ECONOMIC and FINANCIAL

REVIEW

Office of the Vice-President
Strategy, Risks and Performance

April 15, 2019

AUTORITÉ DES MARCHÉS FINANCIERS

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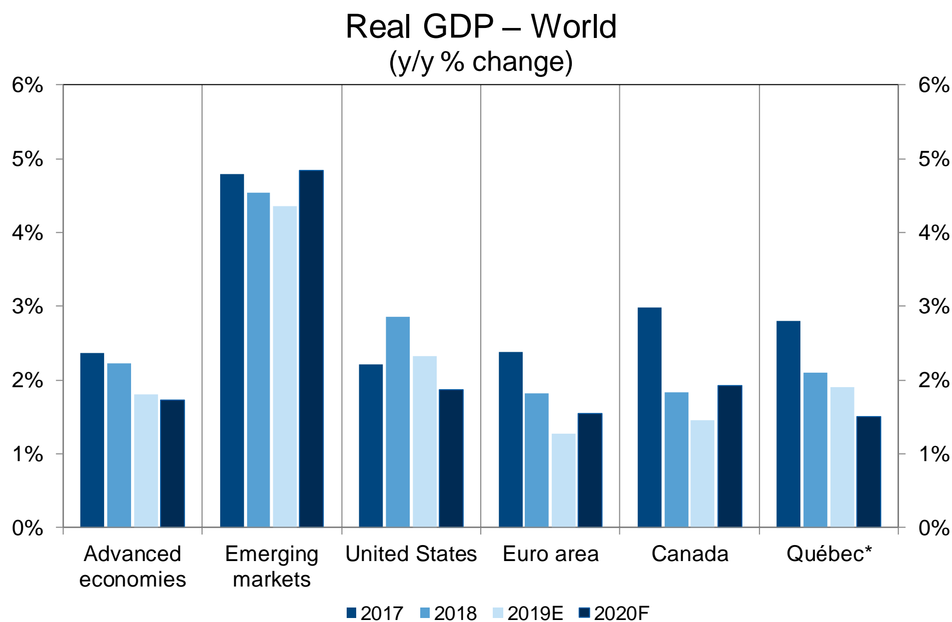
HIGHLIGHTS

- The global economy continues to show signs of losing steam, particularly in Europe, China and Canada. Ongoing trade tensions and the outcome of Brexit are only adding to uncertainty.
- In the euro area, the slowdown is particularly significant in Germany and Italy. Moreover, the European Central Bank has indicated that its key policy rates will remain unchanged for as long as necessary.
- Despite a slight slowdown, the U.S. economy continues to operate at full capacity, bolstered by job and wage growth and strong consumer and business confidence.
- Weakened by troubles in Western Canada's energy sector and a widespread decline in domestic demand, the Canadian economy decelerated throughout 2018 and early 2019.
- Despite having cooled somewhat, Québec's economy delivered a relatively enviable performance for a second consecutive year, posting growth of 2.1% in 2018.
- The financial markets are sending mixed signals. The stock markets rebounded strongly in the first quarter, yet bond yields were down.
- Following cases of LIBOR manipulation, international regulatory authorities are in the process of strengthening and replacing benchmarks. The Bank of Canada and the CSA are reviewing the CDOR and CORRA benchmarks and their framework.

