Document généré le 20 jan. 2025 08:46

Assurances

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Financial Panorama – winter 1966

D. H. Fullerton

Volume 34, numéro 4, 1967

URI : https://id.erudit.org/iderudit/1103595ar
DOI : https://doi.org/10.7202/1103595ar

Aller au sommaire du numéro

Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Découvrir la revue

Citer ce document

Fullerton, D. (1967). Financial Panorama – winter 1966. *Assurances*, *34*(4), 321–330. https://doi.org/10.7202/1103595ar

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Financial Panorama - winter 1966 [1]

by

D. H. FULLERTON

Although at the end of November statistical indicators were still giving off mixed readings of the economic climate, the factors pointing to a renewal of a moderate growth trend following a summer lull seemed to outweight those providing contrary evidence. Industrial production in August bounced back to recover all of the decline recorded over the previous three months. Retail sales, both including and excluding motor vehicles, also rose from their mid-summer lows, as did manufacturers' new and unfilled orders. The sharp October drop in unemployment to 3.5 percent of the labour force, from the 4.0 percent range at which it had held since July, tends to support the view that the improvement would continue into the fourth quarter.

Exports remained surprisingly strong, due in part to shipments under the international wheat contracts, to the automotive treaty, and to the ability of Canadian primary and secondary manufacturers to supply some of the shortages in the American market which have developed as a direct consequence of the Vietnam war. Residential construction, which had weakened more drastically than anticipated under the impact of tight credit conditions, responded to the resumption of CMHC's direct lending programme, and urban housing starts in September rose to the highest level since March. Further help for the ailing housing industry came on November 22nd when the maximum rate of NHA loans was raised to 7¼ percent in an attempt to stem the outflow

[1] Reproduit de "Canadian Banker", avec l'autorisation de l'auteur. Janvier 1967.

of institutional funds into higher yielding assets. Buoyed by these signs of renewed vigour in the economy the forecasters were again predicting that GNP in 1966 would rise by 10½ percent over to a total of $57½ billion.

Few will agree, however, that the danger of an economic downturn has been eliminated. Indeed the forecast of a GNP of $57½ billion implies a slower rate of growth in the second half of the year than was recorded in the first six months. One source of concern was that inventories at the manufacturing level continued to build up at a faster pace than shipments. There was also the danger that the resistance of the angry housewives to the rise in prices at the supermarkets could spread to other areas and dampen consumer spending. Production of durable goods, although above its summer low, had shown little growth since the beginning of this year.

Finally, the drive for higher wages continued to have unsettling effects on the economy. Some 5,000 Canada Packers employees returned to work after a 10-week strike with a settlement granting them a 25 percent wage increase over a three-year period. In mid-November the Air Canada machinists went out on strike with the union demanding pay increases over two years at a rate close to the 30 percent settlements granted last summer to the Seaway workers and the longshoremen. The strike was settled on November 26th, granting increases of 20 percent over 26 months plus some other benefits. A nation-wide postal strike was narrowly averted when the union accepted a temporary settlement which, if well below the amount which its members had been seeking, was high by past standards. Containing the demand for substantial wage increases will undoubtedly head the list of problems confronting the authorities in the United States in 1967, where contracts covering such major industries as

automobiles, rubber and trucking are up for renegotiation. In Canada the battle to hold wage increases to reasonable levels appears to have been lost, and next year the Department of Finance and the Bank of Canada may have problems restraining the cost-push effects of these settlements on prices.

In a determined effort to dampen down the inflationary pressures without tipping the economy into a recessionary phase, both President Johnson and Finance Minister Sharp announced on September 8th a package of measures designed to shift some of the burden of containing inflation away from monetary policy into the fiscal sphere. President Johnson suspended both the 7 percent investment tax credit on purchases of new capital equipment and the accelerated depreciation allowances on new plant construction until the beginning of 1968, and indicated there would be an unspecified reduction in government spending outside the defense area. The Canadian Finance Minister announced the postponement of the medicare programme for one year, and stated that he would introduce a baby budget later this year to increase taxes by at least the amount needed to finance the higher old age benefits. He promised even higher taxes should his assessment of the economic situation deem such action necessary. Although a decision on a tax increase in the United States was deferred pending clarification of the Vietnam situation, President Johnson left little doubt that higher taxes would be called for if the new measures did not succeed in cooling off the rise in capital spending and in interest rates.

