ECONOMIC and FINANCIAL REVIEW

Office of the Vice-President
Strategy, Risks and Performance

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AUTORITÉ DES MARCHÉS FINANCIERS

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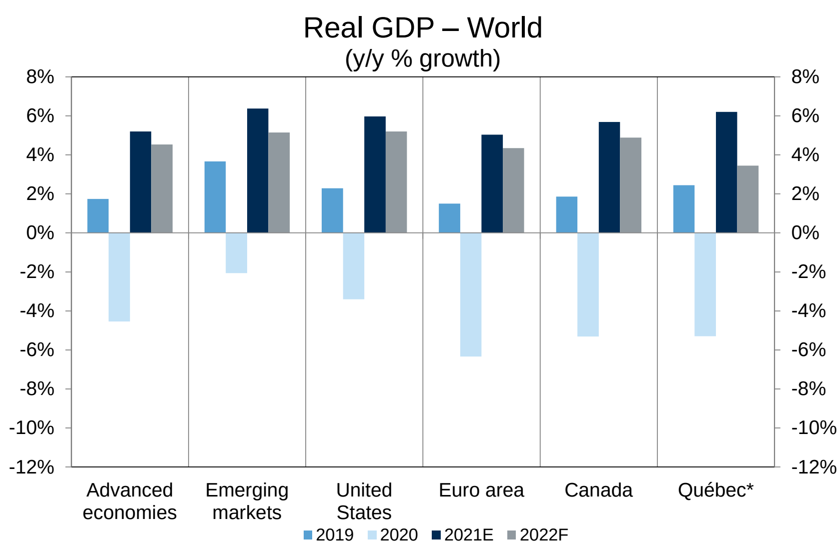
HIGHLIGHTS

- The global economy rebounded significantly in 2021, owing to support from governments and central banks and vaccination programs in the developed countries. However, the recovery was marked by the periodic resurgence of the pandemic and return of public health restrictions.
- The U.S. economy posted very robust growth in 2021, returning to pre-pandemic levels. Inflation rose to 7.1% in December, prompting the Federal Reserve to taper monetary stimulus more quickly in the months ahead.
- In Canada, GDP grew nearly 5%, a level not seen since the mid-1980s. The recovery of the economy and rising prices led the Bank of Canada to end its quantitative easing program.
- Québec's economy is expected to grow more than 6% in 2021, placing it firmly ahead of the rest of Canada. Québec recouped all of the jobs it had lost since the beginning of the pandemic and now has the lowest unemployment rate in the country, at 4.6%.
- Global stock markets posted excellent returns in 2021, especially in the developed countries, with governments maintaining ultra-accommodative monetary policies and economic growth and corporate earnings rebounding strongly.
- Bond yields rose in 2021 from the lows hit at the start of the pandemic. They are historically still very low and, what is more, below inflation.



** For 2022, average of forecasts by major Canadian financial institutions*

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

Economic context

World

The global economy rebounded significantly in 2021, owing to ongoing support from governments and central banks and the successful rollout of vaccination programs in the developed countries.

However, the recovery continued amid the periodic resurgence of the pandemic, which forced health and government authorities to reverse course and occasionally retighten restrictions. The recovery also varied across regions and countries, with gaps widening between the developed and emerging economies. The countries with the highest vaccine uptake rates were able to gradually make a transition back to normalcy.

As restrictions were eased, global demand accelerated. Some economies were even able to return to or exceed pre-pandemic levels of activity. The United States and Québec were among them, and the rest of Canada is on the verge of getting there. In contrast, European and emerging economies are still lagging behind. In Europe, the latest outbreak of infections related to the Omicron variant will delay a more robust economic recovery.

Inflation accelerated sharply around the world, fuelled both by strong demand and by global supply bottlenecks resulting from continuing disruptions up and down the supply chain.

Soaring input prices and transportation and energy costs pushed up prices across the board. This strong price growth has long been attributed to transitory events by central banks; however, it has become persistent, causing them to reconsider their stance. As a result, the process of monetary policy normalization, which has already begun in some countries, should accelerate and become more widespread in 2022.

Global GDP growth should be 5.9% for 2021 and is expected to be 4.9% in 2022, growth rates that are very respectable and far higher than the long-term sustainable trend. The recovery will continue in the developed economies but at a slightly slower pace than in 2021. Among the emerging economies, China will experience the most significant slowdown.

The Chinese economy is currently going through a rough patch and has slowed significantly in the past year. The government is tightening its grip on several industries and is intent on preventing any risk of a speculative bubble in the real estate sector. Large, heavily indebted Chinese real estate developers have defaulted on payments. Most analysts, however, expect an orderly restructuring of the Chinese real estate sector with the support of government authorities.

