

Financial Panorama

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Financial Panorama¹

by

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In the last several years the summer months have been marked by financial crises, impending or in full flower, and Canada's centennial year was no exception. By the first week of September the North American public was becoming increasingly aware of the damage which unparalleled government spending was inflicting on capital markets in both Canada and the United States and of the very real dangers this posed for the economy.

There had been virtually no letup in the demand for long term capital by private borrowers since the business cycle began to level off late last year, and by late spring interest rates had receded only slightly from their 1966 highs. As summer began, long term interest rates responded to the emerging signs that economic growth may have resumed and by the end of August were above their August 1966 peaks. It was against this background that both Ottawa and Washington were forced to take steps to reduce the size of rapidly swelling federal deficits below levels which threatened to tax the very capacity of the capital markets. If the era of the new economics has indeed relegated recessions to the role of historical phenomena, it has also inculcated a ready acceptance of government deficits as a permanent fixture in the modern world. Our political leaders also seem to hold the view that perpetual financing by governments can be accomplished without regard for capital market implications, provided only that one is prepared to regard with equanimity some widening in the degree of inflation which may be tolerated.

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

On August 3rd the American people learned that President Johnson's attempt to finance both guns and butter in a fully employed economy, without raising taxes, had not been very successful. The President officially verified earlier private estimates that the financing of the war in Vietnam concurrently with the programs of the Great Society threatened to send the federal deficit soaring to over \$28 billion in the current fiscal year, and that an income tax surcharge of 10 percent was necessary in order to bring the deficit down to a more manageable level of \$18 billion. Along with postponements of scheduled reductions in the automotive and telephone excise taxes and a continued acceleration of corporate tax payments, the President proposed that the surcharge be made applicable from July 1 for corporations and October 1 for individuals. The long-delayed introduction of the proposed fiscal measure understandably aroused considerable opposition as to its timing in view of business cycle uncertainties. At time of writing there appeared to be little chance that the imposition of a personal income tax surcharge would occur any earlier than January 1st.

Although not involved in financing a major war, Ottawa was also forced to take measures to pare the size of the prospective federal deficit. Finance Minister Sharp reportedly revealed to his cabinet colleagues early in August that if proposed spending programmes were not sharply cut back, cash requirements for the current fiscal year would rise sharply above the \$1.5 billion forecast in the June budget. It was clear that even the forecast deficit would impose a serious strain on capital markets and the deficit in fiscal 1969 was likely to be higher still. Mr. Sharp used the deteriorating bond market to help drive home the point that the federal government did not have unlimited borrowing power, and that spending must be reduced if taxes were not to be raised.

Canadians may be forgiven if they exhibit some scepticism that Mr. Sharp's advice would be implemented. At the beginning of September the only announcements of spending cutbacks involved some winter works projects and the space satellite programme, but the public had seen little sign that the government was prepared to forego any of its major proposals. Unless Ottawa gives very clear evidence that it has established some orders or priority in its unending list of expenditures, and a firm resolve to limit its borrowing, the capital market will remain in its current depressed state. 197

The Stock Market

Indications that the inventory adjustment was virtually completed and that the North American economies had resumed an upward growth trend provided disappointing second quarter profits and the news of the proposed U.S. tax surcharge. By August 9 the Dow-Jones industrial average had reached 926.7, 9 percent above its June low and 2 percent higher than its previous 1967 peak set last May. However, the appearance of profit-taking, American bombing in Vietnam close to the Chinese border, heightened concern about inflation, the profits squeeze and the threat of a prolonged strike in the automobile industry combined to reverse the upward momentum and by August 25 the Dow-Jones average had fallen to 894.1. Prices strengthened again following the announcements of price increases for certain steel products and on September 5th the Dow-Jones closed at 904.1, 2½ percent below its August high.

The Toronto Stock Exchange industrial index over a nine week period beginning June 5th rose 6½ percent to 172.2, but by September 5th had backed off 3 percent to 167.4. That the Toronto index did not fall much further than New

York was surprising in light of the jolt given by Algoma Steel's August 21 announcement that it was laying off 900 workers and stretching out a \$175 million expansion programme. The move was reportedly necessitated by reduced steel demand and the prolonged construction strikes in southern Ontario.