To reinforce his determination to halt the upward spiral in prices, Mitchell Sharp on September 14th requested the Steel Company of Canada to rescind its announced 3 percent increase in prices of steel products, a request which was complied with the following week. Later that month both the

Finance Minister and the Minister of Industry, Mr. Drury, put the Canadian automotive industry clearly on notice that the price differential between Canadian and U.S. cars in the 1967 model year must continue to narrow. The 7½ cent a pound increase in the price of nickel posted by INCO in November was reportedly a compromise brought about after pressure was exerted by Ottawa to reduce the 12 cent boost originally planned. Canada appeared to be edging toward an era of price guidelines, a move which the Governor of the Bank of Canada seemingly endorsed in a recent speech in Rome. Mr. Rasminsky, after noting that there were "few brilliant successes to which one could point where income policies have worked when put to a rigorous test" nevertheless went on to say:

> "...a basic assumption on which monetary policy, as well as fiscal and other policies directed towards affecting the level of aggregate demand, depends is that if total demand is not excessive, competition in the economy will ensure that reasonable price stability is maintained. If competitive forces cannot be relied upon to ensure that technical progress in production is reflected in the pricing policy of corporations and to keep income demands within reasonable bounds, that is, within the bounds of what the economy can really provide in the form of goods and services at reasonably stable prices, clearly some workable supplementary measures must be found. These supplementary arrangements cannot be a substitute for over-all policies which keep the increase in aggregate monetary demand within the real capacity of the economy to expand. But the experience of many countries suggests that monetary and fiscal policies need to be supported by some technique which mobilizes the force of public opinion behind non-inflationary behaviour by those who are in a position to deploy strong market power."

The Third Annual Review of the Economic Council of Canada, published on November 22nd, contains one of the most comprehensive discussions of incomes policies which has yet been presented to the Canadian public. The Council

categorically rejected the use of income policies as being inappropriate in the Canadian setting of fragmented jurisdictions, except for temporary emergency situations. The Council advocated instead a better co-ordination of the broader instruments of fiscal and monetary policy complemented by other measures designed to stimulate the supply rather than the demand side of the economy. Along these lines, the Council again called for effective manpower policies to meet shortages in the labour market, and for programmes which would improve our productivity performance. All levels of governments were criticized for their failure to appreciate fully their roles as large employers and as direct participants in collective bargaining, and for the "needlessly destabilizing growth pattern" of their construction expenditures. The Council called for a much greater degree of federal-provincial co-operation across the whole spectrum of fiscal planning as a means of promoting a more stable growth rate. The Review did not discuss one obvious weakness in this laudable objective — that the success or failure of co-operative government planning will depend on finding a solution to the same question of jurisdiction which inhibits the successful implementation of a federal incomes policy.

The Stock Market

The stock market in October responded to evidence that business activity in the third quarter had resumed a moderate upward trend following the second quarter pause. By October 27th the Dow-Jones industrial average had risen by 65 points or almost 9 percent from its October 7th low of 744. The uptrend levelled off in the early part of November, as the market awaited the results of the U.S. elections and President Johnson's operation, and the subsequent resumption of the rise was cut short by the announcement by General Motors that its automobile production in December and

January would be cut back 8 percent. On November 23rd, the Dow-Jones industrials had fallen back to 797 but was still 7 percent above the October low.

Prices in the Canadian stock market again exhibited a seeming reluctance to participate fully in any recovery in New York; at its current level of 144.7 the Toronto Stock Exchange industrial average was only 5½ percent above its October low.

In our Centennial Year Canadian stock prices may not perform as well as those in the United States. For one thing the refundable corporate tax payments imposed by Mr. Sharp last March will probably continue until the fourth quarter of nex year, with a consequent dampening effect on dividend payments; wage costs are more likely to be a heavier burden in Canada than in the United States, where recent and prospective wage settlements fall well short of the average 9 to 10 percent annual wage increases granted this year in Canada. Finally, the heightened attraction for the U.S. market on the part of Canadians is evident in the DBS statistics for the first eight months of this year, which show that Canadians bought a net amount of $150 million American stocks. This trend may well limit the recovery in the Canadian market, unless action is taken in the near future to encourage investment in Canadian equities. A few steps in the direction of tidying up some inherent weaknesses in our market have been taken — the amendments to the Ontario Securities Act, for example, now require corporations to disclose their operations in much more detail than was formerly the case. Joint federal-provincial conferences on securities legislation are another sign that the authorities are aware that our investment mechanism is faulty, but more concrete action is needed if the Canadian stock market is to be pulled out of

its doldrums, and to function as an effective segment of our capital market.

The Money Market

The tone of the bond and money markets in Canada by early November had improved moderately from the state of near-panic which had prevailed at the end of August. At that time the effects of the unsuccessful Government of Canada September 1 refunding operation, and the steps taken by the U.S. Federal Reserve Board to tighten credit in that country, had combined to raise yields on short-term Canadas to the 6 percent level. The early September announcements in both Canada and the United States that monetary policy had accomplished all it could under the circumstances, and that fiscal measures would shortly be introduced, helped markets in both countries. The improved sentiment, which was reinforced by threats of tax increases during the American election campaign, and by the U.S. peace offers made in the United Nations, resulted in prices of short Canadas rising to the 5.50 percent yield range. However, this improvement was not reflected in yields on commercial and finance paper, and in November prices of short Canadas weakened as the government refunding issue drew closer, and yields moved close to the 5.75 percent level.

