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Financial Panorama - spring 1967 [1]

by

D. H. FULLERTON

The long-heralded arrival of Centennial Year found the Canadian economy embarked on a period of somewhat slower growth, following the longest sustained expansion in its history. In the six years which ended in December 1966, the growth in Gross National Product amounted to no less than 60 percent. This surge in activity took place during a period in which this country experienced the fastest increase in labour force of any of the developed countries. The civilian labour force grew by 16 percent but the number of those at work rose even more rapidly — by 21 percent. The large pools of unemployment available at the beginning of 1961 were virtually exhausted despite the shift of farm labour into the cities and the entry of women into the labour force in greater numbers than ever before. Highlighting Canada's importance in the international markets, the value of export sales more than doubled in this six-year period and imports from abroad rose by over 90 percent. All in all, an impressive record.

Officials in Canada and the United States are now faced with the task of steering their respective economies past the dangers of recession without generating so much stimulation that even greater problems will be created. Most estimates of real GNP in Canada in 1967 call for an increase of close to 4½ percent compared with 6½ percent last year, while in the United States the increase this year is expected to approach 4 percent, down from 5½ percent in 1966. The private

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

sectors in both countries, faced with lagging consumer demand, are now in the process of working inventories down to more comfortable levels. Although the official survey of capital spending intentions in Canada has not yet been released, most forecasters are looking for an increase of about 5 percent. This estimate may well be revised upwards if business sentiment parallels that of the United States where a recent McGraw-Hill survey forecast a rise in 1967 spending for plant and equipment of 6.3 percent. This was slightly above the rise of 5 percent anticipated early in December by the joint Department of Commerce-SEC survey. Even more significantly, the latest estimate looked for a higher level of spending in each successive quarter over that of the previous three months. However, this somewhat reassuring sign was quickly offset by continued weakness on several other indicators, making it extremely difficult at time of writing to come to any firm conclusion as to the course of the North American economy during 1967.

The Stock Market

The Canadian stock market celebrated the arrival of Centennial Year — and perhaps the passing of a most depressing year in 1966 — by climbing sharply. By January 20 the Toronto Stock Exchange industrial average had risen 12 points or more than 7½ percent from its 1966 close, and was 16 percent above its October low. Following some hesitation, prices rose again in February but on a much more moderate scale. By February 27, the industrial average stood at 160.1, 8½ percent higher than at the beginning of the year. The more restrained February growth reflected in part profit-taking following the rapid advance as well as fears that the prospective report of the Carter Commission on Taxation would recommend the imposition of a capital gains tax.

Surprisingly, the Canadian stock market put in a better performance than did the American market as measured by the Dow-Jones industrial average which recorded a rise of only $6\frac{1}{2}$ percent over the first two months of the year. This divergence is probably explained to a large degree by differences in the relative importance of various industries in the two indexes. The Toronto average includes bank stocks which improved with the expectation that the new Bank Act would shortly be passed, while the Dow-Jones is heavily weighted by stocks such as the automotive group which had weakened under the impact of inventory reductions and lagging retail sales.

North American financial markets were subjected to a barrage of policy statements from officials in Ottawa and Washington, the net effect of which was to remove some of the uncertainties which had been weighing on the stock market about the future course of fiscal action. The first of these was Canada's baby budget, introduced on December 19th by Finance Minister Sharp, which announced a doubling of the maximum amount which individuals must pay under the 4 percent Old Age Security tax and a 1 percent increase in the Federal sales tax applicable to most goods. That these proposed changes in taxes were only just sufficient to finance the higher old age security benefits reflected the change in the economic climate from that prevailing three months earlier, when Mr. Sharp had threatened to impose even higher taxes to restrain inflationary pressures.

On January 10th President Johnson delivered his State of the Union message, followed two weeks later by the budget message. The President echoed Mr. Sharp's determination to impose only the minimum possible tax increase. To pay for Vietnam and other defence expenditures, estimated to rise by $5.8 billion in fiscal 1968, as well as higher spending for

social security programmes, the President recommended a 6 percent surcharge on corporate and individual income taxes (to last for two years or as long as is warranted by the cost of the war in Asia). The new surcharge would not come into effect until July 1. The Federal deficit, measured on a National Accounts basis, is expected to rise from $2.6 billion in the last half of 1966 to an estimated $4.9 billion in the first half of 1967, then fall back to $3.1 billion and $1.0 billion in the second half of 1967 and the first half of 1968 respectively. This apparently reflected the Administration's belief that the current weakness in the private sector would be dissipated by early summer, with a resumption of more rapid growth in the last half of this year.

The budget proposals may well undergo considerable revision at the hands of the new Congress. If at the time the measures are up for debate there are no clear signs that the adjustment phase has passed and that the economy has in fact begun to grow again, the numerous conservative members may advocate a smaller tax increase and the earlier restoration of the 7 percent investment tax credit which was suspended until January 1, 1968.[1] The publicity given to statements in this vein by Congressional leaders and to Federal Reserve Board Chairman Martin's misgivings that inflationary pressures had in fact subsided served to confuse the issues once again. Until the strength of the United States economy can be more clearly assessed, and until the fate of the budget proposals is determined, it is likely that the stock market may face a continuing period of uncertainty.