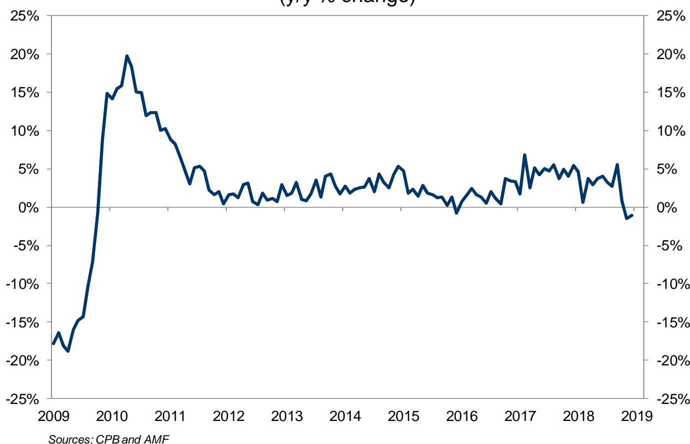


ECONOMIC CONTEXT

WORLD

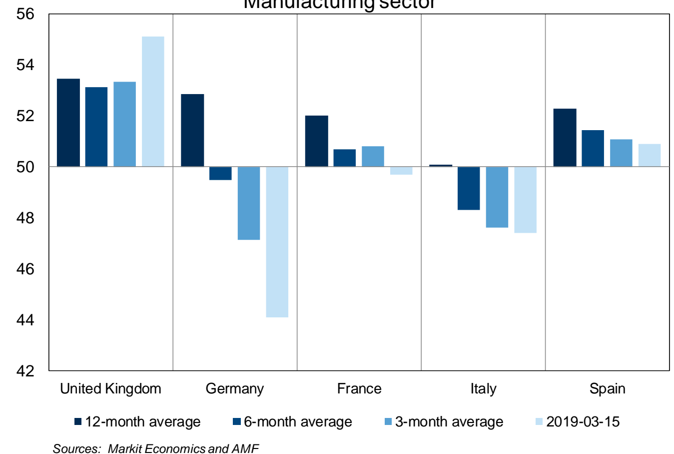
The global economy continues to show signs of losing steam, with indicators pointing to a slowdown virtually everywhere, especially in Europe, China and Canada. Ongoing trade tensions and the outcome of Brexit are only adding to the uncertainty. The IMF, the OECD and several central banks have revised their economic forecasts downward for 2019.

This weakening of the global economy is evidenced by a decline in global exports volume since early 2019. The purchasing managers indexes, reflecting an economy's vitality, have also been trending downward for months in several countries. In the euro area and Japan, these indexes even declined to below the critical threshold of 50, signaling a contraction in the manufacturing sector and a slowdown in the overall economy.



Economic growth in the euro area has been on a downward trend for several quarters. The slowdown is particularly significant in Germany and Italy. The European Central Bank lowered its forecasts and indicated that rates would remain on hold until the end of the year.

Although it only recently ended its asset purchase program, the central bank has done an about-face and announced the creation of a new program to provide cheap long-term loans to euro area banks in order to stimulate lending.



In the United Kingdom, the Brexit deadlock continues after a series of votes in the British Parliament. A deal between London and Brussels has been rejected three times and no other scenario for leaving the European Union has garnered the support of a majority of British MPs. The Brexit deadline has been extended twice, first until April 12 and then until October 31, to avoid a no-deal Brexit. In the meantime, authorities and businesses on both sides of the Channel have started preparing for a no-deal Brexit, which would result in the reintroduction of regulatory checks and tariffs and significant supply chain disruptions.

The pace of U.S. economic growth has slowed somewhat owing, among other things, to the partial government shutdown in December and January. The U.S. Federal Reserve and the Bank of Canada did not hike their key policy rates in the first quarter. In light of the more uncertain economic outlook, both central banks downgraded their economic forecasts and

decided to pause before continuing to normalize their monetary policies.

Trade negotiations between the United States and China are ongoing and some progress has been made. The United States has therefore decided to delay the tariff incease on Chinese imports that was scheduled to take effect on March 1. However, the U.S. administration is still threatening to impose tariffs on the auto industry and wielding the tariff threat in its trade negotiations with the European Union.

China, which is already suffering under the U.S. tariffs, is facing sharply declining domestic demand and diminishing demand in its export markets. China's economy grew only 6.6% in 2018, the lowest rate since 1990. The Chinese government has now reduced its growth target to 6.0%-6.5% for 2019.

