



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

***Running a Gauntlet of Deflationary Pressures:
The Challenges Facing Investors and Issuers in a
Time of Uncertainty***

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These days, whenever I hear about the outlook for our financial marketplace I am reminded of the story of Adam and Eve. When they were cast out of the Garden of Eden, supposedly Eve turned to Adam and said: "I guess we're going to have to get used to a new paradigm."

Talk of changing paradigms has become pretty common. But the 2008 financial crisis truly did mark a dramatic transformation.

The post-war model of smooth, stable business cycles has collapsed under the weight of excessive leverage. Governments and institutions fed a borrowing and spending boom in North America and Europe. The balloon was bound to burst.

It's a problem with no quick fix. Banking crises may stem from irrational expectations, but what is the rational expectation for how long it will take to work our way out of this one?

A good place to look for an answer is in the exhaustive study of financial crises by economists Kenneth Rogoff and Carmen Reinhart. In their book *This Time is Different* they explain that the average downturn caused by a banking crisis is deep and long. Typically, they last a half-decade or longer.

The impact can be seen in our financial markets. Officially we may not be in deflation. But market participants face deflationary pressures. That includes falling equity and debt prices. And it includes market turbulence accentuated by fears of financial default and economic uncertainty.

Just a few months ago, the economy saw an optimistic moment, what might be called a “market spring.” Green shoots appeared and markets were expected to move gradually higher, pushed by a steadily improving recovery until we saw a sharp market sell-off in April, led by commodity shares.

Late summer and fall brought a market collapse amid protracted and acrimonious debate over the U.S. debt ceiling and the mounting debt problems in Europe.

In fact, the TSX Composite Index has fallen 10 percent this year and the TSX Venture Index is down by about 30 percent.

We hear considerable talk about profound changes in the capital markets. They are characterized by low interest rates and a steady downward drift in financial asset prices.

Severe market volatility has been exacerbated by new active players, such as hedge funds and high-frequency traders. That’s illustrated by steep and sudden movements in share prices -- as exhibited in last May’s “flash crash.”

Clearly, pervasive indebtedness is weighing down recovery. The problem is rooted in both Europe and the United States. And neither Americans nor Europeans have found the fiscal and monetary policies to counteract the reigning uncertainty.

One of the mechanisms we could count on to curb excessive deficits has disappeared. Think about it: When the U.S. government allowed deficits to rise, what used to follow? Bond markets would drive up sharp increases in interest rates on long-term bonds. That reaction pressured the government to take steps to curb deficits and bring down rates.

When concerns were rampant about increased federal spending in 1993-94, for example, the 10-year rate on Treasury bonds climbed from 5.2 percent to 8 percent in a little over a year.

But when Democrats and Republicans cooperated to reduce the deficit, 10-year yields dropped to half that rate. That brought down the cost of borrowing – and opened the door to the Clinton boom.

Clinton political adviser James Carville, the Ragin' Cajun, summed it up pretty well. He said he used to think if there was reincarnation, he wanted to come back as the president or the pope ... But now, he said, "I would like to come back as the bond market. You can intimidate everybody."

But who's intimidated now? Bond rates seem to be unable to move up. Even with the financial disorder in the equities and commodity markets since July, Treasury interest rates on 10-year Treasury bonds have gone down. Even after Standard & Poor's decision to downgrade U.S. Treasury bonds, rates went down. The bond markets seem to have acquired their own law of gravity.

That removes an important constraint on government deficit spending. What has caused this?

Well, for one thing, the proportion of U.S. treasury bonds held by foreign central banks has been increasing. Since 2001, emerging markets alone have accumulated more than \$5 trillion in official exchange reserves.

Meanwhile, the Federal Reserve Board itself has become a major buyer of longer-term Treasuries, with 1.6 trillion dollar purchases for QE 1 and QE2.

Central banks dominate the bond markets – but they are not all that interested in getting higher yields. The Fed is buying U.S. Treasuries to stimulate the economy. The other central banks are doing it to prevent their home currencies from appreciating compared to the U.S. dollar. They're prepared to accept lower yields, unlike traditional bond-holders.

