Assurances

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Financial Panorama
Winter – 1967

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Aller au sommaire du numéro

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Financial Panorama[1]

Winter — 1967[1]

par

DOUGLAS H. FULLERTON

In the early days of December Canadians were attempting to assess the implications of a host of uncertainties — political, economic, and financial — affecting the outlook for 1968. The Confederation of Tomorrow conference of provincial premiers, the pronouncements of the Quebec Estates General, British devaluation, feverish speculation in gold, a new if as yet unnamed American Secretary of Defence, Mr. Sharp's second consecutive mini-budget, the apparent defeat of President Johnson's tax proposals, and the rejection of the more radical suggestions found in the Carter Commission Report, all were factors which served to limit the number of year-end forecasts of growth in GNP for the coming year. Prior to the new budget, Canadian economists had been looking for a growth rate in GNP in 1968 ranging between 7 to 9 percent. Price increase reduced the estimated rise in real GNP to 4 to 4½ percent. The presentation on November 30 of Mr. Sharp's new budget and the emergence of some bearish fourth quarter indicators have altered some of the assumptions on which these preliminary guesses were based. American economists were looking for a 1968 GNP of $835 billion, up about 7 percent, but these estimates assumed the implementation of a tax rise of 10 percent effective January 1st. Early in December the forecasters were quietly reworking their figures on the basis of revised fiscal assumptions.

[1] Reproduit de "Canadian Bankers" avec l'autorisation de la Revue et de l'auteur.

The Mini-Budget

Mr. Sharp made good his November 10 announcement to Parliament that he would later in the month present supplementary budget proposals designed to cool the inflation psychosis developing in Canada and to restore orderly conditions to the capital market on which the government is very dependent. On November 30 he proposed a 5 percent income tax surcharge applicable January 1st to individuals' basic tax. The Finance Minister exempted from the effects of the tax the first $100 of basic tax and he put a ceiling of $600 on the amount by which his proposals would affect those in high tax brackets. Corporations escaped the tax surcharge but Mr. Sharp advocated an acceleration of corporate tax payments. In addition, the refundable tax on profits imposed in 1966 would be returned to corporations beginning in June 1968. The treatment of the corporate sector was designed to shore up weakness in capital investment intentions on the part of both Canadian corporations and American subsidiaries in Canada, particularly in the manufacturing area.

Taxes on tobacco and liquor were increased as much as 10 percent effective immediately. Mr. Sharp had little to offer in the way of combatting the continued escalation of wage demands and prices beyond a renewed promise to request cooperation from labour and management in these fields.

Devaluation of Sterling

The devaluation of sterling on November 18th had some short term market repercussions in Canada. On Monday the 20th the Canadian dollar weakened by half a cent, long term bonds declined by about one point and Canadian stocks, following New York, dropped sharply in the first hour. However, the Bank of Canada provided support in the bond market, buying back about $25 million of the new $6\frac{1}{4}$'s of

1973 at 98½ (one point below issue) and buying several key long term Canada issues as well. The stock market rebounded immediately, however, closing on the Monday only slightly below its Friday close. Prices since have continued to rise. A similar recovery was shown in both U.S. and Canadian bond markets, in part in expectation that the devaluation would persuade Congress of the desirability of passing the proposed 10% increase in the U.S. income tax.

Devaluation also caused a severe but short-term run on gold and gold stocks. The announcement that the French government was withdrawing from the gold pool, which has supplied gold to the London market for years as a stabilizing force, served to fuel the speculators' activities. Subsequently, President de Gaulle suggested that a return to the gold standard was desirable; this no doubt reflected the views of gold-fanatic Jacques Rueff, one of his principal advisers, and a strong advocate of doubling the price of gold. But a firm declaration by President Johnson that the price of gold would be maintained, and statements by other members of the gold pool that they would supply all the gold needed to stop any rise in its price, brought the speculation to an abrupt halt, and gold stocks fell sharply.

There is growing evidence that the U.S. is wearying of these continuing attempts to exploit gold speculation as a weapon of blackmail against the dollar, and congressional as well as public support for removing the gold backing from the dollar and setting it free is building up. Democratic Representative Henry Reuss of Wisconsin, chairman of the House International Finance Committee, suggested that gold is on its way out as an international currency, and that eventually its value would sink to "something much closer to $6 an ounce."

As for the appropriateness of the 14.3% level of devaluation, there seems to be general agreement that it is about right. For one thing, many observers felt that anything more would have given rise to a spiral of devaluations in other countries; most of those countries which followed Britain's lead this time had outstanding exchange problems of their own which would be accentuated by the fall in sterling.

292 Another factor was that the 14.3% rate reflected a new departure in exchange rate changes. In the past such moves have tended to go farther than was necessary to protect the currency against further attack by speculators; this time the protection is provided by fresh support from the Fund and from central banks of other countries. But the effect is to limit the amount of breathing space for the British economy, requiring continuing tough anti-inflationary policies to release more goods for export. Countries providing the stanby credits appear in fact to have stipulated fairly stiff conditions to ensure that such policies would be followed.

