

ECONOMIC and FINANCIAL

# REVIEW

Direction principale  
des affaires internationales  
et de la vigie stratégique

April 16, 2018



**AUTORITÉ  
DES MARCHÉS  
FINANCIERS**

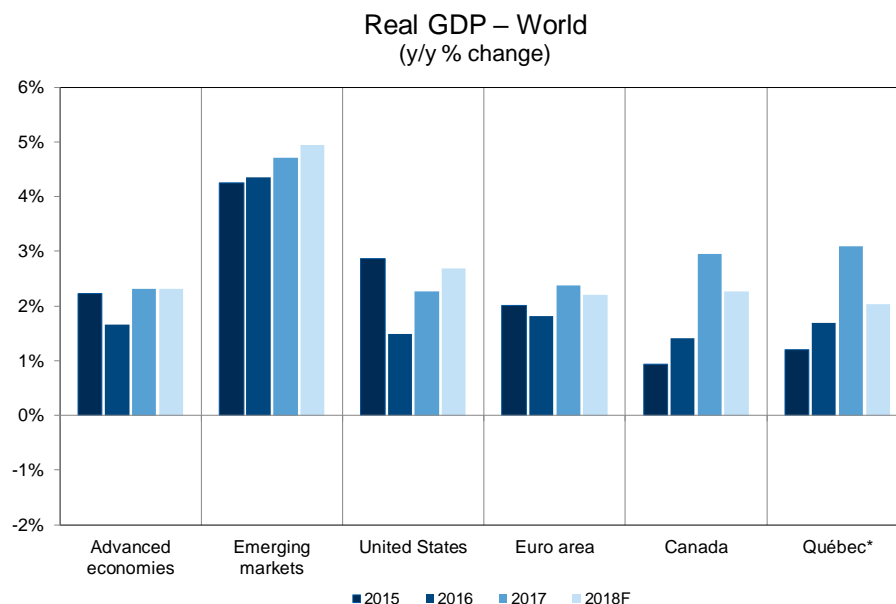
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## HIGHLIGHTS

- The global economy forged further ahead and continued to boast solid growth at the start of 2018. However, U.S. protectionist measures have led to uncertainty about future developments.
- The euro area economy recorded its strongest growth in years, buoyed primarily by exports. The European Central Bank has signalled that it could terminate its asset purchases by the end of the year.
- The U.S. economy, which was already running on all cylinders, received added support from the new tax and fiscal measures approved by Congress. The Federal Reserve further tightened its monetary policy in March.
- The Canadian economy was particularly robust in 2017, but has shown signs of losing steam over the past few quarters. The macroprudential measures that came into effect in January appear to be having an impact on the residential real estate market.
- At 3.1%, Québec GDP growth for 2017 was the province's best performance in the past 15 years, slightly outpacing the Canadian economy. The unemployment rate has remained at a historic low.
- After a long period of low volatility, stock markets hit pockets of turbulence during the first quarter of 2018, owing to higher-than-projected inflation expectations and concerns about a trade war.
- Bond yields have risen noticeably since the start of the year due to inflationary buildup and the prospect of faster-than-expected monetary tightening.



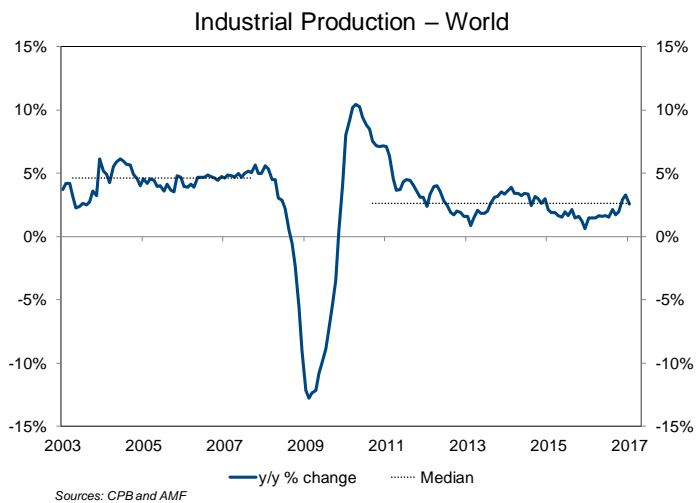
\*For 2018, average of forecasts by major Canadian financial institutions

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

## ECONOMIC CONTEXT

### WORLD

The global economy forged further ahead and continued to boast solid growth at the start of 2018. The upward trend was especially notable in developed economies, but also extended to emerging markets. A number of global indicators were on the rise, particularly with respect to exports and industrial production. Likewise, the latest manufacturing surveys pointed in the same positive direction.



The uptrend in the global economy produced a gradual return of inflation and a decline in monetary stimulus by central banks, notably in the United States, Canada and the United Kingdom. Nonetheless, monetary policies were still accommodative and provided additional support to the global economy.

However, storm clouds gathered in the form of mounting protectionism. The U.S. administration created turmoil across the globe when it announced new trade tariffs, initially on steel and aluminum, then specifically on Chinese products. The spectre of a global trade war triggered concerns about an abrupt end to the current rise in global economic growth.

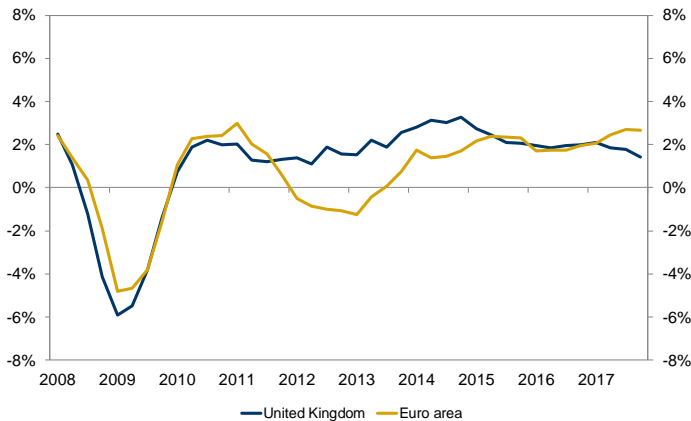
Meanwhile, the U.S. economy was running on all cylinders and should maintain that pace in the foreseeable future. In addition to the corporate tax cuts announced in December 2017, the government passed a budget containing significant fiscal spending that will stimulate the economy. The Federal Reserve once again raised its key policy rate in March, bringing it to a range of 1.50 to 1.75 per cent.