United States

After a somewhat disappointing third quarter, the U.S. economy rebounded and ended the year on a more positive note. Bolstered by a significant bounceback in jobs and wages, consumer spending posted a net improvement in recent months, despite strong growth in inflation and declining consumer confidence.

Recent months have also seen a net improvement in business investment. Amid the current labour shortage, businesses redoubled their efforts to improve productivity and address the labour shortage through production automation and digitalization.

The labour market kept up a strong pace, creating more than 6.4 million jobs in 2021. Nevertheless, the U.S. economy is still 3.5 million jobs short of its February 2020 peak, having recouped only 84% of the job losses from the spring of 2020. The jobless rate nonetheless declined significantly, standing at 3.9% in December 2021.

Despite this employment deficit, the labour shortage is still being acutely felt, with job vacancies reaching a record high of 11 million last fall. The labour shortage reflects a mismatch between employers’ needs and workers’ skillsets, which has been exacerbated by economic and labour market upheavals during the pandemic.

In December, inflation reached a 40-year high, with the consumer price index rising 7.1%. This accelerated growth in prices is forcing the hand of the Federal Reserve, which has decided to taper monetary stimulus more quickly than planned. The Fed's bond-buying program will be gradually reduced and is expected to end in March 2022. The Fed will then proceed with its first rate hikes. According to the latest projections of Federal Open Market Committee members, the policy interest rate could be raised at least three times in 2022.

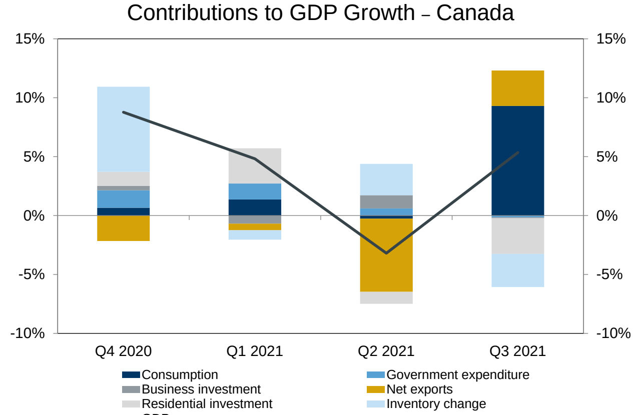
Preliminary GDP growth numbers show the U.S. economy grew 5.5% in 2021. Growth in 2022 will continue to be robust, although slightly less so than last year. Fiscal policy will remain relatively flexible, mainly owing to the infrastructure plan that was passed after a hard-fought vote last fall. Moreover, financial conditions will still be very accommodative despite expected monetary tightening. Inflation should slow gradually but remain above what Americans have been accustomed to in recent years.

As elsewhere, the resurgence in cases related to the Omicron variant will impact the overall economy and confidence levels. As last year, developments in the pandemic are increasing uncertainty over the economic outlook early in 2022.

CANADA

Canada's economy rebounded in the third quarter of 2021, with GDP up at an annualized rate of 5.4%. Consumer spending, especially on services, contributed significantly to the increase. Conversely, business investment and residential investment posted declines.

Contributions to GDP Growth – Canada



Sources: Statistics Canada and AMF

Household spending on services picked up significantly but remains below pre-pandemic levels. The employment recovery, increased confidence and accumulated savings should support the firming of spending on services in the coming quarters. However, the return of stricter lockdown measures will delay a full recovery in this type of spending.

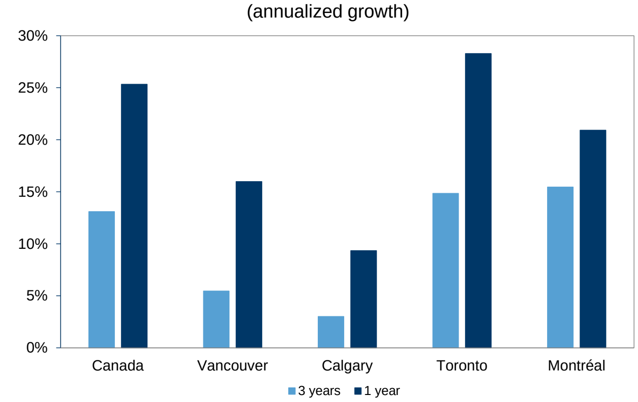
Although business investment fluctuated sharply over the last year, a significant recovery in productive capital spending is expected in 2022 as businesses seek to modernize their equipment and counteract the labour shortage by investing in automation.

