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Financial Panorama

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Financial Panorama

by

DOUGLAS H. FULLERTON

M. Douglas Fullerton veut bien nous permettre d'utiliser les chroniques qu'il donne périodiquement à Canadian Banker. *Chaque trimestre, nous en reproduirons une avec l'autorisation de cette revue.*

M. Fullerton est un spécialiste des questions financières. Il est aussi l'auteur de livres qui font autorité. Nous sommes certains que nos lecteurs liront ses articles avec intérêt. — A.

Events, with financial and economic implications, followed each other thick and fast during the month of November. On election day the voters confounded the pollsters by electing another minority government, a result not calculated to contribute to business confidence. The day after the election, a tender for a Quebec Hydro bond issue in the New York market was postponed, and a statement by the Minister of Finance made it clear that the U.S. authorities had requested that Canadian issues be deferred until the quarter beginning January, 1966. The implications were that Canadian borrowers were likely to face some form of rationing in future in their U.S. borrowing, and financial markets and the exchange rate were adversely affected. Then several days later Walter Gordon, Minister of Finance, resigned his portfolio because he felt he had given bad election advice to the Prime Minister. On November 17 it was disclosed that the Johnson administration was moving to tighten the screws on U.S. direct investment abroad, and Canada could undoubtedly expect to experience some reduction in the flow of this form of capital from the United States. Altogether a very unsettling two weeks, and as this goes to press we cannot help but wonder from what quarter the next unexpected blow will come.[1]

It is becoming increasingly clear that the new Finance Minister, presumably Mitchell Sharp who has been appointed acting minister, will have no trouble finding problems to which he can turn his attention. The accumulating signs of pressure on resources posed by continuing economic expansion, and the growing evidence that access to American capital will be limited, will make monetary management an increasingly delicate operation. The minister may well be compelled to reinforce reliance on monetary measures with some of the fiscal weapons available in his arsenal. As an editorial in the *Financial Times* put it recently:

> Tight money as the sole anti-inflationary weapon is unfair and economically undesirable; it has a way of squeezing hardest where the squeeze is least needed.

By November it was clear that money was tighter than it had been in some time. Concern over the head of steam building up in the construction industry, and the two per cent increase in consumer prices recorded early in 1965, led the Bank of Canada in August to limit further expansion in the money supply. Interest rates, already rising in the wake of the Atlantic debacle, rose further still and by mid-November were at their highest level in five years. This upward movement in yields, although accompanied since September by a similar yield rise in the United States, led an increasing number of borrowers to approach the U.S. market. The extent of this borrowing, of course, aggravated the U.S.

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[1] Cet article a été écrit en novembre 1965.

balance of payments difficulties and led to their recent action to slow the pace of Canadian offerings in their market.

The resilience of the Canadian economy has surprised many observers who had been anticipating that signs of weakness would appear before the end of this year. Instead, the expansion picked up, and the economy is straining against the ceiling of available capacity. Industrial production began to rise again in the third quarter after flattening out in the spring; retail sales, seasonally adjusted, rose sharply in August, presumably helped by the tax cut. The seasonally adjusted rate of unemployment in October fell to 3.2 per cent of the labour force, the lowest rate in nine years, and lower than the rate in the United States. A mid-year capital expenditure survey placed the 1965 increase in investment spending at 19 per cent, compared with the 14 per cent increase forecast earlier. However, the effects of monetary restraint appear to be having some effect on the construction boom. The shortage of mortgage money was mainly responsible for the September drop in housing starts.

The first guesses about the outlook for 1966 are now being put forward cautiously. In both Canada and the United States a continuation of the economic expansion at a slower but more sustainable growth rate is expected. Some forecasters are looking for a rise of seven per cent to eight per cent in the value of Canada's GNP, or about 4½ per cent in real terms. Among the factors likely to push the expansion through its sixth year are a continuing high level of capital expenditures, a rise in spending by provincial and municipal governments, and substantial wheat exports. Shipments of wheat to fill the Russian contract will continue through the first half of 1966. The Chinese have promised to purchase a minimum of $200 million worth of wheat over a three-year period beginning in August of next year, and this spring negotiations will take place to determine whether the contract will be enlarged to total sales of \$900 million, stretched over a five-year period.