So U.S. policy-makers are isolated from the pressures that used to compel them to cut deficits. A valuable tool of fiscal stability seems to have been eliminated.

Meanwhile, other traditional economic panaceas seem to be losing their impact.

John Maynard Keynes' solution to a slow economy was increased spending and public debt. But the debt-to-GDP ratio in the United States has reached its highest level since World War II. Yet economic growth has sagged.

Excess reserves in the U.S. banking system have expanded from 1.8 billion dollars in 2007 to 1.5 trillion dollars now. Yet we saw no substantial impact on economic growth.

It's hard to get people to spend when they are overwhelmed by household debt. And people have a long way to go in deleveraging their household balance sheets.

In this global environment, Canada stands out among the G20 countries. Our financial sector is on a sound footing. Our fiscal and monetary policies have been well managed. They are characterized by competitive corporate tax rates and contained deficit financing.

But even though we have punched above our weight, our domestic markets are tightly yoked to the global economy. We're a small, open economy – highly export-dependent.

As such, Canada is heavily influenced by the policy decisions of other governments. Most notably, that includes monetary stimulus in the United States and European actions to address fiscal deficits and debt overhang.

Not surprisingly, investors are worried.

There is a great line in the Tom Stoppard play *Arcadia* that goes: “It is the best possible time of being alive when everything you thought you knew is wrong.”

Well, a time marked by exciting new discoveries, inventions, and technologies may indeed be exciting. But what about investors suddenly discovering that so many of their traditional touchstones cannot be relied on? Exciting isn't the word that most would use.

Investors know only too well from recent experience that their accumulated financial wealth is at risk. They are desperately trying to preserve capital as well as achieve a return.

And everywhere they look they seem to see reason for uncertainty.

There is uncertainty about the financial system itself, because of its integrated nature – an interconnectedness demonstrated by the fact that there are now 70 trillion dollars in outstanding credit default swaps. There is uncertainty about government’s ability to address debt – especially in the United States and Europe.

Among all of the storm warnings, there seems to be no safe port.

Investors are finding it increasingly difficult to pursue a long-term view.

Keynes once said “In the long term we are all dead.” But before that, most of us retire. Pursuing a secure retirement has become increasingly challenging.

Concerns are exacerbated as investors get older. At some point, they have to convert their portfolio into income-yielding assets. Not only does the law require that they withdraw minimum amounts from their RRIF tax shelter. But reality requires that they draw on RRSPs and RRIFs for retirement income. This is particularly true for those who experience longer than average lifetimes.

But retirees converting savings into traditional investments, such as GICs or government bonds, can't generate sufficient income. In 2006 a one-year GIC paid 3 per cent a year. Now it pays 1 percent. That's less than the rate of inflation. And for a \$100,000 portfolio that translates to a loss of \$2,000 a year in income.

Investors looking to invest in dividend-paying companies are finding them harder to come by. Other than REITs, how many companies listed on the TSX pay a dividend yield of 4% or more? Just 75, or about 2 percent of listed companies.

Income-seeking investors have few choices to pick from to pursue diversification strategies. Annuities are at rock bottom. And of course even among companies that provide dividends, investors have to worry about dividend adjustments.

Investors at the end of their working years face the prospect of delaying their retirement. They have to combine it with work. They have to reduce their portfolios. They have to cut back their lifestyle.

Advisors are making the best of a bad situation. They're keeping their clients invested in investment grade debt securities, dividend-paying blue-chip companies, and higher than normal holdings of cash and liquid assets to weather the storm.

What impact is this having on issuers?

Equity financings in Canada were down 31 percent in the third quarter this year, compared to the second quarter. Corporate debt offerings also fell in the third quarter. We estimate these offerings this year to be down roughly a fifth.

According to DBRS, the Canadian commercial paper market contracted by 6 percent last year and the market is expected to shrink even further this year. The main problem seems to be that it is so hard to sell the paper, due to investor risk aversion and low short-term rates.