With global supply chain disruptions significantly impacting foreign trade, Canadian exports were down nearly 9% from pre-pandemic levels in the third quarter. As Vancouver is a major transit hub for trade in goods, transportation problems were further exacerbated by the recent flooding in British Columbia.

The cooling of the real estate market continued at year-end, with residential investment posting two consecutive quarterly declines. The sector, which had been a key driver of growth since the summer of 2020, has been a drag on the rise in GDP in recent months. Housing starts, which peaked at over 330,000 in March, have slowed considerably.

Nevertheless, home sales reached a record high in 2021, and the inventory of homes remains extremely low. As a result, the pressure on prices is still substantial. In November 2021, the MLS Home Price Index was up 25.3% year-over-year.

House Price Index
(annualized growth)



Sources: Canadian Real Estate Association and AMF

Market conditions remain tight, and favourable demographics will likely buoy housing activity in the coming year. Conversely, expected interest rate hikes and reduced affordability should cool demand. In the end, a gradual return to a better balance between supply and demand is expected.

The labour market completed its recovery in September, and job growth has continued since then. However, the pace of employment growth has slowed substantially. At 5.9%, the unemployment rate is now very close to pre-pandemic levels, at 5.7%.

Labour shortage issues, which were already present before the spring of 2020, have quickly resurged and are now widespread in many industries. Job vacancies and the job vacancy rate are at all-time highs.

The pandemic seems to have exacerbated difficulties in matching labour supply and demand, and it will definitely take time for workers who have been inactive for a while to acquire new skills and find jobs that match them. Moreover, basic trends like the aging of the population are accentuating labour shortage problems.

Inflation increased during the year, reaching 4.7% in November, its highest level since 2003. The rise in inflation in 2021 is due to supply and demand imbalances resulting primarily from the pandemic and the economic policies implemented to mitigate its consequences. Although these imbalances are proving to be more persistent than expected, they should ease in 2022.

The end of government support measures and the gradual tightening of monetary policy should help alleviate pressure on global demand.

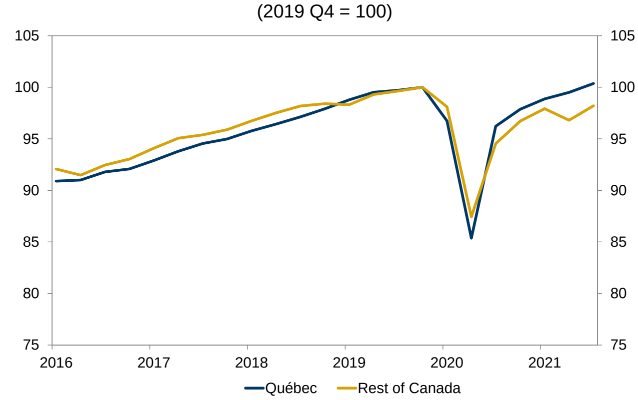
The Bank of Canada ended its quantitative easing program in the fall, citing the economic recovery and rising prices. However, it is maintaining its policy interest rate and expects inflation to ease back to around the target by late 2022. The first increase in the policy interest rate could come as early as this spring.

GDP growth for 2021 is expected to approximate 5%, the largest increase since the mid-1980s. Soaring case numbers related to the Omicron variant have forced the return of lockdown measures and the closure of many non-essential businesses in some areas of Canada, including Québec. However, the economic impact of such measures is expected to be less significant than during the previous surges. As a result, the recovery should continue in 2022, albeit at a slower pace than in 2021.

QUÉBEC

The Québec economy rebounded sharply after the shock caused by the pandemic and is now in an enviable position compared with the rest of Canada. Québec's economy is expected to grow over 6% in 2021.

Gross Domestic Product
(2019 Q4 = 100)



Sources: Institut de la statistique du Québec, Statistics Canada and AMF

The growth in the economy was fuelled by domestic demand, including consumer spending, which took over from residential investment as the main growth driver this year.

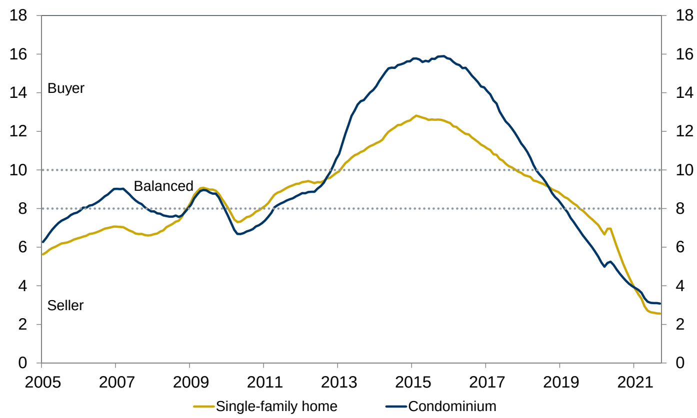
Spending on services recovered substantially in 2021 but remains below pre-pandemic levels. The return of stricter health measures due to the Omicron variant will delay a full recovery in a number of industries.