Continued economic growth in the United States, where forecasters are looking for a four per cent to 4½ per cent increase in real GNP, should also benefit our export trade. A McGraw-Hill survey of capital spending plans put ex-

pected investment outlays in 1966 at a level eight per cent above 1965, and this fall survey is often considerably on the low side. In Britain sterling has escaped once more the immediate threat of devaluation, and the pound appears stronger than it has been in over two years. The British balance of payments recorded a surplus in the second quarter, the trade deficit has continued to narrow appreciably, and sterling reserves have been built up. If the British economy does manage to get on solid ground again, Canadian exports to that country will be sustained and may even rise modestly. Imports into Canada may well accelerate, however, given the capital investment expenditures which always bring with them imports of heavy machinery and equipment, so that the current account deficit in 1966 will not likely be much below the \$1 million level.

The state of the economy and the balance of payments are not the only problems facing the new Minister of Finance. In view of the Atlantic Acceptance fiasco, he may want to take a fresh look at bringing finance and trust companies under the aegis of the Bank Act, as recommended in the Porter Report. With tighter control of capital exports to Canada, will he be as concerned as Mr. Gordon about foreign ownership? Will he abolish withholding taxes to reduce Canadian borrowing costs? What will be his approach to the Canada Development Corporation? Some of the answers may be clearer when the new House of Commons assembles in January.

Stock Markets

The Canadian stock market has not yet managed to exhibit anything remotely resembling the strength shown in the New York market. The Dow-Jones industrial index by early November had recouped all of the 11 per cent decline recorded in May and June, and had pushed up a further 16 points. The Toronto industrial index, however, was still five per cent below the May high. Several reasons have been advanced to explain this divergence — among them: the uncertainties surrounding the election campaign, the resulting minority government, the loss of investor confidence following Atlantic. Although these may well be contributing factors, more significant influences appear to be the lack of new American investment in Canadian equities, due in part to the interest equalization tax, and the lower level of Canadian corporate profits.

In the first eight months of 1965 Canadians have repurchased from foreigners $187 million of Canadian preferred and common stocks. Non-residents have been reducing their investment in Canadian equities every year since 1961, and this trend has accelerated sharply this year. In the face of inflows of this magnitude it is surprising that the Canadian stock market has managed to advance at all. Seasonally adjusted statistics show that in the first six months of 1965 corporate profits in Canada had risen at an annual rate of only one per cent above the fourth quarter of 1964, and in fact had declined slightly in the second quarter; in the United States on the other hand corporate profits were up 11 per cent.

Looking ahead, the plus factors will probably be mainly the growth of the economy and the continuing interest of investors in common stocks as a hedge against inflation. On the minus side are tightening U.S. controls over capital flows to Canada, and the squeeze on corporate profits. In view of the recent uneven performance of Canadian stocks, in a period of unprecedented prosperity, it is difficult to cast one's vote on the side of a sustained bull market through 1966.

The Money Market

Following the near-crisis in the money market after the default of Atlantic Acceptance in June, the Bank of Canada permitted a substantial expansion in money supply so that the chartered banks could extend loans to finance companies denied access to their customary money market sources. However, as noted earlier, growing inflationary pressures led to a change of policy in August and expansion in the money supply virtually ceased. Mortgage lending institutions found themselves strapped for cash and were forced to raise their rates to try to stem the outflow of maturing short-term funds. Demands for business and personal loans took up what little surplus was available in the banking system. The banks were reluctant to countenance any further reduction in their liquidity position, already close to the minimum 30 per cent of total assets which they apparently feel is appropriate.

Inevitably there has been a substantial rise in short-term rates. Yields on treasury bills in mid-November were 4.17 per cent, only one-eighth of one per cent below bank rate. Top quality finance company 90-day paper was being offered on a 5.50 per cent basis, compared to a pre-Atlantic rate of 4.75 per cent, and six per cent was paid on one to three-year notes. Even this increase failed to attract substantial funds; statistics published by the Bank of Canada show that by September the outstanding amount of finance company paper had fallen over $100 million from June, while commercial paper was down $50 million. In November the chartered banks introduced certificates of deposit designed to attract large deposit accounts on a short-term basis. This may well cut further into the funds available to these borrowers.