On February 24th the Carter Report was released. Although it did contain proposals for implementing a capital gains tax, there were a number of other proposals designed to encourage common stock ownership by Canadians. The Report itself suggested (Vol. 6, pp. 147-150) that the adop-

tion of its recommendations would be essentially bullish for the stock market. The investor, however, will probably be wise to withhold judgment until there is clearer evidence that the Report — or at least the sections of its favourable to equities — would in fact be adopted.

The Money Market

The reaction to the State of the Union message and the United States budget for fiscal 1968 was even more dramatic in both the short and long-term capital markets. The budget message contained a strongly worded statement advocating the desirability of a lowering of interest rates on a world-wide basis. This was followed on January 21st by the Chequers conference of the Finance Ministers of the United States, the United Kingdom, France, Germany and Italy, at which the feasibility of a concerted move toward lower interest rates was reportedly the main item on the agenda. The Federal Bank of West Germany had already reduced its discount rate to 4½ percent from 5 percent on January 5th to bolster its sagging economy and a further reduction to 4 percent was instituted on February 16th. In the interval the central banks of Britain, Sweden and Belgium all announced reductions of ½ percent in their discount rates and the Bank of Canada lowered Bank Rate to 5 percent from 5¼ percent effective January 26th. In announcing this move, Mr. Rasminsky stated:

> "This reduction in Bank Rate should be taken as an indication of the Bank's view that the recent easing of credit conditions was appropriate to Canada's domestic economic circumstances and its external financial position."

Although in the U.S. the Federal Reserve discount rate remained unchanged at 4½ percent, the major banks moved

to lower their prime loan rate from the 6 percent level to which it had been raised in August 1966. At the end of January the Chase Manhattan reduced its prime rate to 5½ percent while at all other banks the rate was lowered to 5¾ percent.

Although these initial steps toward a reduction in the cost of credit were welcomed in Washington, the Administration evidently grew impatient with the stickiness exhibited by the downward movement of rates in other countries. In order to facilitate the continued reduction of rates in North America without endangering an influx of borrowers from foreign countries escaping the higher interest costs existing in their own capital markets, the President on January 25th requested a two-year extension of the interest equalization tax and a doubling of the tax rate to a maximum of 30 percent. Continued exemptions for Canada, Japan and the developing countries from the application of this tax were recommended.

The Canadian short-term market successfully digested two offerings of Government of Canada securities in a two month period. At the end of November the terms of the Government's December 15th refunding operation were announced. To refinance the $450 million issues maturing in mid-December and the $50 million CNR issue due January 2, two short-term issues were offered — 5½ percent bonds due January 15, 1968 on 5.88 percent basis and 5¾ percent four year bonds on a 5.89 percent basis — in addition to $100 million 5¾ percent bonds of 1992 to yield 5.94 percent. There was a novel twist attached to the two short-term issues: the combined amounts of these two issues were set at $400 million "or thereabouts". The Government would accept as much as $440 million or as little as $360 million of the total subscribed for. This 10 percent leeway was evidently de-

signed to avoid the disturbance of the existing yield structure witnessed at the time of the August refunding disaster. In any event, aided by the Bank of Canada's take-up of a minimum of $35 million of the thirteen-month issue and $175 million of the 1970 maturity, prices of these two issues rose to a premium. The final allotments were set at $125 million for the 1968 bonds and $300 million for the 1970's, somewhat less than full use of the "thereabouts" option.

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As part of a new cash offering, the Federal Government on January 31st offered for tender $100 million treasury bills maturing December 1, 1967. The bills were awarded on a 4.51 basis, compared to the previous regular bill auction at which the rates averaged 4.68 percent for 91 day bills and 4.67 percent for six month bills. The inverted yield structure reflected the view that lower interest rates would prevail through the course of the year, as well as the improved liquidity position of the chartered banks who purchased virtually all of the new bill issue.

Perhaps because of a recent ruling by the Department of National Revenue, the new Canada issues offered for delivery on February 1st did not include a short-term bond. Late in December rumours which had been circulating for many months were confirmed by the announcement that the discount on short-term bonds would be deemed as income for tax purposes if purchased by corporations after December 1st. Some confusion still exists because National Revenue did not choose to define "short term" in a precise fashion. Since the Federal Government has been the largest issuer of short discount bonds, this decision effectively restricted its access to corporate short-term funds.

The easing of credit restraints in the short-term market brought about a decline in the rate on three month treasury bills of 62 basis points from mid-November to the last tender

in February, while yields on short-Canada bonds dropped 70 to 90 basis points over the same period. Even the beleaguered finance companies have benefitted, although because of the Atlantic aftermath, foreign-owned finance companies could place their short-term paper more cheaply than could Canadian companies. By the end of February rates on 90 day finance company paper issued by the largest companies were quoted at 5⅝ percent to 5⅞ percent, compared to the December high of 6½ percent. In the Eurodollar market the yield on three-month U.S. dollar deposits had dropped from the high of 7⅛ percent to 5½ percent at the end of February. Monetary authorities in both Canada and the United States appeared to adopt a more restrictive policy in February and the decline in short-term rates levelled off. However, on February 28, the Federal Reserve Board announced a reduction in the level of reserves held against savings deposits. These changes may serve to stimulate a further downward move in short-term rates.