Business investment moved in a see-saw pattern throughout the third quarter and remains below pre-pandemic levels. Foreign trade also fluctuated sharply during the year, although the trade deficit shrank in the third quarter.

It was a record year for Québec's real estate market in both sales and housing starts, with the latter reaching an all-time high of over 110,000 in January 2021. Although housing starts have declined since then, they are still far above the historical average.

Home sales also declined at the end of the year, but so did new listings. As a result, amid continued strong demand, market conditions tightened even further and the unsold residential inventory to sales ratio reached a record low.

Unsold Residential Inventory to Sales – Québec
(in number of months)



Sources: QPAREB and AMF

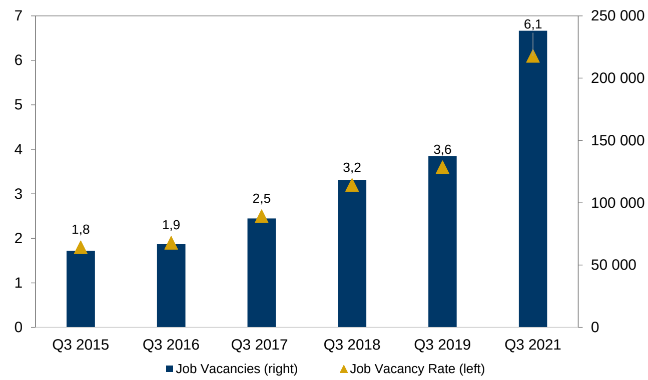
Upward pressure on prices therefore continued to be substantial. Property prices jumped 14.1% in November. The resulting reduction in affordability combined with the expected rise in mortgage rates should cool the real estate market.

Some forecasters even believe that a slight price correction, particularly for single-family homes, cannot be discounted, especially if the economy and labour market slows down or interest rates rise too quickly.

As of November, the Québec labour market had recouped all job losses from the spring of 2020. The unemployment rate also fell back to pre-pandemic levels, at 4.6%. Québec now has the lowest unemployment rate of any Canadian province.

Labour shortage issues in Québec are glaring: a BDC report released in the fall shows that Québec is the Canadian province where businesses are having the most difficulty hiring personnel. The province had over 238,000 job vacancies in the third quarter of 2021.

Job Vacancies and Job Vacancy Rate – Québec



Note: Data for Q3 2020 haven't been compiled by Statistics Canada due to the pandemic.
Sources: Statistics Canada and AMF

After the strong recovery and buoyant growth of 2021, Québec's economy is expected to post more moderate GDP growth in 2022. Like everywhere else, the economy in Québec is facing a number of challenges that could dampen growth over the coming quarters, including supply issues, a labour shortage, high inflation, and rising interest rates.

The most significant of these challenges, and the one most likely to limit growth, will undoubtedly be the labour shortage. However, the latest surge in infections related to the Omicron variant and the restrictions announced at the very end of 2021 will also affect economic growth over the very short term.

FINANCIAL MARKETS

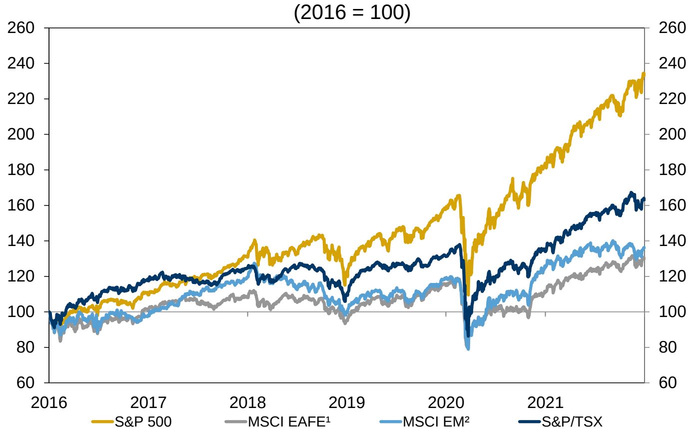
STOCK MARKETS

Global stock markets made excellent gains this year. The MSCI World Index, which tracks the major stock markets in the advanced economies, ended 2021 up 20% owing, in large part, to ultra-accommodative monetary policies and the significant rebound in economic growth and corporate earnings.

