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FINANCIERS

Economic and Financial Review

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Office of the Chief Economist

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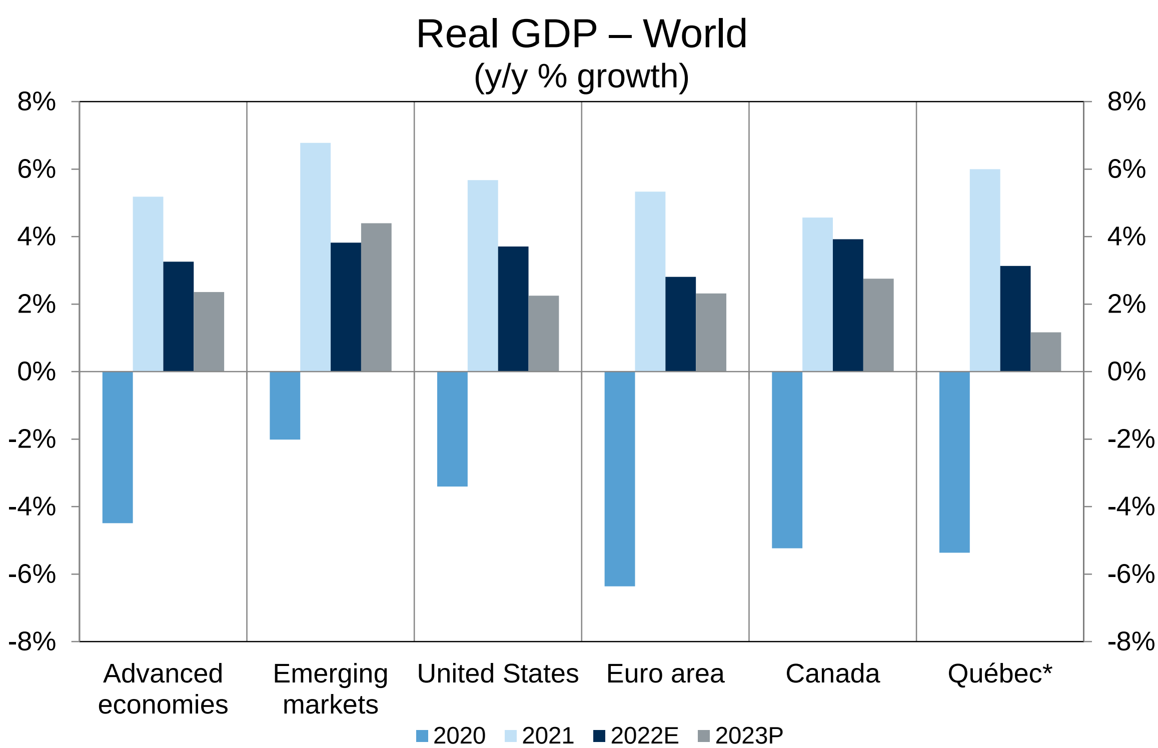
Highlights

- The Russian invasion of Ukraine and China's zero-COVID policy are jeopardizing the global recovery, leading to persistent and widespread inflation. Central banks are accelerating rate hikes and revising their economic forecasts downward.
- The Canadian economy continued to perform well in the first half of 2022, despite rising inflation and an adverse global environment. The Bank of Canada has raised its policy interest rate several times in recent months, including a 100-basis-point lift in July.
- In Québec, the economic recovery gained further momentum in the first quarter of 2022. The labour market is still grappling with a labour shortage, with the province reporting close to 225,000 job vacancies.
- The stock markets have fallen significantly since the beginning of the year. U.S. stock indexes entered bear market territory, with decreases of over 20%, while the S&P/TSX fared slightly better on the strength of the energy sector.
- At the same time, the major bond indexes, where returns move inversely to yields, also incurred significant losses. High inflation and monetary tightening pushed up yields across maturities.
- The cryptoasset market has also been going through a period of substantial turbulence since the start of 2022. For example, after peaking at around US$67,000 in November 2021, Bitcoin has lost more than two thirds of its value.