198 The sharp uplift to stock prices which took place in mid-summer was accompanied by exceptionally high trading volume in New York. This gave rise to concern in some quarters about the dangers of excessive speculation and led officials of both the American and New York stock exchanges to suspend margin transactions in several listed stocks. In addition trading hours were shortened for a two week period to eliminate a clerical backlog built up from the heavy trading volume. However, while some speculation was undoubtedly present, the July upsurge was concentrated more in the blue chip stocks than in the glamour stocks which had been the focus of attention earlier this year.

The recent behaviour of the stock market reflects a lessening of confidence in earlier predictions that the economy had in fact shaken off any recessionary tendencies. Inflation remains an area of prime concern — in July alone the Canadian consumer price index rose almost 1 percent to 150.2, more than 4 percent above the level of a year earlier. The mid-year survey of capital investment intentions revealed that although manufacturers had revised upwards their 1967 investment programme since the initial survey was made, their spending for plant and equipment would still be well below that of 1966. Should the automotive workers tie up the American industry for any length of time, the Canadian economy will suffer from the repercussions with the danger that more companies will follow Algoma's lead and cut spending further still. This summer's poor wheat crop may well remove much

of the steam from our export trade. The reduction in tariff barriers which will slowly emerge now that agreement has been reached on the Kennedy Round should give Canada the opportunity of increasing export markets — provided that our competitive position is not further eroded by high prices and a depressing productivity performance. But until a clearer view of economic trends can be obtained (and the duration of the automobile strike is known) stock market trends will likely continue to be unsettled.

The Money Market

Aggressive bidding for short-term funds by the chartered banks served to maintain upward pressure on yields on money market instruments during the summer. At the end of August, the banks were offering $5\frac{3}{4}$ percent for one year term deposits, $\frac{1}{2}$ percent above the rates paid three months earlier. Rates as high as 6 percent could be negotiated for 3 to 6 month money offered in size. In order to stem the flow of funds into the banking system, trust companies were forced to raise their rates and at the end of August were paying $6-6\frac{1}{2}$ percent for one year deposits. Yields on shorter term securities such as finance company and commercial paper were also marked up by about $\frac{1}{2}$ of 1 percent during the summer. Only in the market for short-term Government of Canada securities was there any sign that rates had stabilized following the rapid increase of last spring. Canada bonds maturing in the 1969-70 area at the end of August were trading at close to a 5.50 percent basis, about where they were in mid-June. Yields on 91-day Canada treasury bills rose from 3.96 percent in mid-April to a peak of 4.40 percent two months later and fluctuated at a somewhat lower level during the balance of the summer. At the last tender in August the yield averaged 4.34 percent.

The stability in the market for Canada securities in the face of an expansion in supply at the weekly treasury bill auctions, and a new cash offering of Canada bonds aimed exclusively at the money market area, stemmed from the greater appetite for liquid assets on the part of the banking system. Although the government increased the supply of bills by \$50 million in the June-August quarter, the rapid expansion in money supply enabled the chartered banks to add over \$100 million to their holdings in this period. Following a small contraction in June, money supply rose at a seasonally adjusted annual rate of 18 percent over the following two months, bringing the rate of increase since the beginning of the year to more than 14½ percent. This expansion in liquid assets took place concurrently with a rise of more than \$400 million in loans, so that the more liquid asset ratio remained close to the level of 32 percent to which it had risen in mid-May.

During the same period of relative stability in yields on Government of Canada market instruments, rates in the United States were rising rapidly. The yield on three-month U.S. Government treasury bills rose over 80 basis points at the first tender in July and by the end of August had climbed a further 20 basis points. The substantial gyrations in this segment of the American market largely reflected new federal financing which was concentrated in treasury bills and in competing tax anticipation certificates.