Sources: National Bureau of Statistics of China and AMF

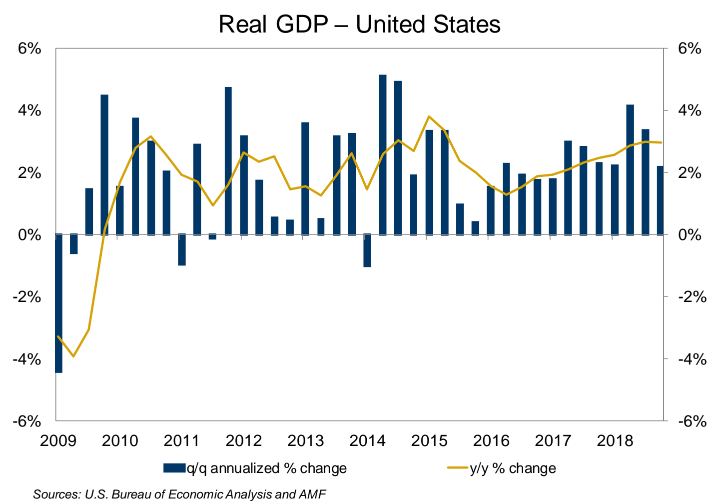
Financial markets are sending mixed signals. Following the downturn in the last quarter of 2018, the stock markets rebounded in the first quarter of 2019. After an excessive bout of pessimism, investors appear to have had their confidence restored by the pause in Federal Reserve rate hikes, the progress in trade negotiations between the United States and China, and the strength of the U.S. economy. However, bond yields are on a downward trend because of the slowing global economy.

At the same time, oil prices have risen more than 30% since December owing to OPEC oil output cuts and supply disruptions in Venezuela.

United States

The U.S. economy slowed during the second half of 2018, ending the year with a growth rate of 2.2% in the fourth quarter. For 2018 as a whole, however, GDP posted a 2.9% increase, its best performance since 2015.

The economy's strong performance was supported by solid job and wage growth, strong consumer and business confidence and a highly expansionary fiscal policy.



Sources: U.S. Bureau of Economic Analysis and AMF

GDP growth primarily came from an increase in consumer spending, business investment and, to a lesser extent, government spending.

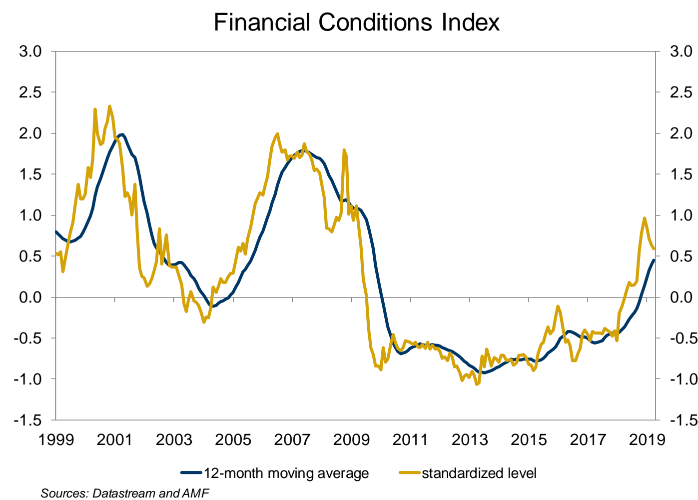
It appears from recent economic data that the slowdown seen at the end of 2018 continued during the first quarter of 2019. Manufacturing production and capital goods orders are showing signs of softening, while retail sales have dipped. By contrast, residential activity appears to be stabilizing after several months of decline and the purchasing managers index is likewise sending positive signals.

Despite a slight deceleration in job creation in the first quarter, the job market remains strong. Employment growth averaged 180,000 new jobs per month; the jobless rate is sitting at 3.8%; wage growth is strengthening; and the number of job vacancies continues to climb.

The partial shutdown of the federal government at the start of the year was no doubt very challenging for government workers, who were without an income for

several weeks. However, the adverse effects on the economy were modest and temporary.

Financial conditions are tightening but continue to be very loose, despite the key policy rate hikes announced by the Federal Reserve (a total of 100 basis points in 2018), increased borrowing costs for households and businesses, and a higher equity risk premium.



