Assurances

Financial panorama, summer 1966

D. H. Fullerton

Volume 34, Number 2, 1966

URI: https://id.erudit.org/iderudit/1103575ar
DOI: https://doi.org/10.7202/1103575ar

See table of contents

Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

Explore this journal

Financial panorama, summer 1966[1]

by

D. H. FULLERTON

The first faint cracks in the North American boom appeared early in May. Faltering new car sales in the United States, attributable to a variety of factors — ranging from an unusually cold spring to the auto safety hearings — appeared to be the main trigger for a sharp decline in the stock market. In Canada, although manufacturers report that car sales are holding up well, the Maclean-Hunter survey of consumer spending intentions suggests that plans to buy new and used cars are down to the lowest level in two years, and plans to purchase major appliances are not as expansive as they were a year ago. At this stage it is difficult to determine whether these economic symptoms will prove to be anything more than chills brought on by the unseasonable weather, or whether they will develop into more fundamental disturbances which will eventually permeate the economic life of both Canada and the United States.

Apart from some reservations about the less optimistic attitudes currently mirrored in the stock market and in the survey of consumer attitudes, the Canadian economy still appears to be operating from a position of underlying strength. Employment, industrial output, unfilled orders, wages and salaries continue to rise, and pleas for restraint still echo around Ottawa and in business circles. The Governor of the Bank of Canada noted in his Annual Report that the requirements of governments, businesses and consumers were com-

[1] Cette étude a déjà paru dans "Canadian Banker". Nous la présentons à notre tour, avec l'assentiment de l'auteur et de la revue.

bining to produce very substantial demands on the economy which threatened to outrun its capacity to increase output of goods and services. On the same day that his report was released, March 11th, the Governor emphasized the necessity for some moderation in the growth of the overall demand by increasing Bank Rate to 5¼ percent. It is interesting to note that this is the first change in rate made independently of a similar change by the Federal Reserve in the last few years.

The results of the first survey of 1966 capital investment intentions provided additional proof of the pressures building up in the economy. After increasing by 16 and 17 percent in 1964 and 1965 respectively, capital spending is expected to rise a further 14 percent this year. Spread across a range of primary, secondary and service industries, the incrase implies a high level of construction outlays for factories, office buildings and similar structures and greater spending on machinery and equipment. However, pressure on the construction industry may be reduced somewhat by lack of growth in residential construction. Housing starts are now expected to fall a minimum of 15 percent this year, but the substantial number of apartments and houses carried over from last year, on which work is yet to be completed, will maintain expenditures in this area at least until fall.

Faced with the need to dampen down the inflationary spending plans evident on all sides, the Minister of Finance took an imaginative and flexible approach to fiscal policy in his first budget. Three main measures were introduced to induce some postponement of business spending: an experimental refundable tax, cuts in capital cost allowances, and the announcement that the sales tax on production machinery would be reduced next April and completely removed one year later. Turning to other sectors of the economy, Mr. Sharp proposed the reversal of virtually all of the 1965 personal income tax reductions and a 10 percent cutback in Federal Government construction programs. Despite this reduction in spending, the Government surplus this year will not be as large as in 1965. The budgetary deficit is forecast at $150 million compared with $34 million in the fiscal year ending March 1966. On a national accounts basis the fiscal 1965-66 surplus of $494 million will rise to $615 million; however, this latter figure includes the revenue from the new refundable tax of $160 million so that regular Government of Canada operations will have somewhat less of a deflationary impact than last year.

The mid-year survey of business spending plans, normally released early in August, may provide some indication of the amount of investment which has been postponed as a result of Mr. Sharp's proposals. There are several operative factors which could mitigate the extent of the cutback. For one thing, the reduced depreciation allowances do not apply to purchases already contracted for on budget night. The accelerated capital cost allowances granted to manufacturing and processing companies with a minimum (25 percent) degree of Canadian ownership, under which they can write off new machinery and equipment at a rate of 50 percent a year, will not lapse until the end of this year. Companies which so qualify may well advance expenditures planned for 1967 in order to take advantage of these higher write-off privileges. Secondly, manufacturers' investment in machinery and equipment last year was well below intentions indicated by the mid-1965 survey. If this shortfall resulted from delays in delivery brought about by shortages of labour and materials rather than from revisions in spending intentions, manufacturers may proceed with their investment plans this year, even at higher cost, rather than incur any further delays. Finally, as the heads of many large corporations have pointed out, the time lag between the announcement of the refundable tax and its imposition is too short to permit much revision in investment programmes. Expenditures which are likely to be deferred as a result of this tax are those not slated for implementation until late this year or those not yet in the works.