The Government of Canada on July 10 offered three new short-term issues totalling \$175 million. These consisted of 5% bonds due October 1, 1968 at 99.50 to yield 5.44 percent, 5½'s of April 1, 1969 at 99.90, yielding 5.56 percent and 6's of December 15, 1971 at 99.75 to yield 6.06 percent. Due to the somewhat surprising 6 percent coupon and the attractive concessions to prevailing prices, the issue met with

a fair response. Allotments were set at \$20 million for the one year bonds, \$70 million for the 1969's and \$85 million for the 1971's. The 6's moved to a premium of three-quarters of a point above issue price before the Bank of Canada stepped in to cool initial enthusiasm.

Including the new cash offering which was delivered August 1, the government during the first five months of the fiscal year sold to investors other than its own accounts a net total of \$336 million of its direct and guaranteed marketable securities. Of this amount \$206 million was required to finance the net redemption of Canada Savings Bonds. The government also ran down its cash balances by about \$90 million during this period, so that by September 1st it had raised only \$220 million of the more than \$1.5 billion needed for the whole fiscal year. Although its current bank balance of about \$725 million provides some cushion, the amount of funds which must be raised over the remaining seven months of the current fiscal year will maintain upward pressure on interest rates, particularly in the short-term area, for many months to come. The investment community is anticipating an unusually attractive Canada Savings Bond campaign this autumn. The campaign will be held between October 1 and January 15, the dates on which two issues of more than \$500 million each will mature. Mr. Sharp will certainly face difficulties in the months ahead in attempting to find the cash he needs without an excessive expansion of the money supply.

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Long Term Bonds and Mortgages

This summer the malaise under which the markets for long term securities in Canada has laboured for so many months was clearly visible in the American market as well. The U.S. Treasury $4\frac{1}{4}$ percent issue of 1992 late in August fell to an all-time low of $87\frac{1}{8}$, a yield of 5.17 percent.

Although prices then improved slightly, by early September this issue was yielding about 5.10 percent compared with the "near crisis" level of 5.05 percent in the summer of 1966. Prime United States corporate issues were offered this summer at yield of over 6.00 percent and even these record levels did not generate as much interest as was expected.

202 Regular readers of this column have become aware of our view that the historically high level of interest rates over the past year has been due to much more fundamental factors than tight money. This was echoed in a review published by a large U.S. investment house in July 1967.

"... The developments of the past two years have added importantly to the cumulative mass of evidence that the three fundamental factors of investment life in the United States are growth, inflation and the availability of a vast and rapidly growing pool of capital that logically must seek to get into closer step with the first two realities. Erosion of the purchasing power of the dollar has been the most persistent of all trends in the American economy. Although stability of costs and prices has been greater than in other industrial nations, increasingly the record argues that political realities are such that the economy no longer is deflatable in the sense it used to be. It is to be questioned therefore whether even 6% bond coupons are adequate compensation for the prospective shrinkage of the dollar's value. And it is notable that whereas the first half of 1966 saw considerable efflux of money from common stocks to take advantage of near-record interest rates on fixed bonds, no such trend is in force in 1967. In fact, only the condition of the bond market prevents a much larger reverse movement."

Some of the pundits have described this recent period as one of "expensive easy money". Despite the substantial expansion in money supply, interest rates remain higher than they were a year ago. Long Canadas at the end of August were again above a 6 percent yield, a new Ontario Hydro issue priced to yield a record 6.54 percent was working its way slowly out of dealer inventories just as Quebec Hydro offered a \$60 million issue, of which \$45 million involved

long term bonds at a yield of 7.00 percent. Reportedly building up is a heavy corporate calendar and at the end of August several borrowers were on the point of going to New York in spite of record high American rates. Housing is again likely to bear the brunt of any economy drive by the government, and conventional mortgage funds are as hard to come by as they were last fall, despite prime rates of $8-8\frac{1}{4}$ percent.

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Perhaps the only hopeful sign for a change in the wind is the increasing degree of awareness and concern over the current plight of the capital market on the part of both Ottawa and Washington. While one must applaud the fact that there is now concern in official quarters where before there was none, it is hoped that this concern is translated quickly into action. The capital market cannot stand much more buffeting.