Sources: Datastream and AMF

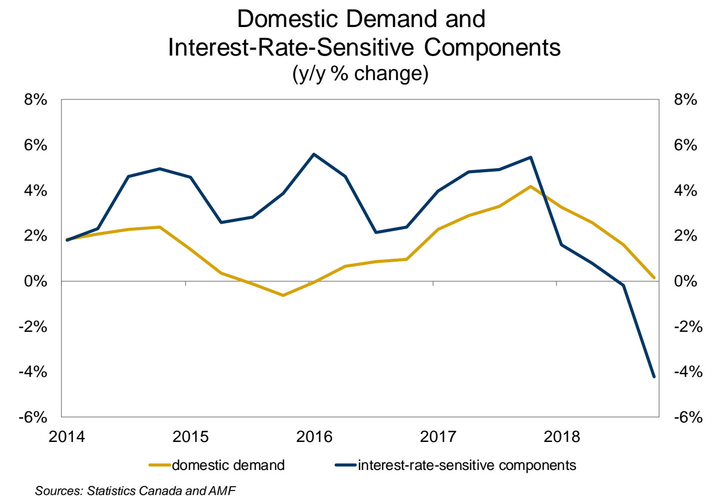
The U.S. Federal Reserve has taken note of the slowdown in the United States and elsewhere in the world and the absence of apparent inflationary pressures. At its last meeting in March, the monetary policy committee voted unanimously to hold the key policy rate at 2.25%-2.50%. According to consensus expectations, the Federal Reserve will take a long pause that could last for the rest of the year.

Because of recent global economic and financial developments and the absence of inflationary pressures, and with inflation on a downward trend as of late, the Fed can afford to take a wait-and-see approach. Nonetheless, in a context of full resource utilization and wage growth, the tide could turn quickly in favour of additional monetary tightening.

CANADA

Weakened by troubles in Western Canada's energy sector and a widespread slowing of domestic demand, the Canadian economy decelerated throughout 2018 and closed the year on a lacklustre note. The fourth quarter saw annualized quarterly growth of 0.4% and annual growth for 2018 was 1.8%.

Domestic demand shrank for the second consecutive quarter. Interest-rate-sensitive components of demand (residential construction and consumption of durables) were particularly affected, dropping 4.2% year-over-year in the fourth quarter.



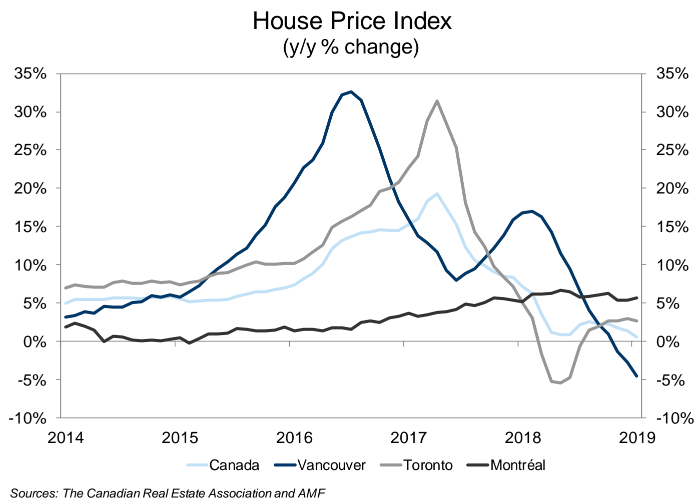
Sources: Statistics Canada and AMF

Household spending continued to lose momentum. In the fourth quarter, it posted its weakest growth since 2015.

Business investment contracted in the fourth quarter, decreasing 10.9% on an annualized basis. While the decline in private sector investment appeared to be a one-time occurrence, given full resource utilization, it has now lasted three quarters. This decrease is all the more surprising because some of the uncertainty surrounding NAFTA renegotiations has dissipated, which should normally lead to a pick-up in private sector investment.

Residential construction also declined in the fourth quarter. Households seem to be taking longer and finding it more difficult than anticipated to adjust to higher mortgage rates and new federal and provincial macroprudential measures.

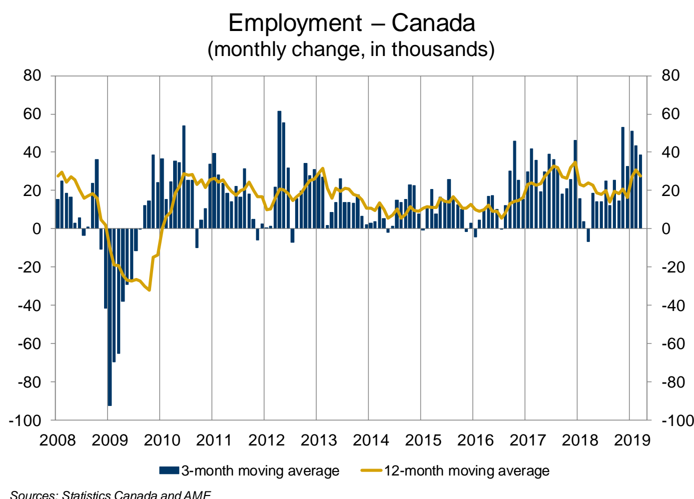
The Canadian real estate market continues to be characterized by major geographic disparities. Prices in the Vancouver area have been falling for the last three months and resale activity is down. In the Toronto area, resale activity has increased in recent months and prices appear to have stabilized.