** For 2023, average of forecasts by major Canadian financial institutions*

Sources: International Monetary Fund, Institut de la statistique du Québec and AMF

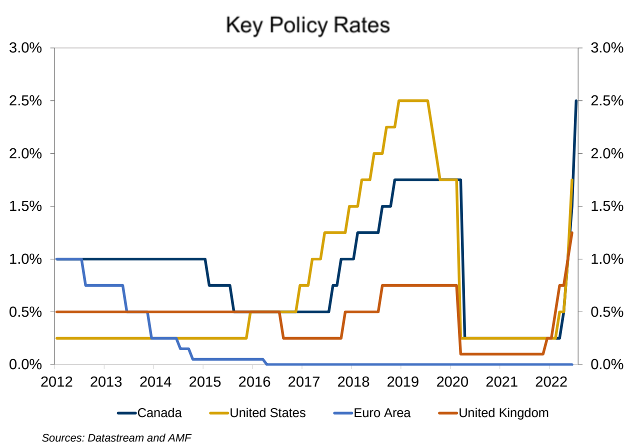
Economic context

World

The Russian invasion in Ukraine and China's zero-COVID policy are jeopardizing the economic recovery by exacerbating inflationary pressures and the slowdown in global demand. The economic forecasts of central banks and international economic and financial organizations (World Bank, IMF, OECD) have been revised substantially downwards in recent months.

The war in Ukraine and resulting sanctions are spurring energy and food prices to ever greater heights. Meanwhile, draconian lockdown measures in China are causing a decline in global demand and production stoppages, which are disrupting supply chains. Inflation, far from temporary, is persistent and becoming widespread.

With inflation and employment at high levels, central banks are accelerating monetary tightening. However, rapidly rising key policy rates could make a soft landing for the economy more difficult, and there is more and more talk of recession scenarios.



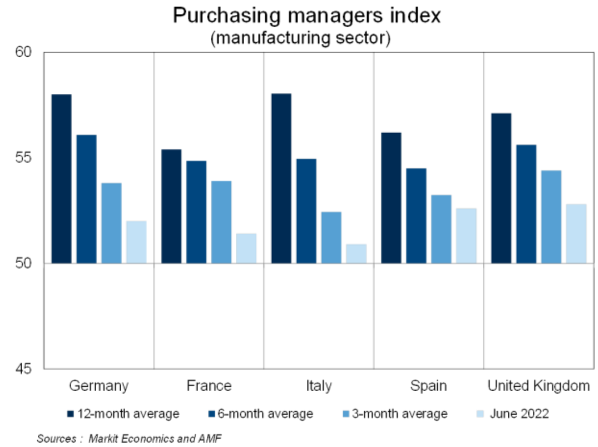
U.S. GDP fell 1.6% in the first quarter owing, in part, to a sharp deterioration in the trade balance, and a return to growth in the second quarter appears uncertain. The labour market also remains tight, with the jobless rate at 3.6% in June and record levels of job vacancies for months.

However, the primary concern for Americans is soaring prices, especially at the pump. The inflation rate reached 9.1% in June, its highest level in more than 40 years, and inflation expectations are also on the rise.

To bring inflation back to the 2% target, the Federal Reserve decided to take a more aggressive approach, raising its policy interest rate 75 basis points in June, the largest increase since 1994. This puts the key policy rate in the 1.50%-1.75% range, and the Federal Reserve is hinting that a hike of at least 50 basis points will likely be announced at the next meeting of its Federal Open Market Committee. According to the Fed's projections, the key policy rate could be as high as 3.4% by the end of 2022.

At the same time, the U.S. central bank also began to reduce the size of its US$9 trillion balance sheet by ceasing to reinvest all the proceeds from matured bonds purchased under its quantitative easing program.

On the other side of the Atlantic, the euro area had a strong start to the year, posting annualized growth of 2.5% in the first quarter, but this pace will be difficult to sustain given the war in Ukraine and the effect of the sanctions imposed on Russia. Declining purchasing managers indexes are already pointing to a slowdown.