In Canada, growth was particularly vigorous in 2017, but has shown signs of abating in the past few quarters. On the one hand, imbalances in the real estate market and household debt remain two soft spots of the Canadian economy. On the other, U.S. tax and trade policies, including the arduous renegotiation of the North American Free Trade Agreement (NAFTA), could have a sizable impact on Canada's open economy. In the meantime, Canada has remained committed to free trade, having signed the Trans-Pacific Partnership without the United States.

The euro area economy recorded its strongest growth in years, buoyed primarily by exports. As a sign of business confidence, the purchasing managers indexes of all major European economies have remained at very high levels for months.

In January, the European Central Bank scaled back the monthly pace of asset purchases from €60 billion to €30 billion, and is now signalling that it could terminate them by the end of the year. For the time being, however, subdued inflation does not justify a hike in interest rates.

GDP – Euro Area and United Kingdom  
(y/y % change)



Sources: Datastream and AMF

In contrast, the United Kingdom has seen a steady decline in growth combined with accelerating inflation, pushing the Bank of England in the uncomfortable position of having to prop up growth or halt the rise in prices.

As well, the United Kingdom and the European Union reached an agreement on the Brexit transition period, which will extend from March 2019 until the end of 2020. However, the hardest work lies ahead as the two partners enter into negotiations on future trade relations.

Lastly, populist movements in Europe made new inroads with the Italian elections, complicating matters further for the European Union.

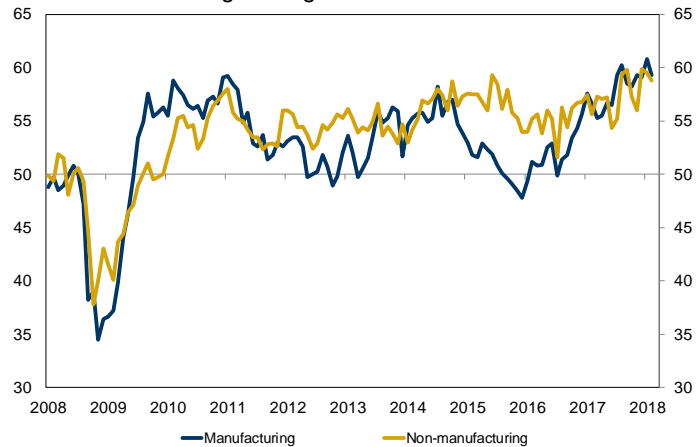
In China, growth remained solid and relied increasingly on domestic consumption. In an effort to raise the standard of living, the new five-year plan expanded coverage of the Chinese social safety net. The high level of business debt, however, remained an important concern as did a possible trade war with the United States.

After a long period of low volatility, stock markets hit pockets of turbulence during the quarter. In February, U.S. markets faced a correction owing to higher-than-projected inflation expectations. That said, some of the losses were recouped fairly quickly. Markets were then jolted once again toward the end of the quarter, this time by a looming global trade war and revelations about the use of personal data by technology firms.

## UNITED STATES

The U.S. economy was briskly buoyant early in the year, as measured by most indicators, including the purchasing managers index. It stood at a cyclical high, reflecting an upshift in manufacturing production. Household confidence was soaring, and employment still on the rise.

Purchasing Managers Index – United States



Sources: Institute for Supply Management and AMF

In the first three months of 2018, the pace of job creation continued unabated at an average of 200,000 or so, sufficient to keep the unemployment rate unchanged at a cyclical low of 4.1%

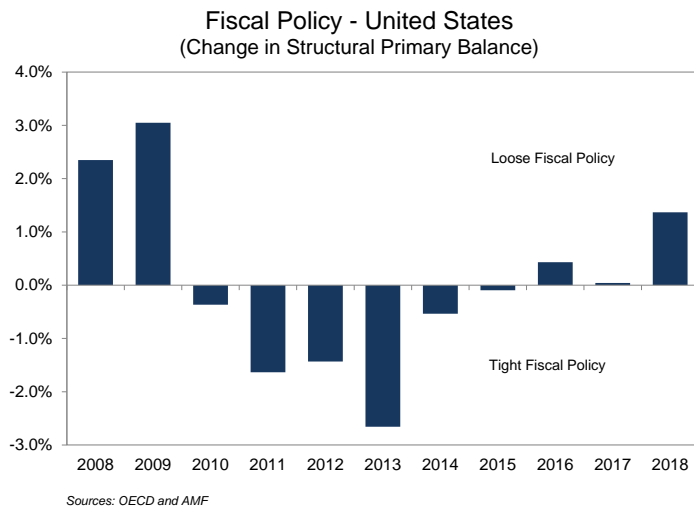
As for residential activity, it was relatively subdued throughout 2017, and home sales and housing starts have seesawed since the beginning of 2018. However, the short supply of new and existing homes and the encouraging rise in property prices should soon spur housing starts.

Although GDP will rise more moderately in the first quarter of 2018, The Conference Board Leading Economic Index® is pointing to solid growth in the coming months. In short, the U.S. is expected to post stronger GDP growth this year.

U.S. fiscal policy has clearly become expansionary. In addition to major tax cuts extended to corporations in December, the latest budget deal approved by Congress contains significant increases in both civilian and military spending.