Larger companies can continue to obtain debt and equity capital. But what about small and mid-sized companies -- Canada's traditional job creators? They have seen a sharp fall-off in financings since the summer. Finding capital for risk investment in this environment is very difficult.

Preliminary data for the year shows that IPOs of small and mid-sized companies in Canada totaled 1.8 billion dollars. That's about a third of the 5 billion dollars that was raised last year. Small and mid-sized equity financings fell 35 percent in the third quarter of this year and can be expected to remain at these low levels for the final months of 2011. We estimate that flow-through shares in the resource sector, which account for a third of small business financing, will be down by 20 to 25 percent this year over last.

Obviously, the investment industry is feeling the impact of the jittery market. Retail revenue will likely be down roughly 20 percent if weak conditions in the summer and fall continue to year-end. The number of firms losing money increased steadily during the April-July period. It has likely moved even higher in more recent months.

As compliance costs escalate in the next year or so as the Client Relationship Model is implemented, operating margins, particularly at small firms, will be squeezed even more. The upshot will be further consolidation among the small firms in the industry.

Well, at least no one can accuse me of trying to sugar-coat the situation.

But there is some potential for a turnaround. After all, the market was up last month, largely on the hopes of a solution to the European sovereign debt problem.

In the October 28th edition of the Wall Street Journal, the headline read “Cheers, Skepticism Greet Deal.” The article stated, “Europe’s new strategy to tame its debt woes invigorated global financial markets, despite lingering questions over how the plan will work and whether it will be enough to end the two year old crisis.”

Well, I say the jury is still out. If we see a credible, comprehensive solution, one can envision considerable improvement in our capital markets.

Financing and trading activity can rebound rapidly if conditions suddenly reverse direction. That's what we saw in the 2008-2009 financial crisis and its immediate aftermath.

And as Dwight Eisenhower once said, "Pessimism never won a battle."

So let me talk about some policies that can be part of the solution.

The Investment Industry Association has made some specific recommendations for the next federal budget, policies that will help investors and small issuers.

First, we believe Canada should meet the G20 five-year fiscal target of reducing the deficit in half by 2013, and begin reducing the public debt burden by 2016. It is important that the government completes the final phase of corporate tax rate reductions. These objectives would contribute to long term investment and growth, attract businesses from abroad and set the mark for other G20 countries to meet their commitments.

Here's the second recommendation: the federal budget should encourage business and job growth by reducing the after-tax cost of capital to small and mid-sized businesses. The Finance Minister can do that, for example, by reducing the capital gains tax rate, by broadening the applicability of flow-through shares , or by extending the preferred corporate tax rate to mid-sized companies.

In light of the challenge that Canadians face building and maintaining a nest egg for retirement, they need some modest adjustments to existing pension arrangements. That would include, for example, giving Group RRSPs the same payroll tax treatment as defined contribution and defined benefit plans.

Group RRSPs are the fastest growing business retirement arrangement in the country, totaling some 40 billion dollars. 3 million Canadians working for small businesses across Canada depend on these plans for their retirement.

The recently proposed PRPP retirement arrangement will broaden the choice for Canadians. The Investment Industry Association has provided concrete suggestions to the Federal Government to ensure that PRPPs are an efficient retirement vehicle.

What about the challenges facing regulators?

Obviously, regulators must continue to address concerns about malfeasance and fraud in the markets that undermine investor confidence. But the unprecedented turmoil in domestic and global markets in recent years is a serious threat to investor confidence.

The reform process that began in 2008 must continue, focusing on regulations related to registration requirements and disclosure, and structural reforms in debt and equity markets.

The financial crisis in 2008 and the more recent turmoil in capital markets illustrate that national markets are tightly interconnected and can react quickly and sometimes violently to macro events and policy decisions that impact the global economy, financial markets and institutions.

In these circumstances regulators need to stay focused. Regulators need to adapt. Regulators need to collaborate with their counterparts across jurisdictions, and encourage discourse and commentary from market participants, to design a harmonized regulatory framework for global markets. One that contributes to efficient and well-functioning markets. And one that protects investors, and mitigates the systemic threats to national markets.

Thank you.