The Russian invasion of Ukraine has accelerated the upward trend in inflation owing to Europe's heavy dependence on Russian oil and natural gas. Inflation in the euro area reached 8.6% in June, with it exceeding this average in 14 of the 19 member countries. The European Russian oil embargo and reduced Russian natural gas deliveries could increase the upward pressure on prices.

Faced with both rapidly rising inflation and a slowing economy, the European Central Bank (ECB) announced that it would be terminating its asset purchase program as of July 1 but that it does not intend to reduce the size of its balance sheet as the Federal Reserve is doing. It also announced an initial rate hike in July, ending the negative interest rate policy started in 2014. Unlike several other central banks of developed countries, the ECB had not yet begun to tighten its monetary policy.

Finally, to prevent a new sovereign debt crisis, the ECB will buy bonds from the more indebted southern euro area countries. The gap between the borrowing costs of the peripheral countries and Germany has widened, threatening to fragment the European currency area.

In the United Kingdom, inflation, driven by rising energy and food prices, reached 9.1% in May, the highest level in 40 years. The Bank of England responded by raising its key interest rate for the fifth consecutive time in June, bringing it to 1.25%.

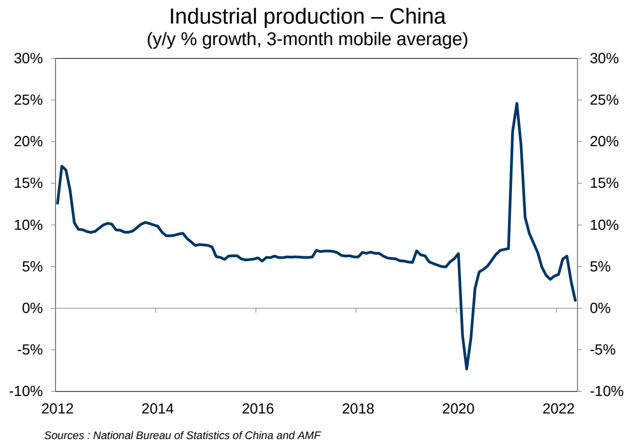
In China, the zero-COVID policy has put the brakes on economic growth, with major implications for global demand and supply chains.

While this policy worked well in the early stages of the pandemic when the Alpha strain was predominant, it is proving much less effective against the more contagious Omicron variant. Several of the country's major cities, starting with Shanghai and Beijing, have been placed in lockdown in the last few months. Hundreds of millions of Chinese citizens have been made to isolate at home or, in some cases, in quarantine centres and undergo mass testing.

China's economy was already struggling with the crisis in the residential real estate market and the collapse of several heavily indebted major developers. In the first quarter, GDP grew only 4.8%, a relatively small increase by Chinese standards and below the already unambitious target of 5.5% set by the government.

The outlook remains uncertain, especially as Beijing intends to continue to take a hard line against COVID-19 outbreaks. Recent economic indicators point to a slowdown, with consumer and business confidence having been shaken.

So far, the Chinese government's support measures have been aimed primarily at businesses, as opposed to households. For its part, China's central bank, unlike central banks elsewhere in the world, is maintaining an accommodative monetary policy.

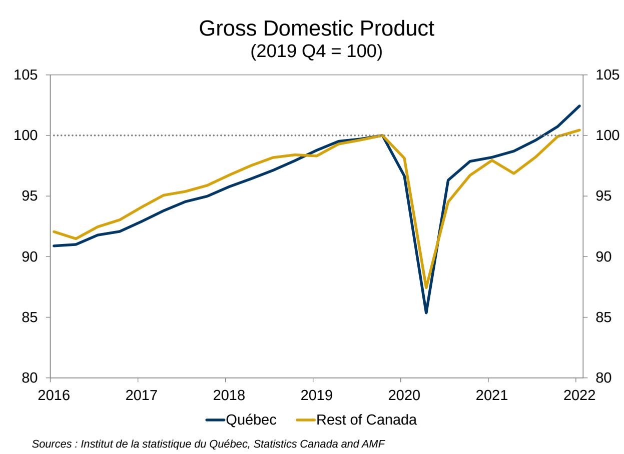


Finally, the pandemic has not yet run its course. Infections with new Omicron sub-variants are on the rise on both sides of the Atlantic, suggesting that a new wave of COVID-19 is coming.