The Stock Market

Those few remaining investment houses specializing mainly in bonds must have cast a glance of envy at their brethren in the stock business. Some recent bonds carrying coupons in excess of 7 percent did attract somewhat more retail interest into the market than had been exhibited at lower rates. However, this retail interest was only a pale shadow of the demand for two convertible preferred stock issues — a $35 million Hudson Bay Oil and Gas issue, and particularly a $100 million issue of Canadian Pacific Investments offered with one warrant per share. Despite the size of this later issue, it appeared that more than the amount offered could have been successfully placed. Some dealers were reported to be avoiding their offices to escape irate calls from clients whose allotments of the CPI stock were short of their orders. The price of the shares climbed immediately to a 4 point premium above the $20 issue price and has since held close to this level.

Despite the size of the new offerings, the Canadian stock market managed to outperform its American counterpart. Although corporate profits reportedly turned up in the third quarter, the likelihood that the strike in the U.S. automobile industry would depress profits of several related industries in the final quarter, along with concern over the international monetary situation and a threatened anti-trust suit against General Motors induced a wave of selling in the American market. The Dow-Jones industrial average by mid-November had fallen 10 percent below its September 25th high of 943.1. In the last two weeks of the month the averages have wobbled irregularly higher and on December 1st the Dow stood at 879.2, 7 percent below its fall peak.

The Toronto Stock Exchange industrials, at 162.0 on December 1st were only 5 percent below their September high. Part of the explanation for the relatively poorer performance of the Dow-Jones lay in the action taken late in October by the Federal Reserve Board in bringing unregulated lenders under margin requirements. In addition, convertible bonds were made subject to the same 70 percent marging requirements as applied to bank loans on stocks.

Money Market

Two successive increases of one-half percent in bank rate in Britain, on October 19 and November 10, were followed by a 1½ point rise to a crisis 8 percent level announced in conjunction with devaluation on November 18th. In order to attempt to stem any massive shift of capital into Britain in pursuit of the high rates available there, the Federal Reserve of New York followed immediately with an increase in the discount rate of ½ percent to 4½ percent. The Bank of Canada announced a 1 percent rise in bank rate to 6 percent. The larger increase posted in Canada reflected the fact that the bill rate had for most of October been bumping against the 5 percent bank rate and in fact had been held to less than this ceiling only by Bank of Canada purchases. This same situation late in September had forced the central bank to raise bank rate by ½ percent, a move taken independently of similar action by the Federal Reserve.

Prior to the sudden announcement of devaluation, the Canadian money market was working its way out of a period of rapid escalation in short-term rates. The chartered banks toward the end of October were paying over 7 percent for three month deposits, and as much as 7½ percent for 30 day swapped deposits. Their action in competing so aggressively for funds was in part an attempt to bolster their year-end balance sheet position, and in part a response to the very wide differential existing on forward exchange rates which raised the yield on swapped deposits by as much as 1½ percent. Commercial and finance company paper rates had been marked up almost a full 100 points during October but even so most such borrowers were unable to approach the rates paid by the banks and they were driven to the sidelines. The skyrocketing of short-term rates on bank deposits terminated when the Governor of the Bank of Canada reportedly requested the banks to impose on themselves a voluntary ceiling on interest paid on term deposits. In the event, yields on fixed term Canadian dollar deposits were abruptly marked down and by early December rates for 90 day deposits were still at the 6¼ percent ceiling.

The Government of Canada offered in a two month period two new issues which were aimed at different types of buyers and which met with distinctly different receptions. The first announcement came on September 18 when the government offered three new short-term issues to refund two issues maturing October 1 totalling $525 million. Obviously designed to appeal to the chartered banks, the offering included a 4¾ percent issue due December 15, 1968 priced at 99 to yield 5.61 percent, a 5½ percent bond due December 15, 1969 at a yield of 5.86 percent, and a 6 percent bond due April 1, 1971 at par. This latter issue attracted considerable interest because of the first use of a conversion feature on a federal issue since 1960. The new bonds were exchangeable at the holders' option within 5 years into 6% bonds due October 1, 1993. The Bank of Canada agreed to take up a minimum of $175 million. Allotments were set at $125 million for the 1968's, $175 million for the 1969's and $225 million for the 1971's. All issues had risen to a slight premium in the aftermarket, when the September 26th increase in bank rate resulted in a rapid change in atmosphere.

The second Government of Canada issue was a cash offering, the terms of which were announced November 14th. Instead of the anticipated reopening of the popular 6's, which had at this stage recovered their late September loss and were once again at a premium, the government offered a new convertible issue, the 6¼ percent bonds of December 1st, 1973, exchangeable within 5 years into 6¼'s of 1944. The issue was offered in the amount of $250 million, plus or minus 10 percent, at a price of 99½ to yield 6.35 percent for six years (or 6.29 percent for 27 years). At the same time the Minister of Finance announced that a $100 million issue of thirteen month treasury bills would be offered for tender on November 28th. The $350 million was destined not only to augment the government's cash balances, which had fallen to a very low $150 million on November 1, but to retire prior to maturity $105 million bonds due January 15, 1968, in order to reduce the New Year refunding to a more manageable $400 million.