The December 1 Government of Canada issue came in three parts: a $150 million one-year issue on a 5.15 per cent basis, hopefully designed to attract taxable accounts; a $100 million three-year four-month issue yielding 5.41 per cent; and $50 million 5½ per cent bonds of October 1975 to yield 5.50 per cent, with the Bank of Canada taking up at least $100 million of the issue. The proceeds of the $300 million issue were to be used to retire the $325 million issue of December 1. The government will also pay off $35 million in CNR bonds maturing in January. Although there was little enthusiasm for the longer bonds, the pricing of them right on, rather than below, the market suggested that the authorities felt that middle term rates were about as high as they would wish to see them.

Long-Term Bonds

Prices of long-term bonds continued the downward trend that has been characteristic of the market since the spring. In July the Bank of Canada withdrew support from long Canadas and allowed yields to rise to the 5.50 level before stepping in again prior to the announcement of the new issue in mid-November. The structure of interest rates in the United States has also undergone an upward adjustment and yields on long-term U.S. government issues are currently ranging between 4.35 per cent and 4.40 per cent. The differential between long-term Canadas and U.S. treasuries, at about 1.10 per cent to 1.15 per cent, is not much higher than the levels prevailing through the summer months, but well above the spread of .85 per cent in effect at the beginning of the year.

Although some pressure was taken off the Canadian market by the parade of borrowers to New York, there were substantial domestic offerings of new issues in September and October. Quebec and Ontario both placed $50 million long-term issues in Canada in September, followed in October by a $33 million Metro Toronto offering, and $25 million Montreals. The two provincial issues and the Torontos, although attractively priced, moved rather slowly with institutional interest limited for the most part to trading. By mid-November long-term Ontarios were down to a 5.70 per cent basis, and Quebec of similar term to six per cent. Most municipal and corporate borrowers were forced to pay well over six per cent. It is hoped that when the flow of pension plan money begins early in the new year, some relief will be provided for provincial and municipal borrowers; however, rising expenditures at all government levels may sop up much of this new source of funds.

In this column last spring we noted that to an increasing extent Canadian financial markets are influenced by international events and liquidity, and particularly by the balance of payments situation of the United States. Developments during the last quarter show just how strong our dependence on external influences has become. Between June and the end of October heavy foreign borrowing and a favourable trade balance pushed our official holdings of gold and U.S. dollars at the end of October up by $164 million, while our creditor position with the International Monetary Fund rose by $60 million over the same period. In winning exemption from the interest equalization tax in 1963, Canada has undertaken to borrow only enough to finance its current account deficit without permitting an increase in official reserves over and above the level of June, 1963. Including our creditor position with the IMF, our reserve position is now $200 million above this benchmark. The November 9 timing of the recent move to curtail U.S. borrowing leads us to conclude that earlier action was prevented by the election campaign.

We are in fact in a new era of American exchange control — informal though it may be — and we in Canada will have to face up to the consequences. How deeply this new regime bites will depend largely on the U.S. quarterly balance of payments figures and gold flows. So long as our reserves hold up we have no case for imposing countervailing import restrictions, our only effective bargaining weapon. If the American position does not improve we may expect further deferments and postponements of our bond issues in the United States, and unless the Bank of Canada is prepared to go on expanding the money supply and supporting the long-term Canada market at the 5.50 per cent level, the increased pressure on our domestic market may well push rates up still higher.

The meaningful interpretation of financial statements. The cause-and-effect ratio approach, by Donald E. Miller. American Management Association, New York.

Comprendre l'importance des questions financières, les régler dans le sens des meilleurs intérêts de l'entreprise, surveiller les indices de bonne ou de mauvaise santé que fournit le bilan, voilà autant de questions d'une importance extrême pour l'homme d'affaires qui dirige une petite ou une moyenne entreprise. M. Miller les étudie dans un style simple et direct. Il a pour les traiter une longue expérience, qu'il a mise à la disposition d'une quantité considérable de gens, qui ont assisté à ces colloques qui, chez nos voisins, prennent le nom de *seminars* ou de *working shops*. Dans sa préface, l'auteur dit: "Certainly it is not intended as a substitute for judgment; it is instead designed to be a prime aid to management judgment and discussion-making." En somme, il s'agit d'un instrument de travail, qui peut servir de guide dans le dédale des problèmes financiers que pose l'entreprise moderne.