of the smaller dealers may have made trades of this sort, but probably few of the larger ones did so.

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SUMMARY

The 1957-58 episode of large speculation in United States Government securities is apparently nearing a close, with speculative positions reduced to manageable or tolerable proportions. Nevertheless, this is an appropriate time to review the facts surrounding the episode as a step in considering whether preventive measures are required and, if so, what measures should be taken.

1. From June 16 through August 12, 1958, the Government securities market went through one of the most disorganized periods in its history; it was so disorderly as to require intervention by the Treasury and the Federal Reserve System. Price declines were exceedingly rapid and extensive, and trading at times was at a virtual standstill, leading to complaints that there was no market.
2. Market unsettlement was fundamentally caused by a shift from expectations of easy money to expectations of tighter money, but the basic problems were greatly aggravated by speculation. It is reasonable to assume that had there been less speculation, price swings would have been more moderate and price declines less rapid.
3. A great many individuals and other non-professionals entered the Government securities market as speculators.
4. The resulting loss of confidence in the United States Government securities market was probably greater than was warranted and created almost insurmountable problems for Treasury debt management, since the Treasury was

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forced to do its August refunding in the midst of drastic price declines which reduced interest in the new issues almost to a minimum--future Treasury financing operations will probably suffer as a result.

5. System credit policy was hampered in that it became necessary for the System to make large purchases of Government securities in the market, thereby providing bank reserves beyond the limits of System objectives. Fortunately for System policy it proved possible later to absorb these excessive reserves.

6. The results of these developments were so undesirable, and the possibilities of even more serious results in the future are so great as to warrant some action to prevent speculation on such a large scale; some degree of informed speculation is, of course, unavoidable and necessary.

7. The main factors encouraging this large scale speculation consisted of expectations of substantial profits and the availability of easy credit. The maintenance of easy credit conditions reduced short term interest rates to a point where banks and corporations found the financing of speculation attractive since it resulted in a greater return than on other more normal short term investments.

8. It is inconceivable that expectations of profit ever could or should be eliminated from the securities markets--curbing profits and speculation in Government securities presumably could be accomplished by direct regulation of the market,

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but this would be contrary to our concept of a free market and would tend to destroy the market as a mechanism for financing the Government and for implementing System credit policy.

9. This memorandum is not intended to explore the ways in which speculation may be curbed since that would require considerable further study. Another speculative spree, such as the recent one, is not likely to occur again for some time--there should be time to work out a well-reasoned solution.

FEDERAL RESERVE BANK OF NEW YORK

September 10, 1958