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Douglas H. Fullerton

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Aller au sommaire du numéro

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Financial panorama: summer 1968

by

DOUGLAS H. FULLERTON

M. Fullerton nous donne aujourd'hui sa dernière chronique trimestrielle. Nous le regrettons vivement, car il a été un collaborateur fidèle et intéressant, à une époque où le marché financier était particulièrement difficile à analyser. Nous voulons lui dire ici combien nous avons apprécié sa collaboration. A.

This will be my last Financial Panorama, and instead of the usual analysis of the impact of current events on Capital markets, I propose to take a longer term and somewhat more personal look at trends in those markets, and where they appear to be leading. I will concentrate in particular on the rising threat to our existing financial system that is being posed by the current inflationary situation.

Perhaps the best perspective on this can be obtained by examining the recent state of the market for long term bonds. For most of the past fifteen months bond prices have been declining, and yields have reached an all-time high. Top grade corporate issues are on an 8% basis, the best provincial bonds yield only slightly less, and most Canadian issues are well above 7%. This trend has been paralleled in the U.S., so that if anything there has been a narrowing of the yield differential between comparable bond issues in the two countries. Late in May, in fact, a relatively small Government of Canada issue, $100 million (U.S.) twenty year bonds, required a rate of close to 7% to attract U.S. buyers.

The question which has been giving bond dealers nightmares for some time is whether the market for long term

bonds can ever recover from the sustained battering it has recently taken. The optimists look to past cyclic movements in interest rates, and suggest that when pressures on the economy ease, rates will fall and some confidence in the long term bond as an investment instrument will be restored. The pessimists — and their numbers have been rising steadily — are beginning to believe that our society faces a set of new conditions that will keep interest rates high, and may push them even higher, in future.

I regret that I must place myself squarely in the pessimist's camp. My progression to this state of mind might be of interest to some readers. I became actively involved in the management of bond portfolios in 1957, and in 1961-62 wrote a book, "The Bond Market in Canada". Among other things, this book emphasized the profits to be made from active bond trading and from exploiting the fluctuations in bond prices as interest rates moved up and down.

Several years ago, however, I began to come reluctantly to the conclusion that the days of the bond market were numbered. A little over a year ago, in fact, I spoke to some investment dealers on the topic "The Dying Market for Long Term Bonds". Finally, this April, I left the business — which is one of the reasons why I will not be continuing to write this column !

What is the thrust of my argument ? Essentially it is that investors have realized that inflation has become a permanent part of our way of life, and that anyone who invests for the long pull in bonds or similar instruments can only lose money. What is more, he can lose it in a variety of ways, as someone who in 1958 bought a Conversion Loan 4½% bond of 1983 at 100 can readily testify. As interest rates rose, the price of the bond fell, and the end-of-May

value of the 4½'s of 1983 was only 76 — with a purchasing power, moreover, equal to only 60 of his original 1958 dollars. His 4½% return on cost does not even compensate him for the increase in prices over the past year — particularly if he had to pay income tax on the coupons.

Is it any wonder that buyers are demanding increasingly higher rates to compensate them for the risks of continuing erosion of their capital? And yet even with these higher rates, many groups of buyers are deserting bonds as an investment, and swinging over to common stocks, property, or other forms of equity. The extent of this swing has been somewhat concealed this past year or two by the very rapid growth in pension funds, notably the public Canada and Quebec Pension Plans. These funds have absorbed a large volume of new bond issues, and have masked the extent of the decline in interest in bonds by individuals and the traditional institutional buyers. (One might add that the CPP and QPP are compulsory, and their receipts are more like taxes than savings; their bond buying serves to provide funds to the provinces in the same way as taxes — although the provinces must pay interest.)

Among other factors which have prevented bond prices from falling even farther is that many bond buyers are still disciples of the cyclical school. At each new level of rates some buying appears from those believing that prices have reached bottom, and that they will soon turn up and provide an opportunity for capital gain. Adherents of this approach have diminished sensibly in number this past few months, however, and are tending to look elsewhere for their capital gains.

We in Canada have also been lucky because of our easy access to the U.S. markets. Even if U.S. rates are nearly

as high as our own, there are at least buyers to be found in that country. Canadian issues qualify for many state and municipal pension funds, and since most of these funds still operate under fairly restrictive, if archaic, rules (most of the money must be in *safe* investments, such as bonds!), the aggregate of money for bond investment continues to be relatively large. In fact were it not for these U.S. buyers this past six months, most of our government and corporate borrowers would have had to do without. The Canadian bond market could not possibly have met the needs — at any interest rate — forcing Canadian government and businesses into a policy of severe retrenchment.