The designing of the bond issue to mature in seven years' time was obviously a means of ruling out substantial chartered bank participation. By blocking off the largest segment of the market for Canadas, the government virtually guaranteed that the issue would meet with what can only be described as limited response. The allotment was set at the minimum $225 million despite the likely take-up by the Bank of Canada of more than its commitment of at least $50 million. In announcing the allotment, the Minister also increased the amount of the new treasury bill offering to $125 million and shortened the maturity to November 29, 1968, thereby enabling the bills to qualify for chartered bank secondary reserves. In the event the 6¼'s were moved slowly, and the bills were awarded at an average yield of 5.65 percent.

In between these two issues, the annual Canada Savings Bond campaign was launched with the current series yielding 5.48 percent if held to maturity. The maximum amount which any single investor was allowed to hold was raised to $50,000 and institutions were permitted for the first time to subscribe for the issue. It would appear that the campaign realized a net amount of over $650 million, although if redemptions during the last twelve months are taken into account this figure would be reduced to $250 million.

The issuing of marketable securities by the government to other investors raised a total of $450 million in the first eight months of the current fiscal year, and there was a net increase of $365 million in outstanding CSB's in the same period. In addition bank balances had been run down over $180 million to $630 million at the end of November. These sources of funds produced $1 billion of the cash required by the federal government this year. (In his November budget, Mr. Sharp stated that his June estimate of cash requirements of $1590 million was unchanged.) Even if current cash balances are run down to the working minimum, it is unlikely that the capital market will have any breathing space between the January 15th refunding and the small issue which matures at the beginning of the new fiscal year.

Mr. Sharp warned that the government would be coming to the capital market many times in the new fiscal year and hinted at a special refunding of the 1959 CSB series prior to its November 1st maturity. The mini-budget contained a forecast of federal cash requirements in fiscal 1968-69 of less than $750 million, assuming all Mr. Sharp's proposals are implemented. This figure, however, excluded two major expenditures — the writing off of the Expo '67 deficit and the initial expenditures for the costly medicare programme which presumably will be implemented on July 1 as scheduled. The lower estimate of cash requirements for the coming fiscal year will also be made possible by borrowing another weapon from the American fiscal arsenal. Air Canada will be forced into the capital market to raise funds in its own name, rather than relying exclusively on federal advances. A $25 million long term Polymer issue placed privately in September on a 7.50 basis was the initial use of this technique by the Federal Government. Mr. Sharp left to a later exposé by Revenue minister Benson a detailed account of precisely which government expenditure programmes had been cut back in the coming fiscal year. He did imply that the raising of the maximum NHA mortgage rate to 8¼ percent undertaken in late September would encourage a continued flow of funds into the mortgage market from private lenders, and let the government to cut back its loans to CMHC, the Veterans Loan Board and the Farm Credit Corporation.

The Long-Term Bond Market

If the Minister of Finance expected his long awaited fiscal measures would have immediate repercussions in the Canadian bond market, he must have been disappointed. The New York market for long term bonds had deteriorated considerably during the fall — the Treasury 4¼'s of 1992 at the beginning of December were trading close to a 5.70 percent level, a drop of about 8 points from prices in effect two months previously. Much of this deterioration reflected the impasse in which President Johnson's proposed 10 percent income tax surcharge found itself. Chairman Mills of the House Ways and Means Committee remained unconvinced by the arguments in favour of a tax increase put forward by the Administration's economic advisors, claiming that the softness exhibited by such key indicators as industrial production augured against higher taxes and that the American government should instead cut its expenditure programmes to the bone. Hopes that the tax bill would be acted upon were raised with the announcement of the devaluation of the pound but died just as quickly once the rush to gold tapered off. At the time of writing, Congress was on the point of adjourning until late in January with Chairman Mills adamant in resisting pressure for quick passage of the bill. The resulting erosion of prices in the American bond market is not likely to be reversed until some fiscal measures are implemented, and the Canadian bond market can hardly be expected to move counter to the trends in the United States.

The two problems which will determine the course of interest rates in the coming year are the size of the American federal deficit and the defence of the dollar in its role as a reserve currency. The American government is by law forced to finance its deficit in the short end of the market. The greater exposure of the dollar to speculators is likely to lead to a less expansive monetary policy, higher short term interest rates and more policies of the guidelines type with the aim of achieving equilibrium in the U.S. international balance of payments. The American government in the new year will be under increased pressure to reduce the size of its balance of payments deficit; one unfortunate consequence is that the powerful protectionist lobby now building up in Washington may gather further strength and damage efforts to implement the tariff concessions obtained in the Kennedy Round. These two problems will have more of an impact on the structure of short-term interest rates but the psychological effect will undoubtedly spread out into the long term market as well. Canadian borrowers can also ask themselves whether the doors to the New York bond market are likely to be opened quite as widely to their issues as in 1967. It is not likely to be a comfortable year in the bond market, Mr. Sharp's efforts notwithstanding.