These comments do not imply that the budget will be ineffective, but only that Mr. Sharp may prove to be overly optimistic in his estimate of the extent of the overall cutback. The budget is certain to dampen the exuberance of business spending and to check any destabilizing tendencies toward overcapacity. One might add that the stock market collapse may be a more significant factor leading to reduced capital expenditures — if indeed they occur — than the budget itself.

The Stock Market

This spring there were growing signs of nervousness in all North American stock markets, and particularly in the key market, New York. A substantial drop had occurred in February but by the middle of April about half of the lost ground had been recovered. Since then, conflicting statements from Washington officials about the necessity of imposing tax increases to combat inflation, debate over the Vietnamese situation, and concern in some quarters over the dangers of excessive speculation left the market susceptible to the slightest change in the economic wind. The announcement by the automobile companies of production slowdowns in the United States, following an aggregate 4 percent drop in factory sales in April and a 15 percent fall in the first 10 days in May probably was the spark which touched off the May break in the market. On May 18th the Dow-Jones industrial average stood 10 percent below the level at the end of 1965, while the Toronto average was off 5 percent.

Prices in both markets were close to the lows of last year. Many analysts feel that the prolonged bull market has come to an end, and expect further declines before the bargain hunters appear to lend support in any volume.

There appears to be no entirely satisfactory explanation for the wave of selling which followed the news from Detroit. New car sales in the United States over the first four months of this year were only 1 percent below last year's past-strike level, and some periodic fluctuation in sales after five consecutive years of expansion should not have been entirely unexpected. Uncertainties about Vietnam, higher taxes, and the possibility of a further tightening in money, have been subjects of discussions for many months. In the event, the decline in the stock market will likely have some adverse effects on consumer attitudes and on the spending plans of businessmen. For this reason, one consequence of the May break in stocks may be to neutralize the pressure in the United States for higher taxes and tighter money.

Whether or not there is any substance in the belief that the stock market provides a good leading economic indicator, it does appear to have the power sometimes to induce economic decisions that make its predictions come true. It will be interesting to see whether the economist bulls or the stock market bears prove to be better forecasters. Certainly, in terms of trends in stock market prices, there are very few bulls in sight.

The Money Market

The increase in Bank Rate led to a substantial upward adjustment in short-term money market rates. Yields on 91-day Government of Canada treasury bills by the end of March had risen to about 5.10 percent, an increase of 40 basis points since the Bank Rate change. Short-term rates over the next two months remained at about this level.

The chartered banks added to the pressures in the money market by reducing their holdings of short-term instruments in order to accommodate the usual spring increase in the demand for loans. Between mid-March and mid-April the banks reduced their treasury bill holdings by a substantial $175
100 million, a move which brought their "more liquid asset" ratio to below 30 percent, a level which had previously been considered a desirable minimum. When the Bank of Canada stepped in to fill the gap in the treasury bill market, the banks used the cash injected into the system to finance an increase of $170 million in general loans and $200 million in loans to other borrowers, chiefly grain dealers. In the last month the rise in loans has been much more moderate but the banks have been unable to build up their more liquid assets.

The Government of Canada's refunding operation for May 1st consisted of three new issues and met with good response. The shortest maturity offered was a $4\frac{1}{4}$ percent eleven-month bond, priced at $98.90 to yield 5.49 percent, and $155 million was allotted. The other two offerings were additions to outstanding issues: $40 million 5 percent bonds maturing in July 1970 priced at $98.00, to yield 5.54 percent, and $130 million $5\frac{1}{2}$ percent bonds of August 1980 yielding 5.71 percent. The technical innovation introduced in the February refunding to satisfy the demand for long-term issues and to cover dealer shortages was repeated, although different issues were involved. The Bank of Canada offered to buy the new 1967 issue from dealers in exchange for up to $25 million of its holdings of the July 1969 maturity, and to exchange the same amount of its holdings of long-term Canada 1988's and 1990's for the three new issues.

Long-term Bonds and Mortgages

Prices of long-term bonds continued to fall in the Canadian market until mid-March, when the American bond market showed some signs of recovery. One causal factor in that market was the withdrawal of an expected $440 million New Jersey Turnpike bond and a reduction in size of several other new issues. U.S. prices continued upwards for some weeks, but part of these gains were given up at the time of the stock break in May.

