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Financial panorama, summer 1967

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Financial panorama, summer 1967 [1]

by

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As this issue went to press Canadian were digesting the implications of the federal budget. Finance Minister Sharp did not increase existing personal and corporate income taxes and proposed few changes of consequence in other taxes. Expenditures in the current fiscal year are forecast to rise by \$900 million, and revenues by \$600 million; the budgetary deficit will rise by more than \$300 million to an estimated \$740 million. On a national accounts basis the budget will swing from a surplus of \$141 million in the fiscal year ending last March to a deficit of \$301 million in fiscal 1968. Cash requirements, stimulated by prospective large mortgage lending by CMHC, would be over \$1500 million.

The Minister accepted the deficit with equanimity, describing it as "modest" and "a moderate sustaining force this year". We are somewhat more concerned about the inflationary implications of this deficit than is Mr. Sharp — particularly in the light of prospective additions to the budget from supplementary estimates, and in view of the growing signs of a resurgence of the U.S. economy in the last half of 1967. We are particularly alarmed about the impact of the government's expansionary approach upon financial markets, already in some trouble in spite of very easy monetary policies.

The budget speech was filled with expressions of concern about the rapid increase in prices which has already

[1] Reproduit de *"Canadian Banker"*, avec l'autorisation des auteurs.

occurred and the prospect, implicit in the narrowing profit margins and in current wage settlements, of further price increases yet to come. While Mr. Sharp noted that one of the main problems facing Canadians in the next few years was to restore some stability to prices and costs of production, he did not offer any suggestions as to ways of achieving this goal beyond exhortations to labour, business and to the government itself to exercise restraint at the bargaining table.

134 The slowdown in the rate of growth which has been taking place in the economy was reflected in the forecast of a rise in 1967 GNP of only 6½ to 7 percent, of which 3 percent would be accounted for by higher prices. In 1966 the increase in GNP in current dollars amounted to 10.9 percent and in real GNP to 5.9 percent. Mr. Sharp had earlier taken steps to deal with one of the chief depressants to economic growth in 1967. On March 10 he announced that the refundable corporate profits tax would be halted at the end of March rather than the end of September as originally proposed and on March 22 he announced that the cutbacks in capital cost allowances put into effect a year ago would be fully restored on April 1st. In the budget he removed the remaining 6 percent sales tax on production machinery.

The reasons for such actions became obvious when the results of the first survey of capital spending intentions for 1967 were released. After increases averaging 16 percent in each year from 1964 to 1966, total capital investment in 1967 was estimated to rise by only 1½ percent. If the anticipated price rise is allowed for, capital spending would actually decline below last year's level. Even more disconcerting was the fact that spending by the business sector was scheduled to level out, and that the growth would come entirely from an increase in outlays for the construction of plants and equipment by government enterprises and institutions. The recent relaxation of restrictions on business expenditures, the efforts of the government to stimulate housing and the indications that economic growth will resume in the second half of this year, may yet raise projected spending plans.

Mr. Sharp did not implement any of the proposals contained in the report of the Royal Commission on Taxation. Concepts such as integration of personal and corporate income taxes, the inclusion of all capital gains, bequests and gifts as income, the family unit and income averaging are too far-reaching to be put into effect without comprehensive discussion. Mr. Sharp was undoubtedly wise in postponing any action until after interested parties are heard from and the government's position is made known in a White Paper to be brought down before the end of the year.

The Stock Market

The indications that the American economy was rapidly regaining its health led investors to push stock market prices irregularly upwards in March and April. By May 8th the Dow-Jones industrial average had reached a 1967 peak of 909.6, a rise of 16 percent from the beginning of the year. However, the worsening Middle East situation, escalation in Vietnam, the more uncertain complexion of some of the economic statistics published in May, and a rapidly swelling U.S. budget deficit all combined to dampen enthusiasm, and by June 2nd, the average had fallen back 5 percent to 863.3. The Toronto Stock Exchange industrials on the same date stood at 163.3, 10½ percent above the level at the beginning of the year, but 3 percent below this year's peak.

The results of the first quarter corporate profit survey released by the U.S. Department of Commerce, showing a decline in profits of 6½ percent as compared with the first quarter of 1966, had already been discounted to a large extent by the stock market. However, the revisions in earlier estimates of personal income and retail sales forced a reappraisal of the strength of the private sector. The cynics pointed to the downward revisions made to previous data with each new set of estimates as evidence of an emerging "credibility gap" in the area of economic statistics. The rising costs of the Vietnam war, and a potential acceleration in the pace of the economy in the second half of the year posed the threat that monetary policy would again be restrictive, and that fiscal policy would be tougher.