Emerging markets, however, offered negative returns. The MSCI Emerging Markets Index returned -2.3%, mainly reflecting a decline in Chinese stock indexes following a significant slump in growth and an increase in regulatory burden.

The stock markets experienced greater volatility at the end of the year due to the discovery of the new Omicron variant and uncertainty about how it would impact economic growth. Rising inflationary pressures and the prospect of faster-than-expected monetary tightening have also weighed on the stock markets for the last few months.

Major Stock Market Indexes
(2016 = 100)

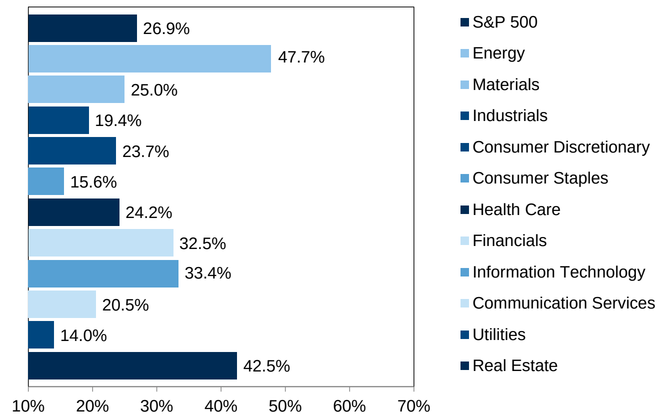


¹ Europe, Australasia and Far East ² Emerging markets
Sources: Datastream and AMF

In the United States, the S&P 500 registered very enviable growth of 27% on the year. S&P 500 company earnings were up nearly 50% in 2021, far exceeding pre-pandemic levels.

Corporate earnings expectations for 2022 are much more modest, with growth expected to be around 9%. All sectors of the S&P 500 posted increases this year, led by Energy, Financials and Information Technology.

Performance of the Main S&P 500 Subindexes in 2021



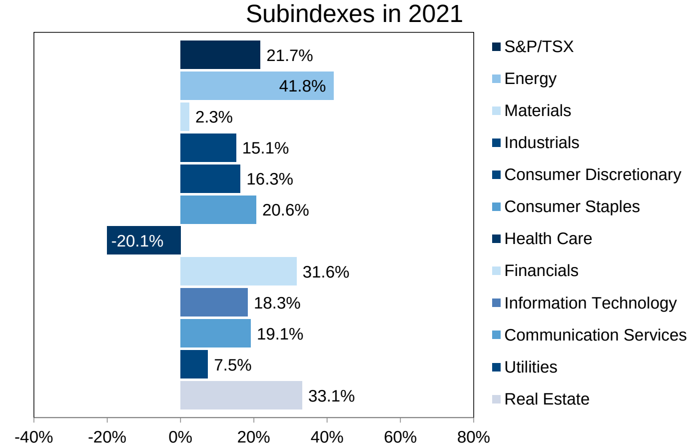
Sources: Datastream et l'Autorité

The European markets generally performed well in 2021, despite underperforming in the second half of the year owing to skyrocketing cases of COVID-19 and the tightening of public health measures.

In Canada, the S&P/TSX lagged slightly behind the S&P 500 in 2021, but still returned a highly respectable 22%. Like the U.S. index, the TSX was boosted by increases in Energy and Financials.

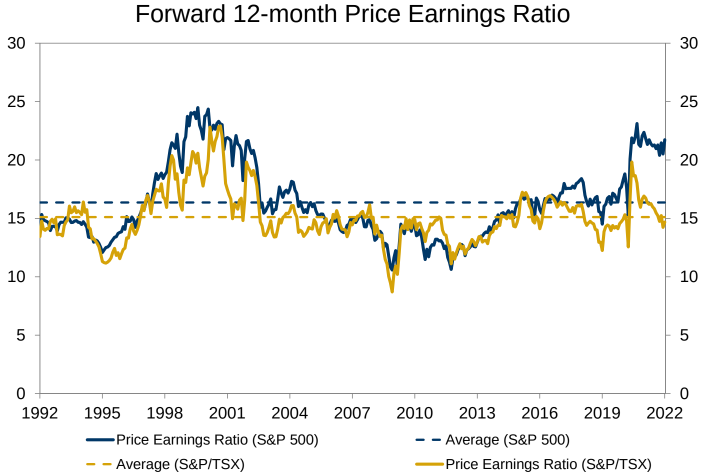
Energy benefited from the strong recovery in oil prices, a reflection of brisk global demand and supply constraints, while Financials were bolstered by improving economic conditions and robust capital markets.