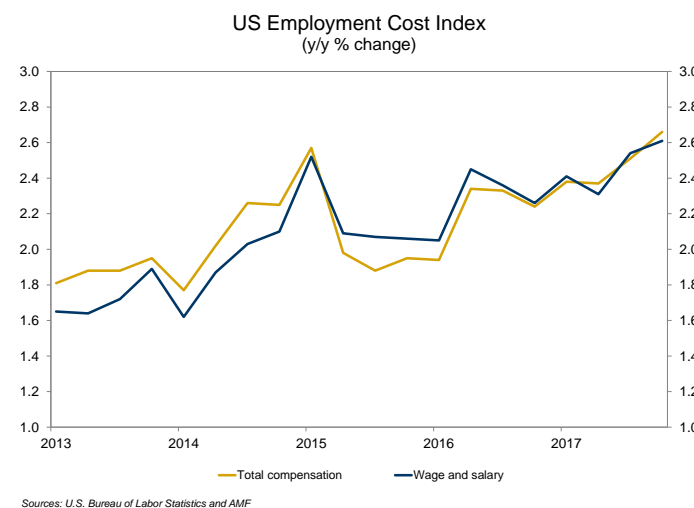
While these tax and fiscal measures will drive economic growth in the near term, they will also greatly swell the budget deficit and the public debt.

It is unorthodox and even imprudent to use tax and fiscal measures to stimulate an economy that is enjoying full employment. U.S. fiscal policy could cause inflation pressures to build up and compel the Federal Reserve to further tighten its monetary policy.



For now, inflation continues to be muted and is of little concern. However, the bustling economy is constraining production capacity and putting upward pressure on future inflation.

The employment cost index and unit labour costs have thus trended upward. Inflation could also be stoked by the weakening U.S. dollar and the recovery in oil prices.



The Federal Reserve raised the target range for the federal funds rate by 25 basis points, bringing it to 1.50 to 1.75 per cent.

Nonetheless, U.S. monetary policy remained very accommodative. This is also uncommon at the current stage of the economic cycle, with the economy

running at full capacity, the unemployment rate falling to a cyclical low and the fiscal policy easing considerably.

Other rate increases can thus be expected this year and next. Members of the Federal Open Market Committee have so far signalled two or three more hikes in the federal funds rate this year.

However, given the fired-up economy, the risk of accelerating inflation has increased in the U.S., and the Federal Reserve will likely be compelled to raise the rate still further.

## CANADA

With GDP growth pegged at 3%, the Canadian economy was particularly robust in 2017, posting its strongest increase since 2011. However, the economy has already been showing signs of losing steam over the past few quarters.

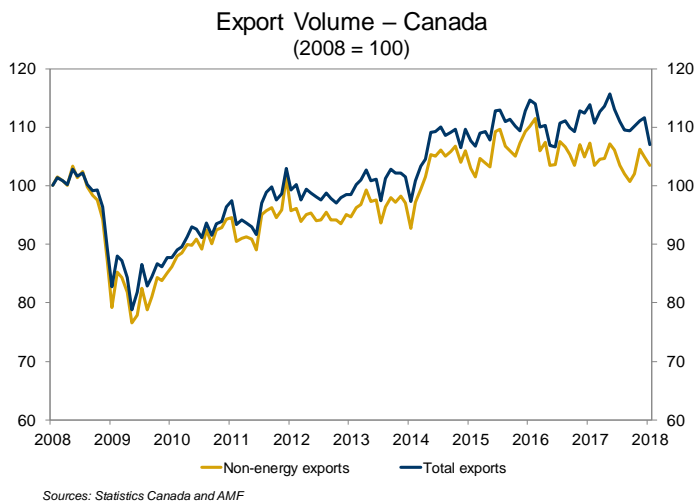


While consumption inched lower, domestic demand continued to strengthen throughout the year amid greater investment and government expenditures.

Business investment growth resumed in 2017 and ended the year up 8.8%. The Bank of Canada's latest Business Outlook Survey confirmed that investment intentions remained positive, suggesting the recovery in investments will continue.

Sustained economic growth, full capacity utilization and higher commodity prices, including oil, will continue to fuel growth in business investment spending.

In contrast, net exports weighed on growth in 2017. Non-energy exports have even been on a downward trend in recent months.

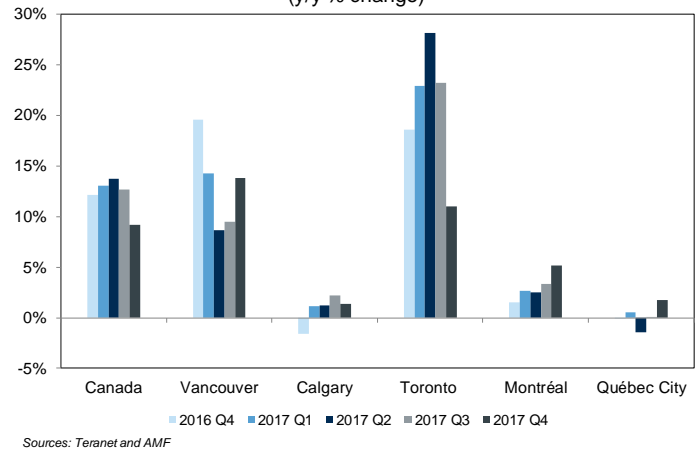


In principle, strong U.S. growth should have favoured Canadian exports. However, the competitive advantage of a weaker Canadian dollar was largely offset by the equally weak, if not weaker, performance of the currencies of competing economies.

Moreover, the unfavourable productivity gap between Canada and the United States, which undermines Canadian business competitiveness, continued to be a challenge. Lastly, NAFTA negotiations have dragged on and protectionism has remained a real threat.