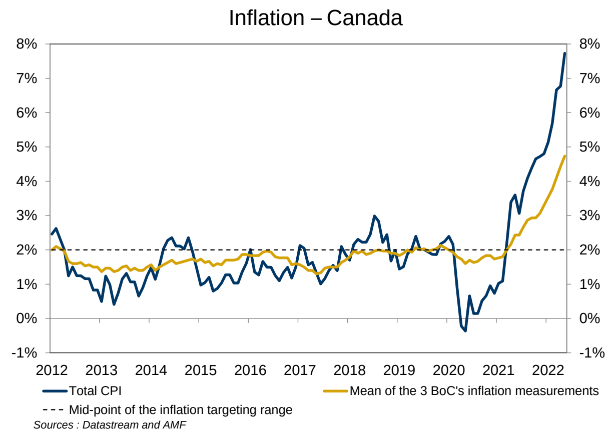
Canada

The Canadian economy continued to perform well in the first half of the year, despite rising inflation and an increasingly unfavourable global environment. GDP grew at an annualized rate of 3.1% in the first quarter, supported by broad-based strength in domestic demand.

While this rate is significantly below the pace observed in the second half of 2021, it is nonetheless faster than the economy's potential rate of growth. This situation is unsustainable over the long term and can only fuel inflationary pressures.



While residential construction is still going at full throttle, the housing market is beginning to show some early signs of cooling, including a slowdown in sales in recent months. Housing price growth, which is still largely positive on a year-over-year basis, is also showing signs of slowing. Rising mortgage rates are gradually tightening borrowing conditions and could cool the housing market even further over the coming months.

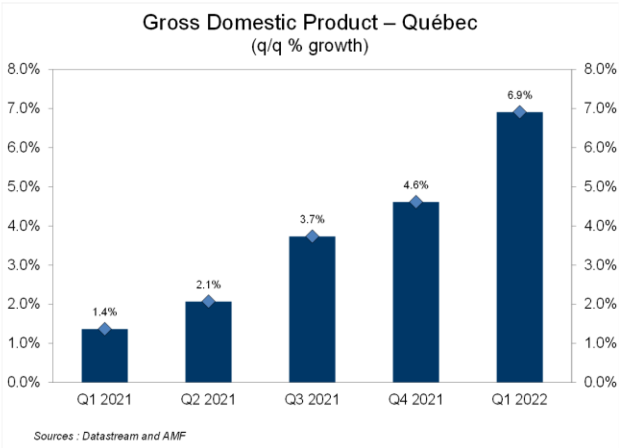


The Bank of Canada has tightened monetary policy four times in recent months, including a stunning 100-basis-point increase in July, in an effort to cool the overheated economy and ease inflationary pressures.

The Bank of Canada's policy interest rate is now at 2.50%, and further monetary tightening is expected before the end of the year. In the meantime, inflation continues to rise at a rapid pace, standing at 7.7% in May.

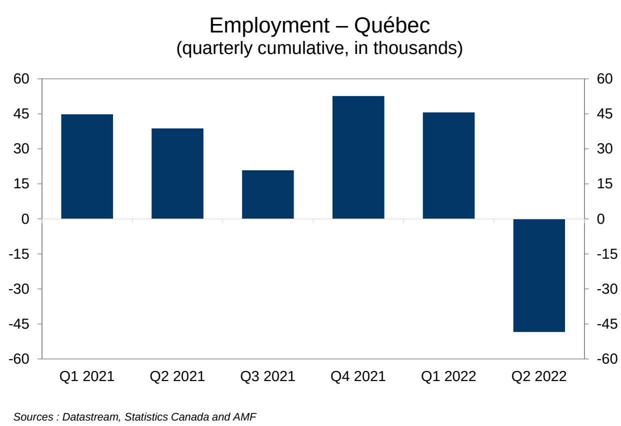
Québec

The Québec economy performed exceptionally well in the first quarter of 2022. Bolstered by household spending and business investment, the province's GDP grew an annualized 6.9%, significantly higher than the 4.6% increase in the previous quarter.