By mid-May Canada 4½'s of 1983 were trading at 1½ points above the March low, to yield about 5.66 percent, although there is a degree of artificiality in the prices of Canada bonds because of the frequent Bank of Canada intervention on both sides of the market. Quebecs and Ontarios were respectively yielding about 6.15 percent and 5.90 percent, not far from their low point in March. Nevertheless, the relative strength of the Canadian market in May was surprising, in the face of the offering of $115 million in provincial issues in the first half of the month, including a $50 million 6 percent Quebec issue. However, these offerings along with some new corporate bonds helped to sop up the supply of available funds, and one provincial issue was called off for lack of interest and several large municipal issues were deferred. Some of the buying interest in the Canadian market may have been caused by the March 16 appeal of Mr. Sharp to institutional investors to stop buying of U.S. dollar "offshore" bonds issued to finance the operations of American subsidiaries. Many investors not only complied with this request but went further and disposed of issues acquired prior to the date of Mr. Sharp's announcement. The rise in price of many of these bonds, of course, made compliance with the Government's announced policy easier to tolerate. A further strengthening influence was the placement of large issues in the New York market; the Province of Ontario, Quebec Hydro and several municipal and corporate borrowers sold issues to American buyers for delivery in the second quarter.

The mortgage market remains very tight. Some outstanding NHA mortgages are available to institutional investors at a 7.00 percent gross yield basis (before servicing costs), compared with 6.75 percent at the beginning of the year. Conventional mortgage rates are now ranging between $7\frac{1}{2}$ and $7\frac{3}{4}$ percent, depending on the location of the property and the credit rating of the borrower. Many approved lenders have ceased making new mortgage commitments, and the Government has announced it will make available through Central Mortgage and Housing Corporation the same volume of direct NHA loans as were granted last year. Rather surprisingly, the high cost of mortgage financing does not appear to be deterring prospective homebuyers; according to Maclean-Hunter, the number of consumers planning to buy a house this summer is the highest ever recorded in the five-year history of the survey.

There appears little immediate prospect for an upward movement in bond prices. The intervention of the Bank of Canada in the market on the selling side in May reflected the view of the authorities that the existing price structure was appropriate and should be maintained over the near term. The spending plans of governments and businesses point to a substantial volume of bond issues in future, and the costs of the refundable tax will accelerate the financing problems of corporations. At the same time some of the pressures may be relieved by a flow of funds out of the stock market. The removal of the 15 percent withholding tax on bonds issued by Canadian governments after April 15 may also help to broaden the U.S. market for such bonds, but in May there was a noticeable cooling in U.S. buying interest in new Canadian issues. The American balance of payments is again causing considerable concern, and some of the official anxiety may have been communicated to the U.S. institutional investment community. Canada's official reserve position still remains high, embarrassingly so given the conditions on which our access to the pool of United States capital is based, and this may be a further deterrent to Canadian borrowing in the U.S. Altogether the bond market outlook is affected by a great many cross-currents, with the economic outlook the greatest single imponderable. Evidence to date, however, suggests the absence of any pronounced trend in bond prices in the near future. However should an international financial crisis occur, the bond market would of course be affected.

Guidelines and Balance of Payments

Debate about the American guidelines died out quickly in Canada following the international ministerial meeting in March, and the issuing of official Canadian guidelines to close to 4,000 foreign companies operating in this country. The effect of these developments was to countermand the U.S. appeal to Canadian subsidiaries of American corporations to increase their imports from the parent company and to repatriate excess earnings, leaving only the request for restraint on outflows of direct investment capital by the United States parent. Foreign subsidiaries have been asked to provide more statistical data bearing on their activities in Canada and on their relationship with the parent companies. This information will help to shed light on the impact of foreign ownership on the Canadian economy, and the move by the Government has been widely applauded in Canada.

Recent developments have not enhanced the outlook for the 1966 balance of payments in either the United States or Canada. The U.S. Department of Commerce has reportedly been forced to revise sharply previous estimates of the 1966 direct investment outflows. Although corporations are complying with the U.S. Government's program the direct investment formula, which set a ceiling for 1965 and 1966 combined, still allows considerable room for manoeuvre and capital exports in this form may decline by only $100 million. Thus, the U.S. Government may face the unpleasant

alternative of imposing further guidelines on the already restless business community or of taking more direct action in an election year.

In Canada the current account deficit seems bound to widen further if the rising level of personal incomes and higher outlays by governments and corporations produce the traditional effect, despite the contraints imposed by the budget, of increasing demand for imported goods. Exports which were very strong in the first quarter should remain high, barring any weakening in the American market. Later in the year they will be maintained by the wheat shipments to China under the terms of the renegotiated agreement and by the lifting of the surcharge on imports into the United Kingdom in November. Before the summer has ended a clearer assessment of our balance of payments outlook should be possible, but we would caution our readers that recent history suggests no reason for optimism that summer weather will provide a more favourable financial and economic climate. In fact, we will do very well this year if, for a change, we can manage to avoid another summer financial crisis.

May 20, 1966.