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Beware of when the debt collector comes calling

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Borrowing money to buy stocks is as old as the stock market. Every era dresses it up in new clothes. In 1929, an American could buy $100 of stock with $10 down, and everyone from chauffeurs to senators did. This summer's model made its debut in South Korea. The wrapper was new. The ending was not.

Once again, the monthly scoreboard belied the turmoil underneath. The S&P 500 slipped 0.1 percent to close at 7,490. The Dow rose 0.3 percent for its fourth straight winning month. The Nasdaq fell 3.2 percent. Under the hood, it was one of the wildest months in years. A $45 billion American hedge fund was forced into liquidation. The world's hottest stock market, South Korea's, fell almost 11 percent in a single day. American semiconductor stocks dropped 20 percent while their businesses reported unprecedented orders, profits and backlogs.

The KOSPI, Korea's version of the S&P 500, was until July the best-performing major market, roughly doubling in a year. Two companies, Samsung Electronics and SK Hynix, make most of the world's memory chips (the foundation of the artificial intelligence boom) and together represent roughly 60 percent of the KOSPI index. In late spring, Korean brokerages began marketing funds that borrowed money to double the daily moves of those two stocks, and margin debt hit all-time records. The average small investor was carrying about three borrowed dollars for every one of their own.

An investor who owns shares outright can ride out any storm. An investor who borrows to buy shares cannot, because when the price falls far enough, the lender wants its money back. That demand is a margin call, and investors who cannot pay have their shares sold for them at whatever price the market offers. Here is the vicious part: the forced sale pushes prices lower, which triggers the next investor's margin call.

Memory chip prices cooled only modestly in early July, but that was enough. By late July, 1.2 million Korean accounts had received margin calls, and some 360,000 were sold out entirely. That's roughly one working-age South Korean in 30. On July 28, the KOSPI fell 10.8 percent in a single session. Regulators banned new leveraged funds and tripled the cash required to trade the old ones, arriving, as regulators usually do, after the horse had left the barn.

A crash in Seoul may sound like somebody else's problem. It is not. Most diversified American portfolios hold these companies through international funds, and the world's investors treat the entire AI supply chain as one trade. Samsung and SK Hynix chips fill American data centers, so when forced sellers in Korea dumped those shares, traders worldwide marked down everything related: Micron, Intel, Nvidia, the equipment makers — all of it. That is how the Philadelphia Semiconductor Index of American chipmakers lost 20 percent in a month. Anyone who owned a technology fund, or a plain S&P 500 index fund, absorbed a sliver of Seoul's margin calls without ever placing a trade.

The month's other casualty was homegrown. A 24-year-old former AI researcher ran a $45 billion hedge fund called Situational Awareness, which owned the AI build-out in concentrated form: chipmakers including SK Hynix and Micron, data center operators, and the power companies that feed them, hedged with bets against software companies such as Adobe. The fund reportedly held about four dollars of stock for every dollar of its investors' capital. In July the trade failed at both ends: the chip and infrastructure holdings fell 35 percent to 47 percent, dragged partly by the Korean unwind, while the software stocks the fund bet against rallied. The fund's banks issued margin calls, and on July 30, Citadel, the firm founded by Ken Griffin, bought the entire public portfolio to keep the wreckage contained. John Maynard Keynes gets credit for the warning that "markets can stay irrational longer than you can stay solvent."

The Federal Reserve added its own tension. The committee held rates steady on July 29 over three dissents in favor of an immediate hike for the sharpest split in years. Chairman Kevin Warsh cut the policy statement to 130 words, offered no guidance, and declared the Fed has "no tolerance for persistently elevated inflation." The bond market took the hint and tightened, driving the 30-year Treasury yield above 5.2 percent — its highest since 2007. The data pulled both ways: growth slowed to 1.5 percent, employers added just 57,000 jobs in June, and core inflation sat at 3.4 percent. A central bank staring at weak hiring and hot prices has no good move, so Warsh made none.

Oil made everything harder. The ceasefire with Iran collapsed, attacks on tankers resumed, and brent crude climbed toward $98 a barrel — up more than 30 percent for the month. Energy stocks (the best sector by far) surged 12.8 percent, as money rotated into banks, industrials and health care. Buried in all this is good news: the equal-weight S&P 500, which gives the 500th biggest company the same vote as the first, hit record highs in late July. The average American company is doing fine.

The companies paying for the AI build-out kept paying. Microsoft held its spending plans steady, grew its cloud business 43 percent, and gained nearly $450 billion of market value in a day. Alphabet grew its cloud business 82 percent and fell 7 percent anyway; its spending pushed free cash flow negative for the first time in decades. Meta's free cash flow shrank 91 percent and its shares sank with it. The market stopped paying for promises about artificial intelligence and started paying for cash produced by it. That discipline is overdue, and it favors exactly the kind of company worth owning.

Used wisely, debt is one of the great tools of prosperity. Families buy homes with it and companies build factories with it. What precipitated July's casualties was a particular kind of borrowing: a loan secured by a stock price. A mortgage lender cannot call the loan because a home's value dips this month. A margin loan is remeasured constantly against a price that moves by the second, and can be called at the worst possible moment. July's casualties pledged their stocks as collateral, surrendering an advantage the ordinary investor holds: the freedom to wait. The investor who owns stocks of good businesses outright, in sensible variety, keeps that freedom, and can be early, unlucky, or temporarily wrong and still come out whole and even ahead.

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