Perhaps more than any single factor, the prospects of an enormous U.S. budget deficit dampened investor enthusiasm for both fixed-income securities and common stocks. In a widely quoted letter from an investment firm, the Federal budget was described as "out of control", while the chairman of the House Ways and Means Committee stated that it threatens to "burst all bounds". Chairman Mills then went on to forecast an administrative budget deficit as high as $29 billion, compared to the Administration's latest estimate of $11 billion. The lack of any official statement about the steps which will be taken to finance a deficit of these proportions, the difficulty in assessing the degree of strength underlying the economy and the important labour negotiations which will get underway this summer all conspire to sap the confidence of even the most bullish American participants in the stock market. The performance of Canadian stock prices can be expected to follow the U.S. trends, unless further steps are taken to encourage equity investment by Canadians along the lines of the Carter Commission proposals.

The Money Market

Buoyed by the substantial expansion in money supply and by the fiscal measures announced early in March to stem the business slowdown, short-term interest rates in both Canada and the United States continued the sharp decline which began last November; by mid-April Canadian rates had fallen to their lowest levels in two years. Yields on most United States money market instruments did not fall quite as precipitously as in Canada so that the differential between the two countries narrowed somewhat.

After the middle of April this pattern was abruptly reversed. Although the trend varied depending on the term of the security, generally speaking Canadian rates rose sharply, while in the United States yields continued to decline or at worst rose very slightly. For example, the yield on Canadian 91-day treasury bills declined from 4.96 at the end of December to 3.96 percent in April, but by the end of May the rate was back to 4.24 percent. In the United States the treasury bill rate had fallen to 3.91 percent in mid-April and by the end of May stood at 3.48 percent. Yields on Canada bonds in the one to three year area had reversed more than half of their earlier 1.00 percent drop in a six week period ending May 31st. Rates on comparable U.S. issues on the other hand in May rose only 20-30 basis points from their April lows.

On April 6th the Federal Reserve Board posted the long-awaited reduction in the discount rate and this was followed immediately by a similar ½ of of one percent reduction — to 4½ percent — in Bank Rate in Canada. However, these moves appeared to be designed more to bring central bank rates into line with other borrowing costs than as a signal that further rate reductions were in prospect. In fact, shortly after the reductions were announced, indications of renewed economic growth emerged, leading to changed expectations as to the likely course of interest rates and raising the possibility that the expansion in money supply would be terminated. In the first four months of this year money supply in Canada had risen at an annual rate of almost 17 percent (seasonally adjusted). Since the demand for loans was somewhat less buoyant, the chartered banks were able to increase their holdings of liquid assets by $500 million, raising their more liquid asset ratio to 31.8 percent from 30.8 percent at the beginning of the year. By mid-April the banks' treasury bill holdings had risen by almost $200 million, almost half of which was taken on when the Government brought out a $100 million new issue of one-year treasury bills for February 1st delivery. In addition, the banks increased their holdings of Canada bonds by $300 million, mostly in maturities of over two years.

In the six weeks ending May 31st, however, the banks reduced their bill holdings and their investment in Government bonds levelled off. The withdrawal of this prop to the market provided the impetus to the downward movement of prices in Canada. In the United States on the other hand spring brought with it the escalation in the forecast size of the deficit. Anticipating that the financing of this deficit would lead to more attractive securities than those currently available, the commercial banks appeared to be building up their liquidity by aggressive purchases in May of bills and short-term Federal bonds. This was in direct contrast to the action of the Canadian banks and undoubtedly contributed to the divergence in the behaviour of interest rates on short Federal government securities in both countries.

There were two Federal refunding operations offered in Canada in as many months and the new issues were brought out under contrasting market conditions. To refund $400 million maturing April 1st, the Government offered investors on March 20 three choices: 4½% bonds due April 1, 1968 priced at 99.85 to yield 4.66 percent, 5% bonds of October

1973 to yield 5.21 percent, and 5¼% bonds of 1990 at a yield of 5.48 percent. The amount of the latter issue offered was limited to $125 million, of which the Bank of Canada agreed to take a minimum of $35 million. The two short-term issues were offered in amounts totalling $350 million, including a repeat of the "plus or minus 10 percent" safety valve, with the Bank of Canada committed to take up at least $115 million. The offering was divided into $175 million of the 1968 maturity and $200 million of the 1973 issue; both sold well.

The issues brought on May 15th for June 1 delivery arrived in a market which had none of the enthusiasm which greeted the earlier issues. Three maturities were offered: 4½% bonds due June 15, 1968 priced to yield 4.60 percent, 5% bonds of July 1970 on a 5.09% basis and 5½% issue of December 1974 at a yield of 5.67 percent. The amount of the offering was $375 million, with the now familiar leeway of plus or minus 10 percent, but what distinguished this offering was the lack of a long-term issue — the first time since December 1965 that the government did not attempt to sell any bonds maturing beyond ten years. Allocations were set at $160 million for the 1968 issue, and $100 million each for the 1970's and 1974's. These issues arrived on a falling market and sold immediately at a discount from issue price, suggesting that the Bank of Canada may have been forced to take up more than the agreed minimum of $135 million.