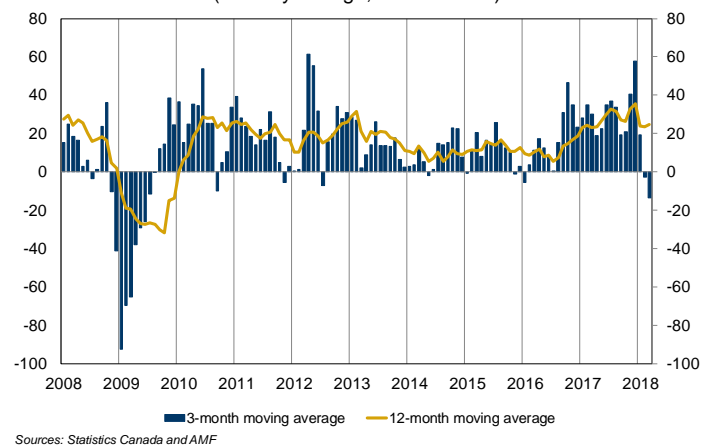
With respect to the residential real estate market, the latest indicators confirmed a further pullback following a brief upturn at the end of 2017. Price increases decelerated across Canada, especially in the Toronto area. Residential sales were also lower in January and February 2018.

**House Prices – Canada (y/y % change)**



The labour market ended 2017 on an upbeat. Employment grew by 427,300 in 2017, the largest increase since 2007.

**Employment – Canada (monthly change, in thousands)**



However, the pace of job creation has slowed since the start of 2018. In fact, over the first quarter, employment even lost some of its gains. Despite this downturn, the unemployment rate remained at a historic low under 6%.

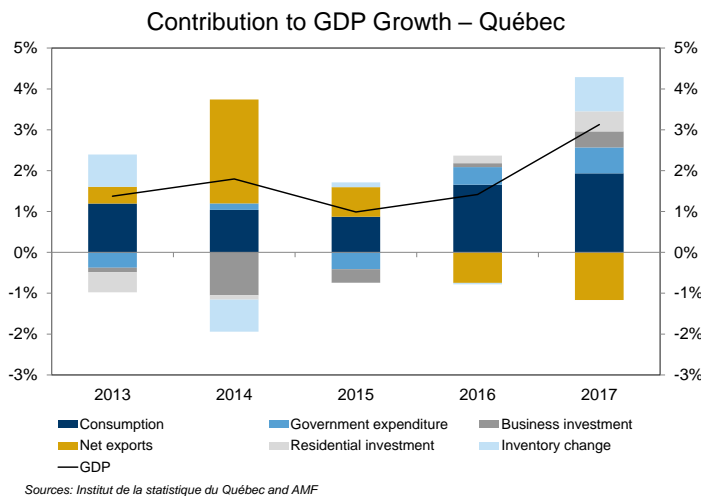
Strong growth and the almost full absorption of excess capacity helped nudge consumer prices gradually higher. In February, the overall inflation rate slightly exceeded the mid-point of the Bank of Canada’s target range. Core inflation (excluding the food and energy components) stood at 1.8%.

The Bank of Canada will pursue monetary tightening in 2018, albeit at a very gradual pace. The Canadian monetary authority will take into account the uncertainty surrounding NAFTA negotiations and the impact, which is still unclear, of the latest

macroprudential measures on the residential real estate market. Lastly, the average of private sector forecasts and recent economic indicators suggest slower growth this year. As a result, the Bank of Canada could well take a more dovish approach than that of the U.S. Federal Reserve.

## QUÉBEC

At 3.1%, Québec GDP growth for 2017 was the province's highest in the past 15 years, slightly outpacing the Canadian economy.



While consumption was the main contributor to the rise in GDP, growth was more broadly based among all components of aggregate demand than in 2016.

The upturn in business investment, higher government expenditure and residential construction bolstered GDP growth, which was partially offset by net exports.

Supported by a vibrant labour market, household consumption advanced 3.1% in 2017. Recent activity in retail sales in addition to the slower pace of job creation early in the year point to a slight pullback in consumption.

The favourable environment also benefited residential real estate. All Québec real estate market indicators stood in positive territory in 2017, buoyed by strong job creation, vigorous economic growth and continuous very accommodative financial conditions.

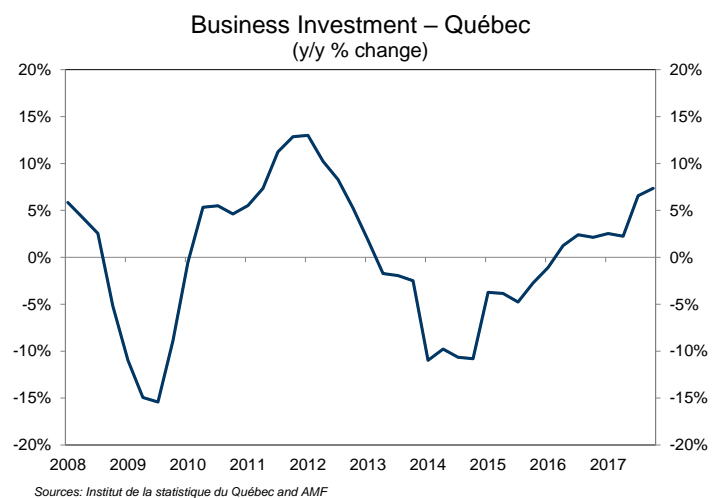
Sales of both single-family homes and condominiums posted record gains. This resulted in price acceleration, with property prices jumping significantly after years of stagnation.

Up over 20% year over year, housing starts continued to trend higher, with the six-month moving average at 50,370 units.

Changes to Guideline B-20 of the Office of the Superintendent of Financial Institutions, which came into effect in January 2018, extended stress-test requirements to uninsured mortgage loans. The changes have apparently already had an impact on the overheated markets in Toronto and Vancouver, while the Québec market has remained much more stable.