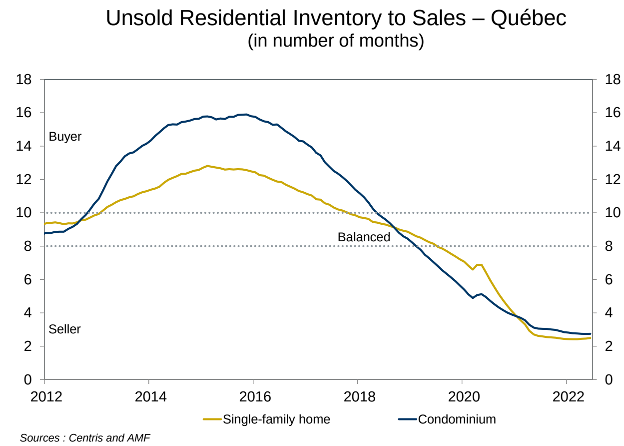
Weak exports, however, widened the trade deficit and subtracted from economic growth.

The strength observed in the economy in early 2022 has been clouded by recent changes in employment. In June, employment fell by 27,000 jobs and the unemployment rate, while still at an all-time low, stood at 4.3%. With close to 225,000 job vacancies, Québec is still grappling with a major labour shortage that is resulting in fewer opportunities to create jobs.



As elsewhere in Canada, average home prices continued to climb in Québec. In June, the average price of units sold in the province was up 15% year over year.

The fragility perceived in sales since mid-2021 was again borne out by a 10% year-over-year decrease. However, housing starts were up nearly 6% year over year (+71,088), a sign that activity in the residential construction sector is still very robust.



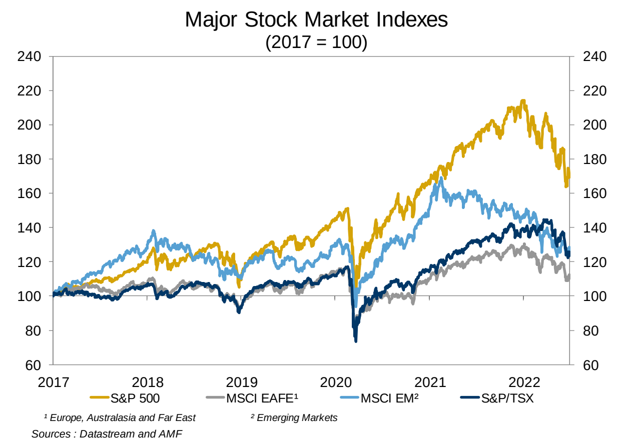
In this tight housing market, affordability has continued to decline and, with its low inventory of unsold homes, Québec remains a seller's market. Rising mortgage rates, however, will help cool the real estate market over the coming months. Some forecasters are talking about prices coming down in the second half of 2022.

As elsewhere, the outlook for economic growth in Québec has been revised downward. Increased borrowing costs and soaring inflation will impact consumer spending, investment and the housing market. Still, the Québec economy could achieve a soft landing owing to the relatively healthy balance sheet of Québec households, which are less heavily indebted and have a much higher savings rate than households in the rest of Canada.

In addition, the current labour shortage, which is occurring in a context of full employment, can only cap the long- and medium-term outlooks for economic growth. As a result, Québec economic growth is bound to slow down in the very near future.