Monetary policy during the last few months appears to have been designed to ease the system while at the same time "leaning into the wind' to prevent security prices from rising too much. The Bank of Canada increased its bond portfolio by almost $150 million at the time of the September re-funding operations and then in the following week sold over $50 million of its holdings into the market, scaling up its selling prices as it was doing so. In October the central bank offered to exchange its holdings of the 4½'s of 1983 for the

two new short issues and it appears that the amount of this swap totalled about $50 million. Total money supply in October rose by $230 million, after seasonal allowances, an annual rate of increase of 13½ percent, the same growth rate as in the third quarter, and well above the 3½ percent rate of the first half of the year. The increase was more than enough to provide for a greater than seasonal expansion in loans, and the banks were able to build up their liquid asset holdings.

The Long-term Bond Market

The improved sentiment which followed the promise of fiscal action in both Canada and the United States saw a gradual rise in prices in the long-term bond market in September and the first half of October. Long Canadas which had fallen to about 6.00 percent yield basis at the end of August were trading six weeks later about 2½ points higher, a 5.75 percent basis; the Ontario Hydro 6's of 1988 were on a 6.12 percent basis, up about 15 basis points from the end of August (although long Quebecs had fallen to a 6.77 percent basis under the weight of a new $50 million issue). Prompted by this apparent recovery in the market new offerings totalling well over $500 million were brought out, and some of these traded to a premium. However, the continuous parade of new borrowers, coupled with rumours of a growing new issue calendar, the possibility that the Government's December 15 refunding would include a long-term issue, and a softening in prices in the U.S. bond market, all combined to halt the advance in the latter part of October, and by the end of November long-term bond prices had given up most or all of their earlier autumn advance.

The continued tightness in the volume of funds available in Canada for long-term bond investment, and some easing in the United States, prompted Canadian borrowers to once

again test the New York market. In October and November over $100 million in new U.S. dollar issues were offered to American investors, despite the narrow difference in the cost of raising new money in both markets which then existed. The limited resumption of borrowing in the United States, the promised cutback of $100 million in expenditures undertaken by the Province of Quebec in the current fiscal year, and the possibility that the successful Canada Savings Bond campaign would reduce the demands of the Federal Government on the capital market in the balance of the year were the only factors promising any relaxation in borrowing pressure on the market.

The new Canada Savings Bond series carried an unusual and much advertised feature, enabling a holder to maturity to "double his money" over the thirteen year life of his investment. Some viewed this type of publicity with a rather jaundiced eye — one editorial writer said: "... the recent promotion of Canada Savings Bonds at times reads much like a Bay Street mining promotion operated out of a 'boiler room'." However, the federal government is decidedly limited in the types of bond instruments which will attract the public, and probably felt that unusual methods were necessary to raise the money it needed. Preliminary figures place gross sales at over $2 billion, exceeding the previous record set in the 1962 savings bond campaign, but the amount of net new money raised amounted to only $712 million as of November 23rd. The average yield of 5.48 percent was the highest ever offered, and forced both British Columbia and Quebec to raise the rate of their outstanding parity and savings bonds to 5½ percent to reduce the threat of switches out of the provincial series.

The recent behaviour of the bond market lends credence to the view that interest rates may not move very far from

the August peak for some months to come. The Canadian market will undoubtedly mark time until the success of the Government of Canada refunding issue is determined and Mr. Sharp's promised baby budget is introduced. Much depends on developments in the United States and President Johnson's state of the union message to the new Congress in January should put an end to some of the uneasiness affecting the American bond market by revealing a final decision on whether or not to impose tax increases.

The conflicting and widely publicized statements on fiscal policy emanating from American economic advisors during the election campaign highlighted the general uncertainty about the degree of strength underlying the American economy. The recently released figures on the U.S. GNP in the third quarter added fuel to the debate, the optimists pointing to the improvement in the rate of growth over the second quarter while the pessimists noted that recovery was not as large as had been anticipated earlier despite the fact that outlays for Vietnam were double the expected increase. Many corporate treasurers are reported to have compounded the confusion by preparing two forecasts of their expenditures next year, one based on the expectation of a higher corporate tax rate, the other on the assumption that the current rates will continue to apply. This type of uncertainty makes the task of forecasting the probable trend in economic developments, always a diffucult exercise at best, much more hazardous. The same uncertainties apply to bond market forecasting, although the degree of recent wage and price increases may have done some permanent damage to the Canadian market for long-term bonds.