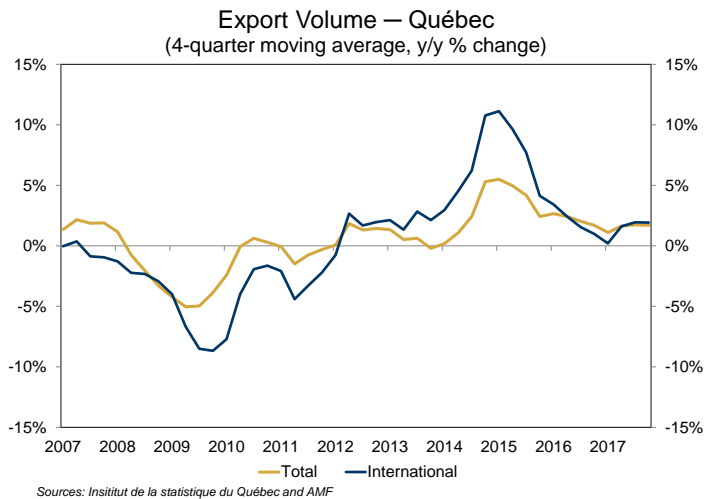
Following years of decline, business investment spiked 4.7% in 2017. The current economic environment, marked by full resource utilization, will create opportunity for further capital expenditures. The uptrend in commodity prices will also help spur a recovery in mining investments.

In contrast, the protectionist agenda of the U.S. government has brought about uncertainty that may overcloud the private sector and delay a number of investment projects.



In 2017, international exports rose only moderately, up 1.9%, and the expected rebound did not materialize. In fact, foreign trade shaved off a few percentage points from economic growth in 2017.





In principle, the global economic environment, stronger U.S. domestic demand and a more competitive exchange rate should spark an upswing in international exports in 2018.

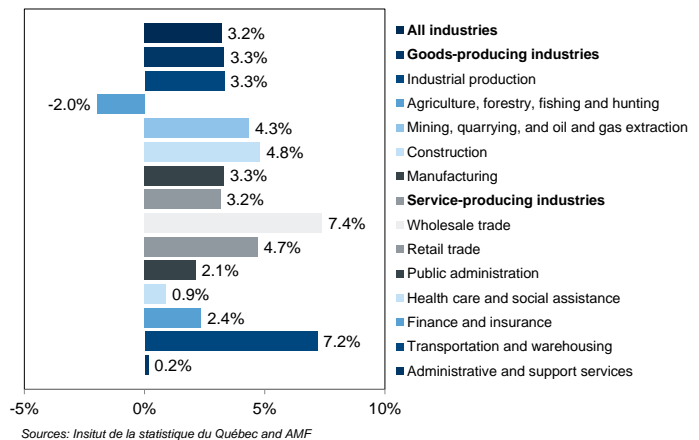
However, the lower U.S. corporate tax burden and uncertainty surrounding NAFTA negotiations are undermining the competitiveness of Québec companies exporting to the U.S. and may also impede the upswing in exports.

The climb in economic growth generated additional revenues for the government, providing it with more flexibility in its public policy-making. In its latest budget, the government announced new expenditures in the amount of \$16B over five years, all the while maintaining a balanced budget and reducing the debt.

From an industry perspective, GDP growth was fuelled primarily by manufacturing, mining and construction.

Robust consumer spending and investments also boosted growth in wholesale and retail trade, as well as transportation and warehousing.

GDP by Industry – Québec (y/y % change, 12-month moving average)



After performing as one of the main growth drivers, the finance and insurance industry grew 2.4% in 2017, down slightly from 2.7% in 2016.

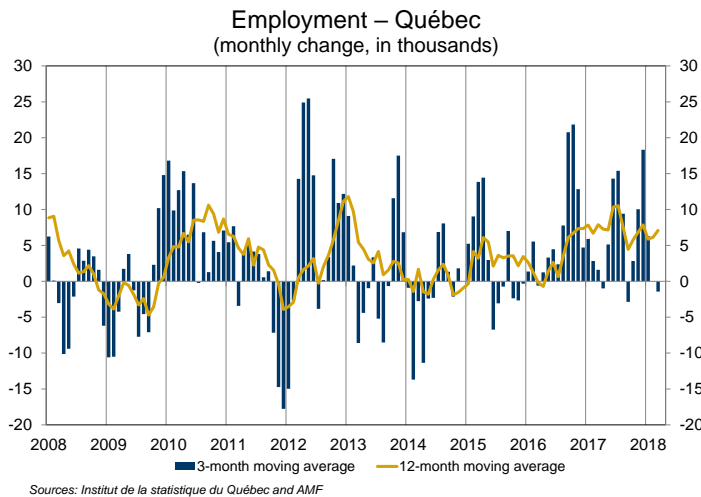
With a relative weight of 6.2% in Québec's economy, the finance and insurance industry is one of the province's largest, along with manufacturing and construction.

As for the labour market, it posted a net gain of 94,100 jobs in 2017, and the unemployment rate fell to a record low of 5% at year-end.

However, the labour market slowed somewhat in the first quarter of 2018. Despite a fine performance in March, employment slipped in the first quarter and the unemployment rate inched up a few tenths of a percentage point.

This uptick may be due to various factors and should not be unduly interpreted as a sign of weakness in the economy, especially since short-term labour market data tend to be volatile. The current slowdown may instead reflect hiring impediments caused by a growing labour shortage.

Despite the minor downshift, the gains registered over the past year remain substantial and will help drive consumption in 2018.



Québec's ongoing economic tailwinds include strong global growth, fiscal stimulus from the various orders of government, a high level of household and business confidence and continuous very accommodative financial conditions despite the hikes in interest rates.

Nonetheless, Québec's economy will gradually cool off in 2018. The province's economic potential, dragged down by smaller gains in its labour force and productivity, cannot sustain growth of 3% or more indefinitely. The pace of the economy will slacken in 2018 and 2019 and return to a more sustainable cruising speed in the long term.

Québec's economy continues to face a number of risks. Given the persistently low interest rates in recent years, households have been able to carry a heavier debt load than in the past without significantly increasing debt service payments.