It will be argued by the optimists that this is a short run view. They say that cyclical forces will soon reassert themselves, the pressures on our resources will ease, and interest rates will decline. Current high interest rates, moreover, will tend to restrain the inflationary forces, reducing private investment and government deficit financing. They cite the effect of the Vietnam war on the U.S. economy, and believe that when it ends the pressure on the U.S. capital market will ease, and this in turn will bring interest rates down in Canada.

These are plausible arguments, but let us examine first the claim that present "high" interest rates will slow expenditures. Interest rates are certainly high by the standards of the past four or five decades, but in North America at least this period has been largely one of price stability; except for the brief surge after World War II, the rate of annual increase in consumer prices, until 1966, seldom reached two percent. This long term pattern conditioned investors to think in terms of a "normal" rate of interest. Between the mid-thirties and 1950, in fact, the *normal* rate on long term Canada bonds was 3%; the absurdity of this only became clear when the Bank of Canada stopped supporting the market in the

early post-war years. The conversion Loan of 1958 established a new level of 4½% percent, but this soon changed to a 5 to 5½% range as bond prices receded.

Yet is 8% today in fact any higher than 4½% ten years ago ? If one pays taxes, it is not likely to be. At say a marginal income tax rate of 35%, an investor today receives a net return of just over 5%, barely enough to compensate him for the erosion in the value of money. An investor in 1958 would have received 3% net — considerably more than the rise in prices in that year. Are interest rates today *really* that high ?

The big question, of course, is whether we can expect this annual 4 to 5% rate of price increase to be reduced. If one discounts the restraining effect of interest rates on capital expenditures — and there is plenty of evidence to suggest that borrowers are growing increasingly aware that inflation reduces the burden of their debt, and are willing to pay almost any interest rate to get their money — then what will slow the upward movement of prices ? Ending the Vietnam war would have some short term stabilizing effects, but there seem to be enough other problems facing the United States, including its own internal strugle against poverty, that any appreciable shrinkage in U.S. government expenditures is most unlikely.

The basic problem remains, and it is not a problem peculiar to North America. Prices are going up because incomes are rising faster than productivity. These wages pressures are partly due to the "revolution of rising expectations". People have become conditioned to expect that their incomes will go up annually by 8, 10 or 12%. This contributes to rising prices, particularly of services, and in turn strengthens the demands for further wages increases. Moreover, workers are

better organized to obtain what they want; the more complex and interdependent our industrial society becomes, the greater the impact of a strike. And with so many formerly unorganized segments of our society now unionized, such as clerical workers, postal employees, and garbage collectors, the collective power of labour has been greatly multiplied.

Is there anything that can change this pattern ? Are we condemned indefinitely to inflation of 4, 5, 6 percent, and more, annually ? Neither government officials or economists seem to have much to offer by way of help. As for me, I can see no light at the end of the tunnel. In theory, inflation can be stopped, but none of the usual methods suggested appear either workable or saleable to the public — at least in the near future.

Voluntary restraint ? In an economy dominated by power groups, is it reasonable to expect one group, labour, to renounce their power base ? Not bloody likely, as Eliza would say. Voluntary controls and moral persuasion ? Again, too little and too late; the time for this approach was two years ago. Mandatory control on prices and wages ? Maybe, but is any group in the economy yet ready for this ? I doubt it, although events may force it. But when one considers that such controls have proved only partially effective in wartime, what are their chances in a peacetime economy ?

Would a complete breakdown of our system, induced by excessive inflation, lead to stable prices ? This "per ardua ad astra" approach is certainly a possibility, but what a terrible solution it would be in terms of the resulting unemployment, dislocation and distress — quite apart from its obvious effect on the capital market. Yet the Germans experienced two such crises in the past fifty years — and this may explain why they have been more successful than most

countries in keeping inflation within bounds in recent years. We North Americans have never gone through a real inflationary meat grinder.

If this pessimistic view is the correct one — and each reader can take his own stand on this question — what will happen to the capital market as we know it ? One can only guess, but a clear product will be the demise of the long term bond as an investment instrument. Money will still be loaned and borrowed, but for much shorter terms and at high rates; special devices such as tax-exemption, warrants and stock may be required as an additional bonus to attract the buyers. Insurance as a form of saving will survive only if it provides some protection against inflation, possibly through such innovations as the variable annuity. Mortgages will have very high rates or involve giving the lender a piece of the equity.

None of these institutional trends is particularly earth-shattering, and indeed all are observable in some degree today. Our capital market is an adaptable organism, and will survive, although the institutions in it were designed to work in a world of relative economic freedom and stable prices. But the process of adaptation will be difficult for many of the institutions, and change rather than stability will be the order of the day.