Net exports contributed positively to economic growth over the last three quarters owing to a slight increase in exports and a drop in imports.

Global growth has slowed and uncertainty arising from global protectionist threats persists. The trade war between the United States and China has still not been resolved, despite some positive signs, and could further affect global growth and, with it, Canadian exports.

The labour market remains relatively strong despite the economic slowdown. The unemployment rate remains close to its historic low, standing at 5.8% in March.



After a spectacular start to the year, job creation should grow more modestly and in line with slower economic growth.

The Canadian economy is going through a slowdown that could just be temporary. GDP could strengthen in the second quarter after the oil industry returns to normal.

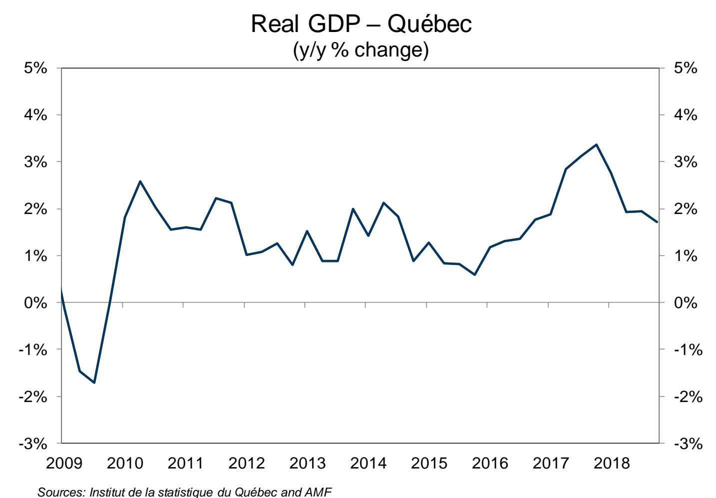
Nonetheless, risks appear to be weighted to the downside. The global economy could deteriorate further if, among other things, the trade war between the United States and China goes on for much longer.

Households could also need more time to adjust to higher interest rates and macroprudential measures in the real estate market, which could continue to be a drag on consumer spending and residential investment.

According to consensus expectations, the Canadian economy will post growth of about 1.5% in 2019. In light of this and the lack of inflationary pressures, it appears unlikely that the Bank of Canada will hike its key policy rate again before the end of the year.

QUÉBEC

Québec's economy grew 2.1% in 2018, putting in a relatively enviable performance for a second consecutive year, despite having cooled somewhat in the last quarters of the year.

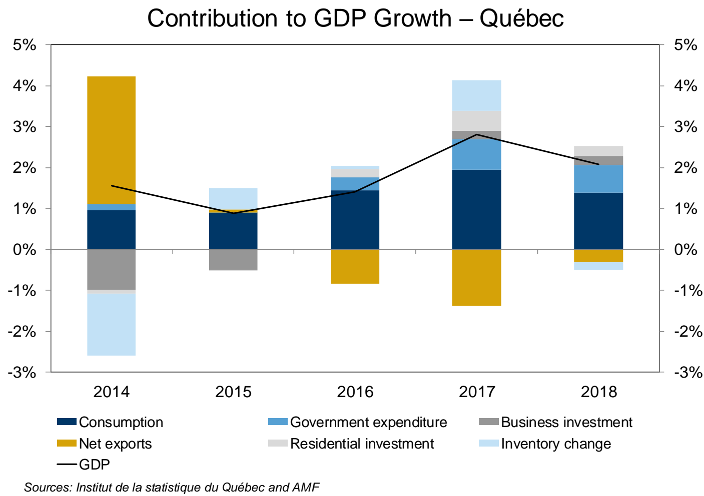


Most of the components of domestic demand gradually decelerated, resulting in more modest economic growth at the end of the year, with GDP posting weak growth of only 1.5% on a year-over-year basis in the fourth quarter.