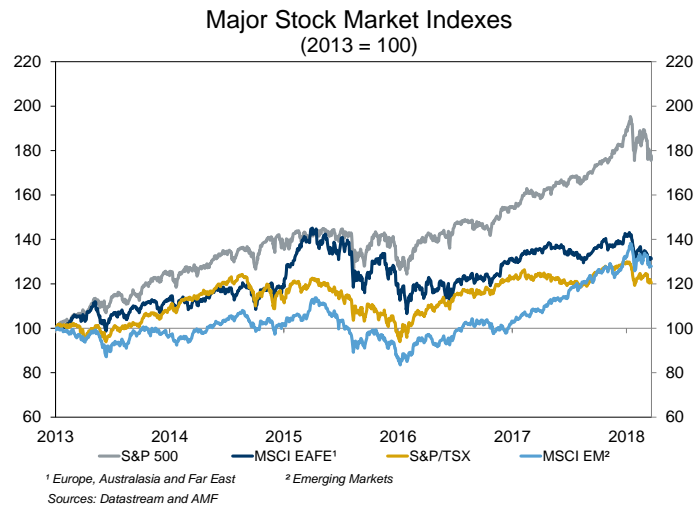
This high level of debt makes households more vulnerable to a sharp rise in interest rates. Although unlikely, such a scenario cannot be dismissed since U.S. and Canadian central banks will be raising their respective key policy rates in 2018 and 2019. Monetary tightening will result in higher borrowing costs.

Lastly, the U.S. administration's current protectionist stance is not an insignificant headwind to a sustained recovery in foreign trade.

## FINANCIAL MARKETS

### STOCK MARKETS

Despite a strong start, the major stock market indexes around the world experienced a challenging first quarter, marked by a sharp correction in February and another pullback at the end of the period. As well, volatility was back with a vengeance.

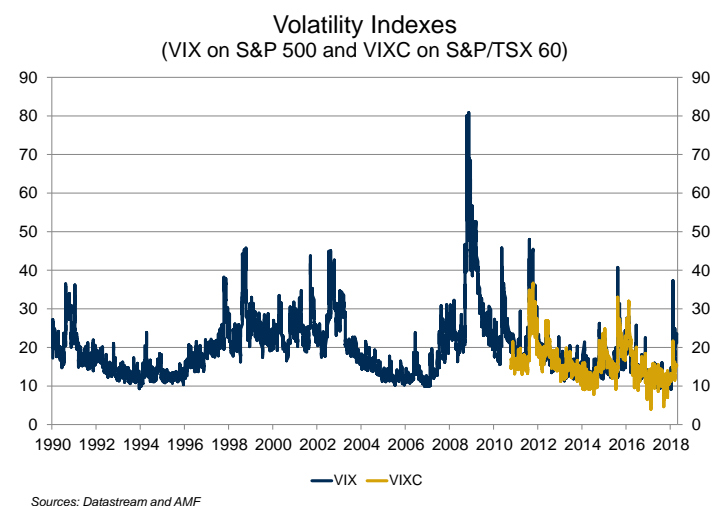


Indeed, in the United States, the S&P 500 started 2018 in high gear, emboldened by an economy at full throttle and a corporate-friendly tax reform.

Nonetheless, after the strongest month of January since 1997, the upward trend came to a grinding halt in February, as a sudden increase in bond yields sparked a correction of roughly 10%. Indeed, 10-year yields rose over 50 basis points to nearly 3% on inflation concerns.

The persistent, ultra-low bond yields in recent years prompted investors to seek riskier assets, particularly stock market securities with their potentially superior returns. But higher yields caused the pendulum to swing back. As well, investors were shaken by the possible adverse impact that a surge in yields could have on the corporate earnings outlook by pushing up borrowing costs and weighing on economic growth.

It should be noted that such a correction is not an anomaly. Steep declines of 10% or more occur on average every 18 to 24 months. In the past 50 years, the S&P 500 has undergone 26 corrections of over 10%, with the latest taking place at the start of 2016. Moreover, to a certain extent, the recent burst of volatility represents a return to normal, as volatility levels had fallen to historic lows in 2017.



The return of volatility, however, did not unfold smoothly. On February 5, 2018, the S&P 500 VIX Index shot up 20 points, its largest daily increase since Black Monday in 1987. Volatility exchange traded funds (ETFs), especially in the United States, incurred sizable losses; some had to be terminated. A few relatively small Canadian ETFs were also affected.

According to some analysts, volatility ETFs may have not only incurred losses, but also contributed to the sudden spike in the VIX as they automatically rebalanced their positions through VIX futures purchases at the close of trading. This apparently created imbalances and a feedback loop.<sup>1</sup>

Since then, after recouping some of the losses from the correction in early February, the S&P 500 posted

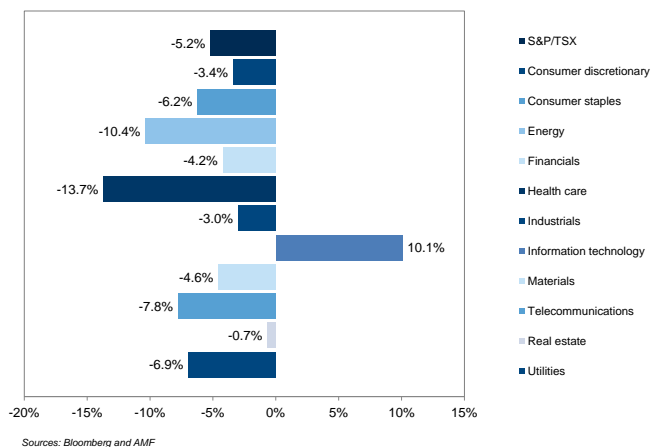
<sup>1</sup> See: Bank for International Settlements (BIS) Quarterly Review, March 2018: *Volatility is back*.

another sharp decline in March. This time, investor confidence appeared to have been sapped by the growing threat of a trade war between the United States and China, in particular, as well as uncertainty surrounding regulatory action with respect to top technology firms and the sustainability of their business models. At the end of the first quarter, the S&P 500 was down 1.2%, with volatility having receded somewhat.