Performance of the Main S&P/TSX Subindexes in 2021



Sources: Bloomberg and AMF

S&P/TSX valuation levels remain relatively subdued, particularly compared with the S&P 500. The 12-month price/earnings ratio for the S&P/TSX 500 is now close to its historical average of 15. The ratio for the S&P 500 is close to 22, well above its historical average of 16. This difference is partly explained by the fact that Information Technology, with relatively high valuations, has less weight on the TSX.

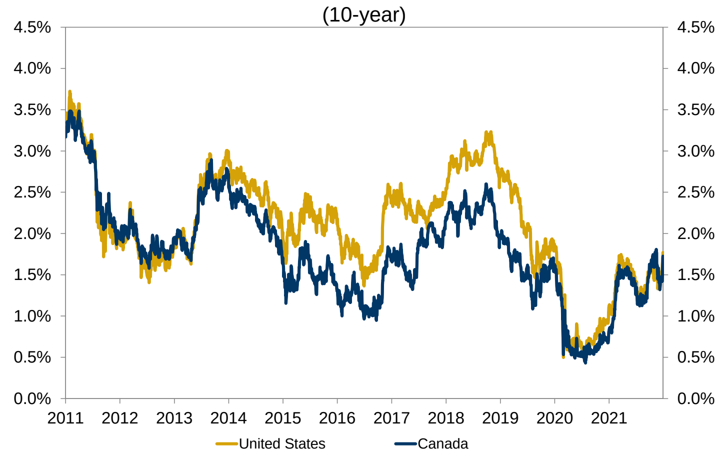


Sources: Datastream and AMF

Lastly, the Morningstar National Bank Québec Index, which tracks changes in the share prices of the largest Québec-based companies listed on the TSX, underperformed the S&P/TSX slightly, posting a return of around 17%. Companies in Industrials and Financials, the two largest sectors in terms of market capitalization, nonetheless posted excellent returns.

BOND MARKETS

Bond yields rose in 2021 from the lows of the start of the pandemic. They are still historically very low and, what is more, below inflation. At the end of the year, long-term yields inched down owing to the discovery of the new Omicron variant and concerns about how it would impact the economic outlook.

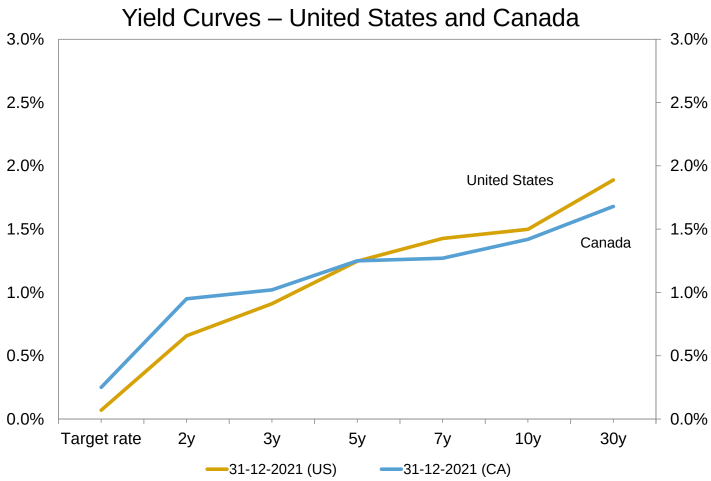


Sources: Datastream and AMF

In contrast, short-term yields rose at the end of the year, reflecting the expectation of faster-than-expected monetary tightening, so much so that yield curves flattened. In 2022, monetary policies will likely be gradually tightened against a backdrop of inflationary pressures and greater economic uncertainty.

In the United States, federal government 10-year yields ended the year at 1.5%, up roughly 60 basis points. At year-end, inflation reached highs not seen since the 1980s.

Inflation expectations for the years ahead have increased considerably, but long-term expectations remain relatively well anchored. Inflation expectations implicit in real return 10-year bond yields are around 2.5%, not far from their historic average. Short-term yields rose at year-end, reflecting the pulling forward of expectations of monetary tightening. A first increase in the policy interest rate could potentially come in the spring, according to market estimates.

