

The Current Market: The Best of Times, The Worst of Times

Rallying Stock Markets – For How Long?

This Fall we have seen the kind of stock market performance Dickens would have appreciated. The steady recovery in secondary equity markets since early September, with the TSX Composite Index rising 9% and the S&P 500 Index up 13%, provided welcome relief for investment dealers coping with the relentless grind of market and business conditions. But there are mixed views about how long this share rebound will last, with many convinced we are in the early stages of a bull market and others skeptical of any extended momentum.

The sudden rebound in equity markets reflects a number of factors, including some improving economic statistics, the Republican victory in the House of Representatives, and the Federal Reserve decision on quantitative easing. The skeptics argue the markets are overstating the discounted benefits of these developments. Business confidence, especially in the United States, remains depressed; the de-leveraging of financial and household balance sheets continues apace; and the U.S. government is mired in large deficits and escalating debt. Finally, the U.S. over-stretched fiscal position leaves monetary policy with the burden of economic recovery – at the risk of igniting inflationary pressures and protectionist sentiment in Canada's largest trading partner.

The academic debate aside, the rising markets have boosted revenues in both retail and institutional markets. While the challenges faced by the industry will continue to gnaw away at revenues and earnings, better conditions will at least provide a cushion and some scope to manage and address these industry challenges.

The Challenges for Investment Dealers

The business challenges come from many directions.

First, despite a firmer tone to equity markets, many investors are still reluctant to participate, partly due to uncertainty about the economic and financial outlook, and partly because of inherent share price volatility and prospects of substantial downside risks. Indeed, large amounts of cash balances in Canadian dealer accounts, totaling nearly \$36 billion at end September, nearly 40% above the pre-crisis level, have moved to the sidelines even as interest rates continue at historic lows. Moreover, dramatic structural changes in equity markets, notably the advent of High Frequency Traders (HFTs), have raised investor caution, as many investors view themselves as disadvantaged compared with computer-assisted HFTs – illustrated by the sharp pickup in net mutual fund redemptions through the early summer months, partly reflecting the publicity surrounding the May “flash crash”. The industry has argued for effective safeguards for HFTs, taking into account such factors as registration, pre-trade risk management and comprehensive surveillance of HFT active trading activity.

Second, the regulatory burden at all firms continues to escalate. Aside from continued IIROC and CSA rule changes in furtherance of regulatory reform, the proposed onerous tax-reporting obligations for U.S. client accounts with all Canadian firms, which go far beyond and are in addition to the exiting reporting requirements for Canadian dealers with the QI designation, have added heavily to the overall compliance burden. The IIAC is making active representation to the IRS and U.S. Treasury to alleviate the reporting burden for Canadian dealers.

Third, net interest earnings from the spread earned on client cash balances plummeted in the post-financial crisis period. These earnings have been nearly cut in half from average levels before the crisis with little prospect of near-term recovery for this relatively small but significant source of retail revenue.

Fourth, small and mid-sized dealers, particularly in the retail business, have found business conditions tough sledding, with operating margins squeezed by falling revenues and rising fixed costs from compliance and technology requirements and falling revenues. Unlike large integrated firms, they do not benefit from significant scale or diversification to cushion the effects of weak retail markets.

Further, many small firms assist small and mid-sized businesses raise equity capital, and these companies have encountered difficulty issuing new equity shares in the past year or so. In this regard, the IIAC urged the House Finance Committee to recommend the forthcoming federal budget reduce the effective tax rate for capital gains.

Despite recovery in secondary equity markets, the two years since the financial crisis have been difficult ones for investment dealers. Investors remain cautious participants in capital markets, companies find financing conditions mixed, and costs face upward pressure from technology needs and regulatory compliance.

Nearly one-quarter of firms earning less than \$20 million per year, roughly 30 firms, have incurred consistent operating losses for much of the past 18 months. Even with some improvement in market tone, merger and acquisition activity among the smaller firms in the industry is likely to gather steam. Twelve IIROC registered firms have resigned in the past 18 months.

Unless markets have shifted to an upward trend, industry earnings will remain under pressure and further firm amalgamations will result.