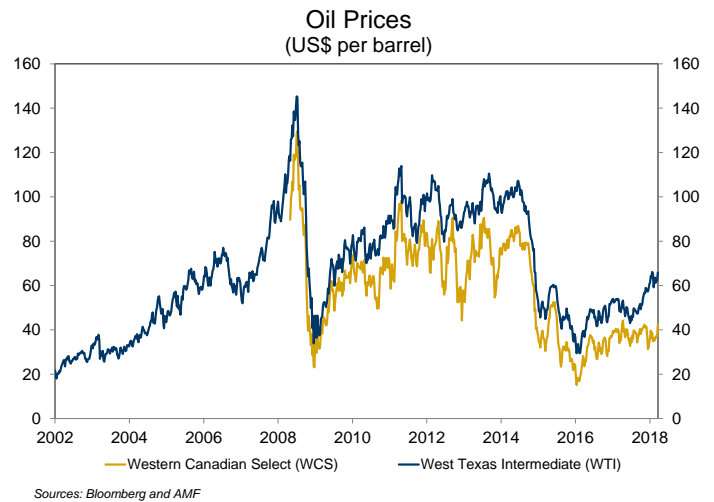
U.S. stock markets should continue to benefit from solid corporate profits and a robust economy. However, growing uncertainty amid rising interest rates and protectionism, not to mention relatively high stock valuations, is overshadowing the performance outlook.

In Canada, the turbulence encountered in early February and in March did not spare the S&P/TSX. Moreover, with the index bucking the uptrend in January, it ended the quarter down 5.2%, once again lagging behind its peers.

Performance of the Main S&P/TSX Subindexes (2018 Q1, q/q % change)



TSX weakness was partly due to the lackluster performance of the energy sector. That said, oil prices (WTI and Brent) ended the quarter in positive territory. Nevertheless, the Canadian WCS, a benchmark for the price of Alberta oil sands crude, continued to trade at a sizable discount to its U.S. counterpart. Since the start of the year, the differential between WCS and WTI has moved between US\$20 and \$30 a barrel, partly reflecting the challenges of transporting Alberta oil toward international markets.



To a certain extent, investor optimism about Canada also seems to have been curbed by the risks overhanging the renegotiation of NAFTA, as well as those tied to household debt and imbalances in the real estate market.

This uncertainty, added to the more gradual tightening of monetary policy expected in Canada, is also reflected in the performance of the Canadian dollar, which has sagged since the start of the year against major currencies, including the greenback.

Lastly, although the shares of Québec publicly traded companies slightly outpaced the S&P/TSX as a whole, they ended the quarter down 4.5% according to the Morningstar National Bank Québec Index. Most sectors underperformed, with only industrials and information technology ending on an upswing.

## BOND MARKETS

Bond yields have risen noticeably since the start of the year, especially in the United States. Inflationary buildup lifted U.S. 10-year yields briefly to 3% in February—a first since 2014—before ending the quarter at 2.7%.

Government Bond Yields  
(10-year maturity)



The U.S. economy is indeed giving more hints of overheating. In particular, wages have been rising more steadily, raising inflation expectations and, in turn, long-term yields.

Inflation pressures also led to higher-than-anticipated expectations of monetary policy tightening, thus driving the uptrend in U.S. short-term yields. Two-year yields have risen some 100 basis points since last September. Consequently, the yield curve has flattened further.

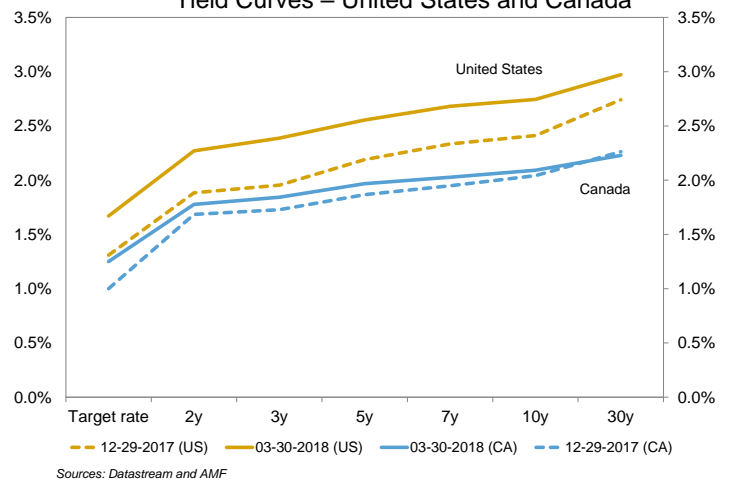
U.S. economic conditions definitely have the makings of an upswing in inflation, with the U.S. economy running on all cylinders and the unemployment rate falling to a cyclical low of close to 4%. As well, U.S. fiscal policy is adding fuel to the fire.

The U.S. government's tax reform and increased fiscal spending will significantly deepen the budget deficit and generate more bond issues, thus adding to the upward pressure on yields. Furthermore, it bears noting that the Fed initiated a balance sheet normalization program by scaling back its reinvestment of maturing bonds. Ultimately, the market will have to absorb an increasing quantity of Treasuries.

Lastly, concerns about a trade war could also contribute to a rise in inflation pressures and bond yields. In contrast, the European Central Bank and the Bank of Japan are maintaining their expansionary monetary policies, thus mitigating the upside potential on yields.

In Canada, yields also climbed at the start of 2018, but ended the quarter basically unchanged. Keep in mind that Canadian yields had jumped vigorously in the second half of 2017. At the time, the surprising strength of the Canadian economy had prompted the Bank of Canada to raise its key policy rate three times.