Financial Markets

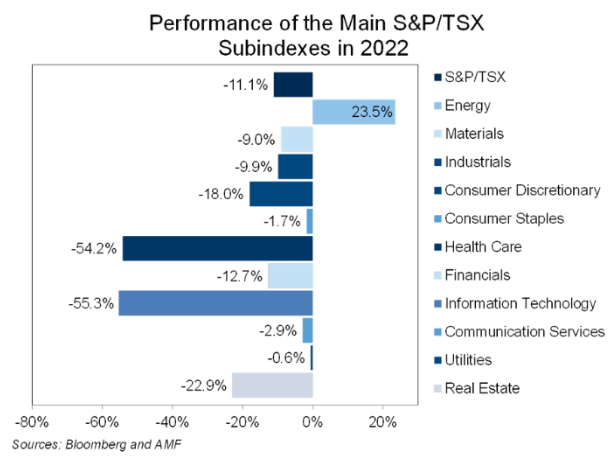
Investors have faced a number of headwinds since the beginning of the year. Skyrocketing inflation, the war in Ukraine, the strong increase in bond yields and aggressive monetary tightening have clouded the economic and financial outlook. In this environment, stock markets have retreated significantly. The MSCI All Country World Index has fallen 18.5% since the start of 2022. Bond markets, which move in the opposite direction to yields, are also down sharply.



In June, the S&P 500, the flagship U.S. stock market index, entered bear market territory, a decline of 20% or more from its most recent peak. It ended the quarter lower by 20.6% from the start of 2022, weighed down, in part, by concerns about the Federal Reserve's more aggressive stance and fears of a recession. Tech stocks, which have relatively high valuation ratios, were particularly hard hit in the markets, weighed down by rising interest rates. The NASDAQ, which is heavily technology weighted, was down 29.5% from the beginning of the year.

In Canada, the S&P/TSX is faring slightly better, with a decline of 11.1% from the beginning of the year. Energy, which represents about 18% of the index, posted a fairly significant gain of 23.5%, buoyed by a marked increase in oil prices. Financials, the most heavily weighted sector of the Toronto index, fell 12.7%, which still bettered the S&P 500 Financials sector. The TSX's Information Technology sector has also dropped sharply, but the impact on the overall index is relatively limited owing to the sector's smaller weight in the index.

According to the Morningstar National Bank Québec Index, Québec-based TSX-listed companies generally underperformed the S&P/TSX. The 14.3% decline reflects in part the absence of Québec companies in the Energy sector. This performance is, however, still slightly better than that of the major developed country indexes.

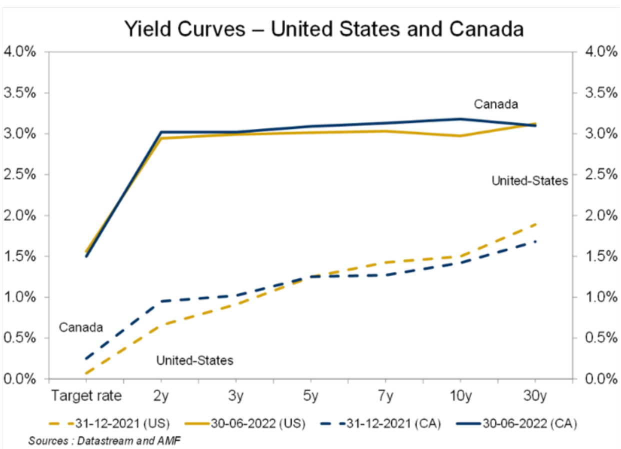


Elsewhere in the world, the major developed country stock markets recorded declines, particularly in Europe, where some markets are more exposed to the effects of the conflict in Ukraine. Lastly, the MSCI Emerging Markets Index, despite a slight rebound in the Chinese indexes at the end of the quarter, has lost 14.9% of its value since the beginning of the year.

Persistent inflation and monetary tightening are the key themes in the bond markets, with the major bond indexes incurring significant losses. In North America and elsewhere in the world, high, persistent inflation increased bond yields and forced central banks to take action. Ten-year U.S. federal government bond yields jumped from 1.5% at the start of 2022 to nearly 3.5% by mid-June, the highest level since 2011, before falling back about 50 basis points on growing recession fears. Fears of a recession—or at the very least a significant economic slowdown—also affected the corporate bond markets, where yield spreads increased significantly.