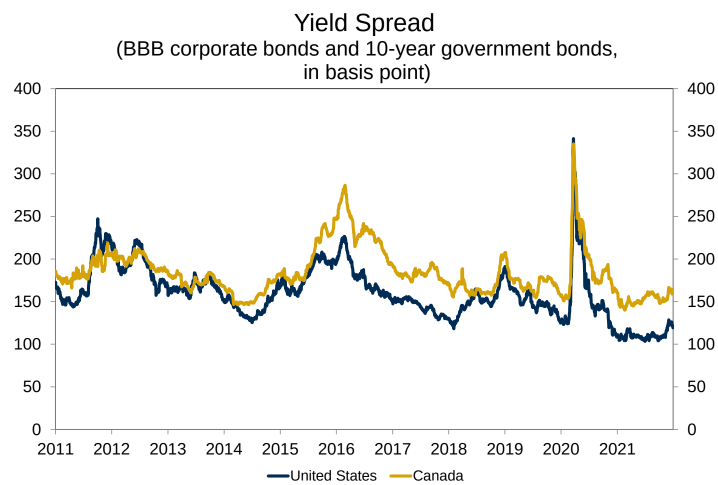


Sources: Datastream and AMF

In Canada, yields on Government of Canada 10-year bonds ended the year at 1.4%, slightly below U.S. yields, whereas short-term yields are a little higher in Canada. The markets are expecting yields to rise slightly faster in Canada than in the United States. In 2022, monetary policy could be tightened in many other countries, including the United Kingdom, where the central bank hiked its policy interest rate for the first time last December.

In the euro area, the situation is quite different. Bond yields in the principal countries remain largely negative, and the European Central Bank (ECB) is expected to remain very accommodative for some time yet. The ECB announced a very gradual tapering of asset purchases, and the markets are not expecting any increases in the ECB's policy interest rate before the end of 2022. In Japan, bond yields are still close to zero, and the central bank is essentially staying on the sidelines.

Lastly, corporate yield spreads continued to be tight in 2021. These spreads, after widening considerably at the beginning of the pandemic, have since narrowed, reflecting an improved economic picture and the support of governments and central banks. Throughout the year, low government bond yields created very strong investor demand for corporate bonds, which typically offer higher returns. These spreads increased slightly at year-end, with the detection of the Omicron variant, although they remain very narrow, historically speaking.



Sources: Datastream, Bloomberg and AMF

Market Performance

Stock Markets

		Level	% change							Last 12 months	
		2021-12-31	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index		881	2.7	5.9	13.0	13.0	19.1	18.3	12.0	735	885
MSCI EAFE[1]		1,362	2.0	4.4	8.5	8.5	16.1	10.6	5.6	1,169	1,379
MSCI Emerging Markets		70,053	-4.3	-8.6	-5.7	-5.7	-2.3	9.5	8.0	68,081	80,514
S&P 500		4,766	5.4	10.9	20.0	20.0	26.9	23.9	16.3	3,701	4,793
S&P/TSX		21,223	3.1	5.2	13.5	13.5	21.7	14.0	6.8	17,337	21,769
Morningstar National Bank Québec Index		387	-6.4	0.5	7.2	7.2	17.4	14.1	9.4	327	420

Bond Markets

		Level								Last 12 months	
		2021-12-31	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.0	1.8	2.0	2.2	2.2	1.3	2.8	2.5	1.3	2.4
Ontario	10-year	2.1	1.9	2.0	2.2	2.2	1.3	2.8	2.5	1.3	2.4
Canada	10-year	1.4	1.2	1.4	1.6	1.6	0.7	2.0	1.7	0.7	1.8
United States	10-year	1.5	1.3	1.5	1.7	1.7	0.9	2.7	2.4	0.9	1.7
United Kingdom	10-year	1.0	0.7	0.7	0.8	0.8	0.2	1.3	1.2	0.2	1.2
Germany	10-year	-0.2	-0.4	-0.2	-0.3	-0.3	-0.6	0.2	0.2	-0.6	-0.1
	AA Corp. (10-year)	2.4	2.2	2.3	2.5	2.5	1.5	3.2	2.9	1.5	2.8
Canada	BBB Corp. (10-year)	3.0	2.8	2.9	3.0	3.0	2.3	4.0	3.6	2.3	3.3
	BBB - 10-year Gov. spread	1.6	1.6	1.6	1.5	1.5	1.6	2.1	1.9	1.4	1.7
	AA Corp. (10-year)	2.1	1.9	2.0	2.3	2.3	1.4	3.7	3.3	1.4	2.3
United States	BBB Corp. (10-year)	2.7	2.4	2.5	2.8	2.8	2.0	4.6	3.9	2.0	2.9
	BBB - 10-year Gov. spread	1.2	1.1	1.0	1.1	1.1	1.1	1.9	1.5	1.0	1.3