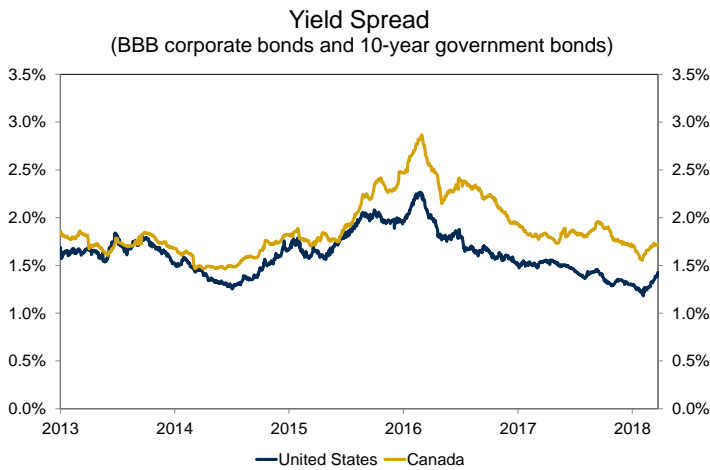
Yield Curves – United States and Canada



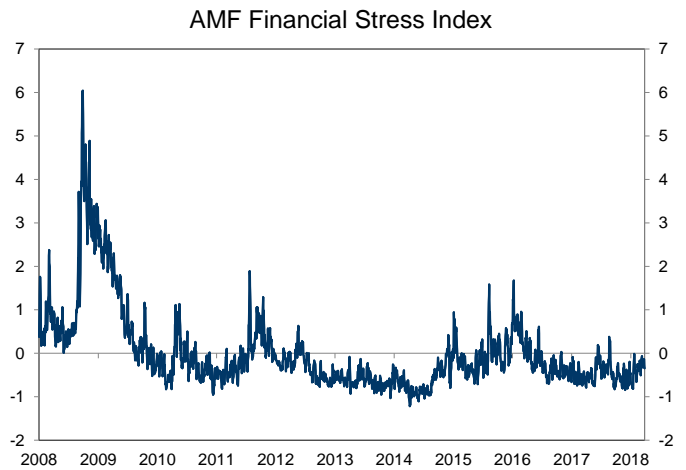
More recently, the Canadian economy has slowed, while a change of tone at the Bank of Canada suggests a more gradual tightening of its monetary policy. Amid the risks associated with U.S. protectionism and signs of a slowdown in the residential real estate market, the Bank is taking a cautious approach. Moreover, the high level of household debt is a soft spot for the Canadian economy, making it especially sensitive to a hike in interest rates.

Corporate bond yields have also been nudged higher, especially in the United States, but spreads with government bonds have remained very narrow, historically speaking.

As a result, stock market turbulence was not cause for much upheaval in the corporate bond market.



Sources: Datastream, Bloomberg and AMF



Sources: Bloomberg and AMF

Financial stress, as indicated by the AMF’s Financial Stress Index, rose only slightly as a result of the turbulence in February. This index is used to monitor changes in the level of financial instability within Canada’s financial system.<sup>2</sup>

Not surprisingly, the uptick in the index was largely due to the stock market. The currency market was also impacted by the uncertainty over interest rate developments. The jolt, however, was limited in both scope and length. The stress index thus remained under its long-term average reading.

Market Performance

Stock Markets											
	Level	% change								Last 12 months	
		2018-03-30	1 month	3 months	6 months	9 months	1 year	3 years <sup>2</sup>	5 years <sup>2</sup>	Min.	Max.
MSCI All Country World Index	574	-2.5	-2.3	2.6	6.5	9.1	5.3	8.2	520	622	
MSCI EAFE <sup>1</sup>	1,107	-2.7	-4.9	-1.8	1.0	2.6	0.6	5.6	1,058	1,207	
MSCI Emerging Markets	61,107	-2.0	0.4	5.7	12.8	19.3	6.5	5.7	50,947	65,823	
S&P 500	2,641	-2.7	-1.2	4.8	9.0	11.8	8.5	11.0	2,329	2,873	
S&P/TSX	15,367	-0.5	-5.2	-1.7	1.2	-1.2	1.0	3.8	14,952	16,413	
Morningstar National Bank Québec Index	275	-1.3	-4.5	1.6	4.6	9.2	5.8	13.5	251	289	

Bond Markets											
	Level	% change								Last 12 months	
		2018-03-30	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.7	2.8	2.6	2.8	2.4	2.4	2.2	3.0	2.1	3.0
Ontario	10-year	2.7	2.8	2.6	2.7	2.4	2.4	2.2	2.9	2.1	3.0
Canada	10-year	2.1	2.2	2.0	2.1	1.8	1.6	1.4	1.9	1.4	2.4
United States	10-year	2.7	2.9	2.4	2.3	2.3	2.4	1.9	1.9	2.0	3.0
United Kingdom	10-year	1.3	1.5	1.2	1.4	1.3	1.1	1.6	1.8	0.9	1.6
Germany	10-year	0.5	0.7	0.4	0.5	0.5	0.3	0.2	1.3	0.2	0.8
Canada	AA Corp. (10-year)	3.0	3.2	3.1	3.3	2.9	2.7	2.3	2.7	2.5	3.3
	BBB Corp. (10-year)	3.8	3.9	3.8	4.0	3.6	3.5	3.2	3.6	3.2	4.1
	BBB - 10-year Gov. spread	1.8	1.7	1.7	1.9	1.8	1.8	1.8	1.7	1.6	2.0
United States	AA Corp. (10-year)	3.6	3.6	3.1	3.1	3.1	3.3	2.7	2.6	2.9	3.7
	BBB Corp. (10-year)	4.2	4.2	3.7	3.7	3.7	4.0	3.6	3.5	3.5	4.3
	BBB - 10-year Gov. spread	1.5	1.3	1.3	1.4	1.4	1.6	1.7	1.7	1.2	1.6

<sup>1</sup>Europe, Australasia and Far East <sup>2</sup>Annualized returns  
Sources: Datastream, Bloomberg and AMF

<sup>2</sup> For more information on the AMF’s Financial Stress Index, see the *Dossier spécial* (backgrounder, in French only) at [https://lautorite.qc.ca/fileadmin/lautorite/publications/professionnels/revues-economique-financiere/revue-economique-financiere\\_T1-2016.pdf](https://lautorite.qc.ca/fileadmin/lautorite/publications/professionnels/revues-economique-financiere/revue-economique-financiere_T1-2016.pdf)

## NOTE

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