Household spending continued to drive the Québec economy, bolstered by the strong labour market and accelerated wage growth.

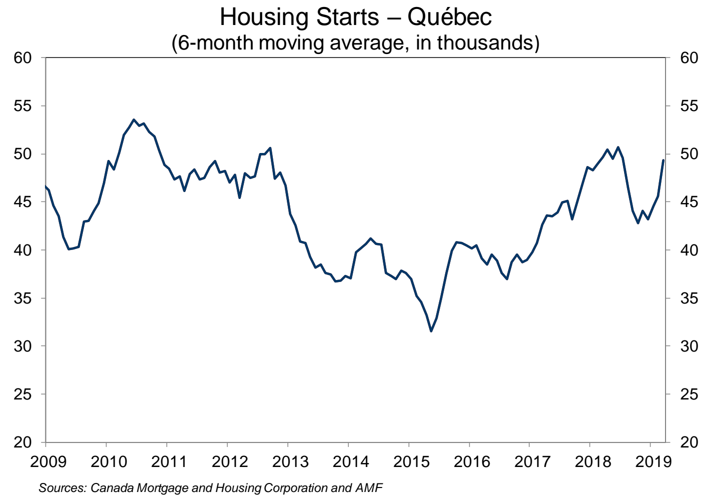
Consumer spending slowed somewhat in 2018, however. There is reason to believe this deceleration is temporary, as it coincides with a mid-year lull in job creation.

Spending is therefore expected to return to a more normal pace this year, but rising borrowing costs will put a damper on household enthusiasm.



Québec's residential sector has gone against the grain this year. Unlike the overheated Vancouver and Toronto markets, which are going through an adjustment period and experiencing some problems, Québec's resale and construction markets have fared very well. Housing starts have remained high, while sales and price growth continued to be strong.

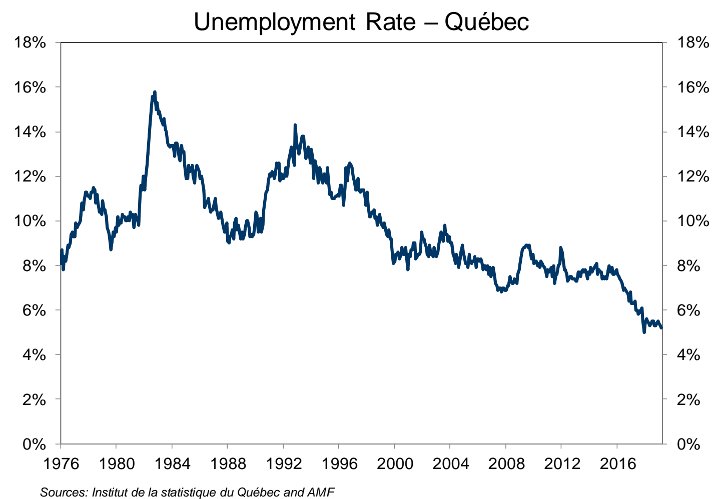
The Québec real estate market nevertheless has cooled compared with the previous two years and is expected to see more modest activity this year owing to slower job creation and higher borrowing costs.



Despite continuing U.S. steel and aluminum tariffs and the ongoing global downturn, exports have managed to shine. Growth was relatively modest, but nonetheless stronger than the trend seen in recent years.

The weak Canadian dollar and recent trade agreements[1] will open up new markets and should spur the expansion of exports.

Job creation has picked up over the past six months, with a net gain of close to 52,500 jobs. The labour market has maintained its momentum since the start of the year. As a result, the unemployment rate decreased slightly and stood at 5.2% in March.



[1] The Comprehensive Economic and Trade Agreement between Canada and the European Union, provisionally in effect since September 21, 2017; the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, in effect since December 30, 2018 among the countries that ratified it; and the Canada-United States-Mexico Agreement, signed on November 30, 2018 but not yet ratified.