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

Sources: Datastream, Bloomberg and AMF

ISSUES TO BE MONITORED IN 2022

- The highly contagious Omicron variant has spread like wildfire since late last fall, forcing authorities to further tighten social distancing measures. This will undoubtedly have a tangible effect on growth in early 2022. This year, the economic situation will continue to depend on how the pandemic unfolds and what actions are taken to contain the spread of the virus and its impact on the economy and employment.
- Inflation was higher and more persistent in 2021 than expected. In the United States and Canada, the consumer price index rose to levels not seen in decades. Soaring prices are already prompting central banks to normalize monetary policy earlier than planned. They will have to do enough to calm inflation pressures without derailing the current recovery.
- The labour shortage is hitting Québec's economy hard. There were a record number of job vacancies last year, with some industries being far more affected than others. The main cause of the shortage is the aging of the population, but the problem has been exacerbated by the labour market upheavals that have occurred since the beginning of the pandemic. Regardless, this situation is dampening economic growth and limiting Québec's GDP potential. The labour shortage is undoubtedly the most urgent issue facing the private and public sectors. Solutions exist and everyone knows what they are, but they are difficult to implement. Employers will have to find creative ways to attract, train and retain people.
- The year 2021 was another exceptionally strong year for the real estate market. Supply is struggling to keep up with demand, and prices are continuing to rise. As a result, affordability is at its lowest level. Although activity has cooled in the past few months, market conditions are still very tight. Anticipated interest rate hikes and soaring prices should help cool the overheated market. The market is expected to see a gradual return to a better balance between supply and demand in 2022. However, its fate depends on whether interest rates rise too quickly or not.
- Generally speaking, Canadian businesses have weathered the economic and financial impacts of COVID-19 well. For example, the number of insolvencies filed has declined considerably since the start of the pandemic. Non-financial corporation debt is nevertheless reaching record highs in Canada. Low interest rates and the economic environment spurred many businesses to take on more debt. In the coming year, Canadian business will have to contend with a number of headwinds, including the gradual wind-down of government support, the anticipated interest rate hikes and an uncertain economic environment.
- The stock markets continued to perform well in 2021 despite the impact of the pandemic, mainly owing to low bond yields and relatively high valuation levels. In addition, corporate yield spreads tightened, reflecting investors' search for yield. A significant rise in interest rates and deteriorating economic conditions could lead to strains in the financial markets.
- The past year has again shown the extent to which the physical risks posed by climate change are increasing rapidly. Costs related to natural disasters skyrocketed in 2021. Canada was no exception: historic floods, record-breaking heat and drought accompanied by unprecedented crop losses. Various regulations related to the development of carbon taxation tools, enhanced disclosure of financial risks related to climate change and incentives to advance the transition to a more sustainable economy are expected at the international level in 2022. Climate finance and sustainable finance will continue to develop.
- Consumers now have access to a growing number of financial products that integrate environmental and sustainability criteria. These products, often labelled as "green," "ESG" (combining environmental, social and

governance criteria) or “sustainable” investments, enable consumers to invest in the transition to a more environmentally friendly, lower-carbon global economy aligned with specific social and governance standards. However, there are no standardized or regulated investment criteria for this new asset class. The absence of such criteria may result in consumers having a poor understanding how certain investment criteria are applied and is limiting financial performance comparability among products. In this context, the risk arising from the disconnect between an investment product’s stated attributes and its asset mix will be an issue to keep an eye on.

- The pandemic has spurred enthusiasm for self-directed brokerage. This enthusiasm has sometimes led to speculation on certain stocks, as evidenced by the GameStop saga in the United States. The speculative fever for those stocks has sometimes been stoked by social media, influencers or promotional practices. Canada did not actually experience any speculative events like those in the United States. The appetite of younger, less experienced investors for self-directed investing could place them at risk of making suboptimal investment decisions. These new trends underscore the need for education about the risks associated with the gamification of investing.
- Digital transformation is a major trend affecting all sectors of the economy, including financial services. The changes are many and profound and have picked up speed amid the pandemic. Changes with the potential to disrupt the financial services sector include the tremendous growth in cryptoassets, including private and public digital currencies, and the emergence of decentralized finance. While these new technologies and business models may meet the evolving needs of consumers, investors and market participants, they are also very risky.
- In addition to exhibiting unparalleled volatility, the values of cryptoassets spiked and reached all-time highs in 2021. For the time being, their size is still relatively modest as a percentage of the overall financial system, but their rapid growth and emerging interlinkages with the traditional financial system are leading regulators to intensify their supervision of them. Cryptoassets could potentially pose a threat to financial stability.
- At a time of digital transformation, cybersecurity continues to stand out as one of the main risk sources weighing on the financial system. A single large-scale incident affecting a financial institution, market infrastructure or provider of essential services could destabilize the entire financial system.