Similarly, 10-year Canadian government bond yields surged 180 basis points from the start of 2022, ending the quarter slightly above 10-year U.S. yields, at 3.2%. Likewise, the 5-year Canadian bond yield, which has a major effect on the mortgage market, shot up approximately 190 basis points.

Even in the euro area, where negative yields have become commonplace in the past few years, yields rose significantly. Ten-year German bond yields, which were in slightly negative territory at the start of 2022, ended the quarter at 1.4%.



The cryptoasset market has been going through a period of intense turbulence since the start of 2022. After reaching a high of approximately US$67,000 in November 2021, Bitcoin lost more than two thirds of its value, ending the quarter at around US$20,000. Other cryptocurrencies, as well as the decentralized finance (DeFi) ecosystem, also experienced considerable volatility that, in some cases, impaired their ability to operate. Even stablecoins, with their value pegged, in principle, to the U.S. dollar or other safe assets, were affected.

The strong turbulence in the financial markets could continue for a while longer. Everything suggests that high inflation and monetary tightening, set against a backdrop of geopolitical tensions, will continue to be dominant themes in the financial markets for several months to come. Steep increases in inflation and yields, both observed and expected, are presenting major challenges for the real economy and the financial markets. Monetary tightening will necessarily act as a brake on economic growth and corporate earnings. In such a context, recession risks are on the rise.

Market Performance

Stock Markets

	Level	% change							Last 12 months	
	2022-06-30	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index	718	-7.6	-14.1	-18.5	-13.0	-13.7	5.6	5.9	703	886
MSCI EAFE[1]	1,188	-6.5	-8.8	-12.8	-9.7	-9.0	1.9	1.6	1,172	1,383
MSCI Emerging Markets	59,621	-5.1	-9.0	-14.9	-16.0	-22.2	0.9	1.9	58,578	76,677
S&P 500	3,785	-8.4	-16.4	-20.6	-12.1	-11.9	8.8	9.3	3,667	4,797
S&P/TSX	18,861	-9.0	-13.8	-11.1	-6.0	-6.5	4.8	4.4	18,717	22,087
Morningstar National Bank Québec Index	332	-6.0	-15.1	-14.3	-16.6	-13.9	2.8	4.8	323	420

Bond Markets

		Level								Last 12 months	
		2022-06-30	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	4.0	3.6	3.1	2.0	2.1	2.0	2.1	2.4	1.7	4.4
Ontario	10-year	4.0	3.7	3.1	2.1	2.1	2.0	2.1	2.4	1.7	4.4
Canada	10-year	3.2	2.9	2.4	1.4	1.5	1.4	1.5	1.8	1.1	3.6
United States	10-year	3.0	2.8	2.3	1.5	1.5	1.5	2.0	2.3	1.2	3.5
United Kingdom	10-year	2.2	2.1	1.6	1.0	1.0	0.7	0.8	1.3	0.5	2.7
Germany	10-year	1.3	1.1	0.5	-0.2	-0.2	-0.2	-0.3	0.5	-0.5	1.8
	AA Corp. (10-year)	4.5	4.3	3.6	2.4	2.4	2.3	2.4	2.9	2.1	5.0
Canada	BBB Corp. (10-year)	5.3	5.0	4.3	3.0	3.0	2.9	3.1	3.6	2.7	5.7
	BBB - 10-year Gov. spread	2.1	2.1	1.9	1.6	1.5	1.6	1.6	1.8	1.5	2.2
	AA Corp. (10-year)	4.1	3.8	3.2	2.1	2.0	2.0	2.7	3.1	1.7	4.5
United States	BBB Corp. (10-year)	5.1	4.7	3.9	2.7	2.6	2.5	3.5	3.7	2.3	5.4
	BBB - 10-year Gov. spread	2.1	1.8	1.6	1.2	1.1	1.0	1.5	1.4	1.0	2.1

[1]Europe, Australasia and Far East [2]Annualized returns

Sources: Datastream, Bloomberg and AMF

NOTE