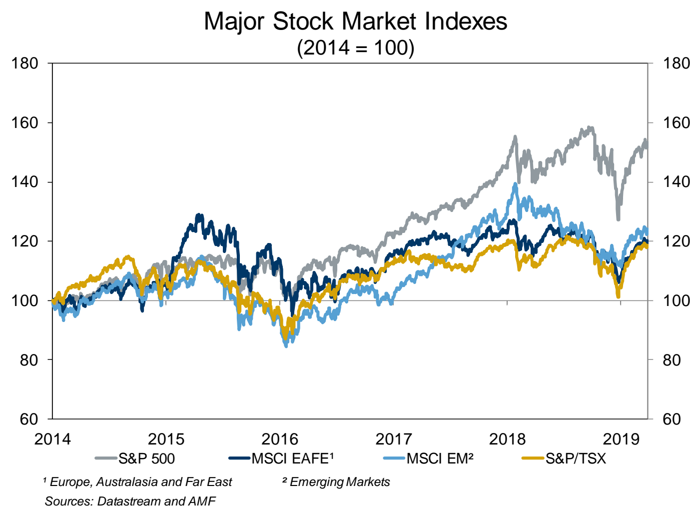
A worsening labour shortage, partly caused by the aging of the population, will continue to exert pressure on the labour market and unemployment rate. Owing to the shrinking labour pool, the unemployment rate could remain stable or decline even further, even though job creation is expected to slow because of a more modest increase in GDP.

The North American economic climate, particularly the economic slowdown in the rest of Canada, will have repercussions for Québec. Although Québec's economy is expected to post more moderate growth than last year, it will nonetheless continue to operate at its full potential.

FINANCIAL MARKETS

STOCK MARKETS

After registering significant losses at the end of 2018, the major global stock markets bounced back in the first quarter of 2019. Investor optimism had been dampened by fears of a global economic slowdown, trade tensions and the expectation of monetary tightening in the United States, but these factors have receded somewhat since the start of the year.

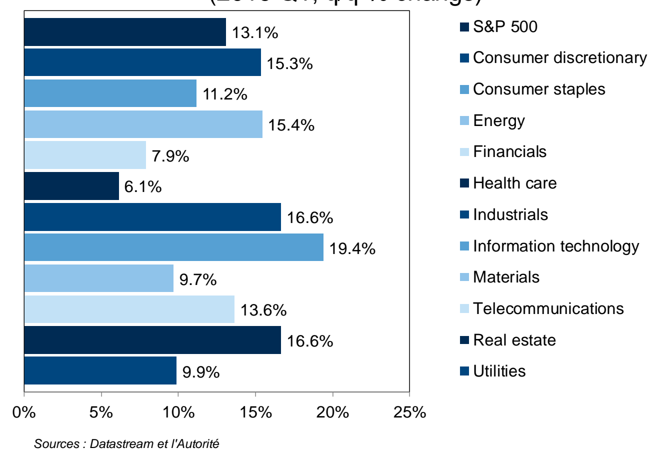


In the United States, the S&P 500 rose 13.1% in the first quarter, erasing almost all the losses from the last quarter of 2018. The U.S. economy has downshifted over the past two quarters, although growth remains quite strong and the worst fears regarding a downturn have not materialized. Similarly, while corporate earnings growth has slowed considerably, the spectre of an earnings recession has been averted for the time being.

The change in the Federal Reserve's tone has eased investor concerns about interest rates rising too steeply. In fact, the Fed recently indicated that it intended to leave its key policy rate unchanged in 2019 and conclude its balance-sheet reduction.

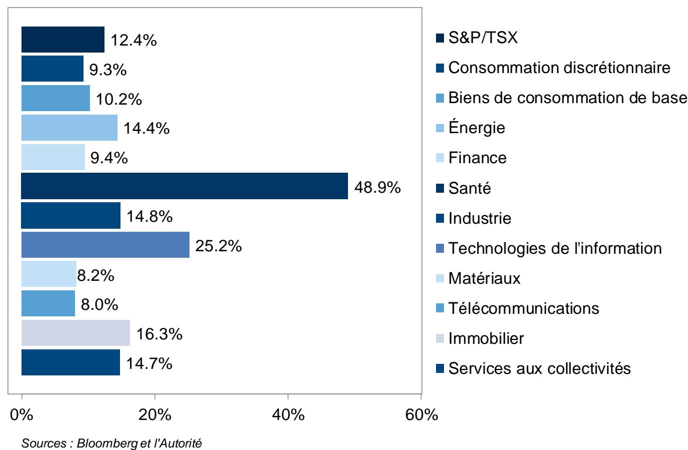
Moreover, the U.S. administration has at times sounded more conciliatory toward China, raising hopes of a possible resolution to the trade dispute.