Long-Term Bonds and Mortgages

The performance of North American bond markets in the first two months of 1967 can only be described as spectacular — a spectacular advance in January followed by a decline of almost equally spectacular proportions in February.

Buoyed by the announcements of tax increases and by the expressed determination of fiscal authorities to reduce the level of interest rates, prices in the U.S. bond market rose by roughly 1½ points in the first two weeks of January. In Canada the improvement was even more impressive — by early February long-term bond prices were 3 to 4 points above their year-end close. However, the Canadian market had not participated in the 3½ point rise recorded in the American long-term market in December, because of the $500

million Federal refunding and a substantial volume of provincial issues. Borrowers were once again quick to take advantage of the easier tone in the market. In the first six weeks of the year over $200 million in new issues were brought out by provincial and corporate borrowers, in addition to the $150 million Government of Canada cash offering late in January.

The Government issue consisted of the reopening of 3 outstanding issues: 5½ percent bonds of October 1, 1975 priced on a 5.70 basis, the 5½ percent issue of 1980 on a 5.71 percent yield and the 5¾'s of 1992 on a 5.69 basis. Again the leeway of plus or minus 10 percent was applicable to the issue. This option was not used however; the final allotments were $70 million for the 1975 issue, $30 million for the 1980 maturity and $50 million for the 1992's. The Bank of Canada agreed to acquire a minimum of $50 million of the new offerings. In the aftermarket, all three issues rose to a premium; the 1992's rose from their issue price of 100¾ to 103½ on February 8th, a yield of 5.50 percent, a far cry from the experience of the mid-December refunding when the same issue fell ⅜ of a point below issue price and was supported by the Bank of Canada on a 5.98 percent basis.

Although the substantial upward improvement in bond prices did attract some small amounts of institutional investment, genuine investors appeared to be outnumbered by those riding the market including the dealers. The rise came to an abrupt halt when the Bank of Canada on February 2nd appeared in the market as a seller of 1992's on a 5.50 basis, signalling satisfaction with the then prevailing yield structure. This action produced a notable cooling of attitudes on the part of investment dealers and their earlier overly enthusiastic reaction quickly turned to one of concern over the size of their swollen inventories. In the United States similar concern

followed Chairman Martin's statement that further steps to lower credit costs might well be precluded by inflationary pressures, combined with a growing list of new issues which had enlarged the March calendar to almost $1½ billion. Bond prices in both countries were rapidly marked down and by the end of February the Canadian market had fallen back about 2 points while in the United States the Treasury 4¼s' of 1992, the bellweather of the Government market, were back to the levels of early December. Due to the greater gyrations in the U.S. market, the differential between Canadian and American Government bonds, which had widened to 1.30% at the end of last year, was back to the more usual spread of 100 basis points.

In our fall last article in this series we stated that "interest rates may not move very far from the August peak for some months to come", adding to this the caveat that much would hang on the forthcoming fiscal measures taken by Ottawa and Washington and on a clearer assessment of the strength of the North American economies than was possible at that time. In the interval yields on long-term Canadas fell from a 5.95 percent basis to 5.50 percent and then rose to close to the 5.70 percent level. That rates moved somewhat farther than we had envisioned is in part the result of our failure to take full account of the mercurial temperament of the dealers, who reacted strongly to the first tangible signs of official action to ease pressure on credit markets after 2 years of rising interest rates. In addition the spreading layoffs in the automobile industry have since confirmed the fact that the economy has entered into an adjustment phase.

Looking ahead, we see no reason for assuming that the long-term market will resume the buoyancy which pushed it up so fast early this year. We still feel, as we suggested in the last issue, that the long-term bond market will bear the

scars of investors' fears about inflation for some time to come. Easier money may indeed still be with us — particularly if business does not improve this spring, but its main impact will probably be felt on short-term rates. Mr. Sharp will shortly introduce his new budget but, faced with the expansionary programmes already announced in many of the provincial capitals, he may well feel disinclined to take any further stimulating action. Although the coming months may bring with them a slower growth, and a somewhat higher level of unemployment than we have seen in the recent past, we believe that the adjustment process will be short-lived and that the basic strength which underlies our economy should again rise to the surface before the Centennial flame is finally extinguished.

Postscripts

1. As this article went to press, further steps in the direction of stimulating capital investment in both Canada and the United States had been proposed. President Johnson recommended the restoration of the 7 percent investment tax credit effective March 10. Finance Minister Sharp announced that corporations would no longer be required to pay the 5 percent refundable tax after the end of March and that depreciation allowances, which were cut in last Spring's budget, would be fully restored on capital goods purchased after March 31.

2. The U.S. House of Representatives on March 15 passed a bill which would raise the maximum interest equalization tax by 50 percent rather than doubling it as the President had requested.