Helping to push Canadian short-term interest rates upwards in May was a notable increase in competition for short-term funds. With the implementation of the revised Bank Act on May 1st, the chartered banks began to offer higher rates on savings deposits and particularly on large fixed-term deposits. At the same time, the finance companies appeared to have reentered the short-term paper market for the first time since January.

Short-term rates in Canada may shortly level out, in part because of a potential demand for short-term securities by corporations attempting to build up their liquid asset holdings. In order to achieve their 1966 capital expenditure programmes, corporations must have been forced to reduce their

financial assets substantially. With the pace of capital spending likely to level off this year, corporations should be in a position to rebuild their short-term security holdings in 1967. On the other hand, the financing of the Canadian deficit will probably result in a substantial increase in the supply of new short canada issues. We do not know if these demand and supply factors will balance each other out, but we would be surprised if Ottawa is prepared to see a further rise in short-term rates.

In the United States, however, short-term rates are likely to rise. Action taken by Congress in the last few weeks may force the Administration to finance the U.S. deficit in the short end of the market. Congress refused to comply with Secretary of the Treasury Fowler's request for a one-shot increase in the 4¼% interest rate ceiling to permit issuing $2 billion in long-term securities. It also denied Mr. Fowler's request for an extension to 10 years in the term of treasury notes (which are not subject to the debt limit), although it did raise the present 5 year term to 7 years. Even if the short-term yield spread narrows considerably in the next few months, it is possible that Canada's official reserves could temporarily exceed the $2550 million ceiling on which our exemption from the interest equalization tax is contingent, due largely to the foreign exchange inflows resulting from the overwhelming success of Expo '67.

The Long-Term Bond Market

One of the forces which probably served to deter the government from offering a long-term bond in mid-May was the excessive number of new long-term issues. Corporations were attracted by lower rates than had been seen for some time, and by the economies of using calendar year-end balance sheets to comply with the 120-day age limit on such data in corporate prospectuses. In April alone over $225 in corporate issues were brought to the market on the heels of offerings in excess of $150 million in March.

This two-month period also saw new provincial issues totalling over $250 million. Meanwhile, the American long-term market was sinking under the weight of a heavy corporate calendar which averaged close to $1.5 billion in April and May and showed no signs of diminishing in June. Although the volume of new long issues offered in Canada dropped sharply in May, the only major offerings being $55 million Quebec's and $29 million Metro Toronto's, prices of long-term bonds generally continued to decline.

The Bank of Canada stepped in to support the battered long-term market on several occasions beginning late in April. While offering no resistance to the decline in prices, the Bank progressively lowered its bids on various long Canada maturities, apparently with a view to raising the yield level in an orderly fashion. By the third week of May long-term Canadas had fallen back to their end-1966 levels and were yielding about 5.85 percent, compared to 5.50 percent in mid-April and a low of 5.45 percent in March. The U.S. treasury 4¼'s of 1992 were quoted at a yield of more than 4.90 percent compared to 4.55 percent in the second week of April and to 4.60 percent at the end of 1966. Late in the month, however, the Federal Reserve entered the market as a buyer of long-term treasuries, and this action had the desired effect of halting the steady erosion in prices. By month-end long Canadas had risen to the 5.70 percent level and long Treasuries were close to a 4.85 percent yield. The long-term Canada-U.S. government differential had not changed appreciably since mid-April, although it had narrowed considerably from the spread of close to 1.25 percent in effect at the beginning of the year.

142 Last fall we predicted that long-term interest rates would not move very far from their August lows, and that the long-term market might bear some permanent scars from investors' fear of inflation. We were surprised when early this year yields on long Canadas fell 50 basis points, but suspected that some of the market strength was due to speculation by investors and dealers more than to any lasting change in market attitudes. Looking back over the last few months, there now appears to have been a substantial amount of "short-term" buying of long-term bonds; too many people counted on making a profit from the expected impact of easier money on long-term rates. We have seen little to change our view that the long-term bond markets in Canada, and to a lesser degree in the United States, are suffering from some fundamental problems. Monetary ease no longer appears to provide the same automatic solution as it has in earlier periods of market distress. Investors may finally have become aware of what inflation does to the value of the capital invested in long-term bond issues, and the use of further monetary expansion to finance deficits of the size now in prospect in the United States will tend more to frighten than to comfort them. We Canadians have escaped the budgetary impact of Vietnam, but have managed to substitute for it a rather profligate attitude towards spending at all levels of government. Is it surprising that the interest of Canadian investors in long-term bonds is declining ?