All sectors of the S&P 500 contributed to the rebound in the first quarter. The information technology sector fared particularly well, increasing 19.4% quarter-over-quarter, followed by the real estate and industrials sectors, both of which rose 16.6%.



Stock markets elsewhere in the world were also up in the first quarter, despite the slowdowns in the European and Chinese economies. The announcement of more expansionary fiscal and monetary measures provided investors with a degree of reassurance.

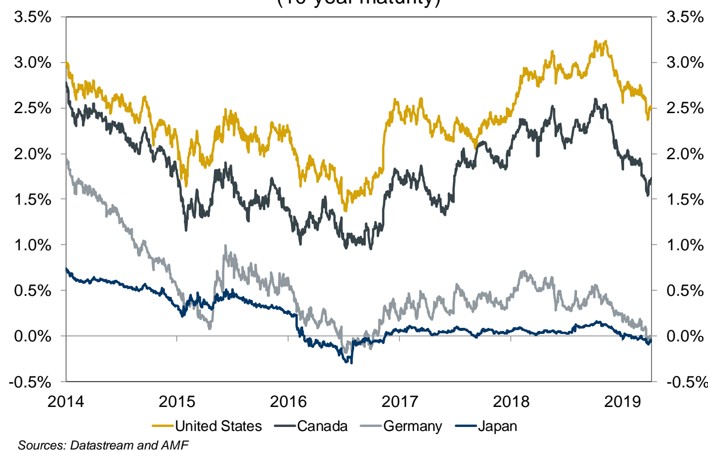
In Canada, the S&P/TSX has gained 12.4% since the start of the year, placing it just shy of its July 2018 peak. This solid performance was due in no small part to the recovery in oil prices, although all sectors posted gains. The health care sector outperformed all others, at 48.9%, reflecting investor enthusiasm for companies in the cannabis industry.



In Québec, the companies of the Morningstar National Bank Québec Index returned 13.6% in the first quarter, faring slightly better than the companies of the S&P/TSX as a whole. As in the case of the S&P/TSX, the health care sector posted a robust performance, as did utilities and financials.

Bond markets

Bond yields in the major markets fell considerably over the first quarter owing to the slowdown in the global economy and the increasingly accommodative tone struck by central banks. Overall, the signals from the bond markets about the health of the global economy are more negative than those from the stock markets.



Yields on 10-year U.S. government bonds ended the quarter at 2.4%, down approximately 80 basis points from their November 2018 peak.

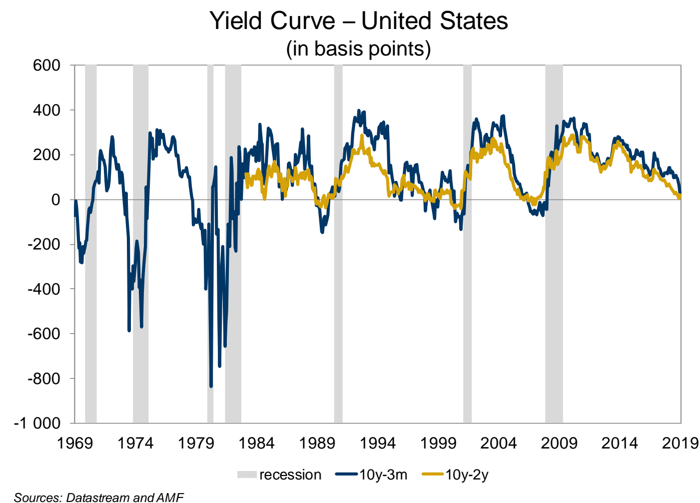
This decrease was due to the slowdown in the global economy, which prompted the Federal Reserve to change course, and to a decline in inflation expectations.

According to the Fed's latest median interest rate projections, there will be no increase in the key policy rate in 2019, whereas two 25-basis-point hikes were projected in December 2018. The futures markets are even pricing in a more than 60% probability that there will be a decrease in the key policy rate this year.

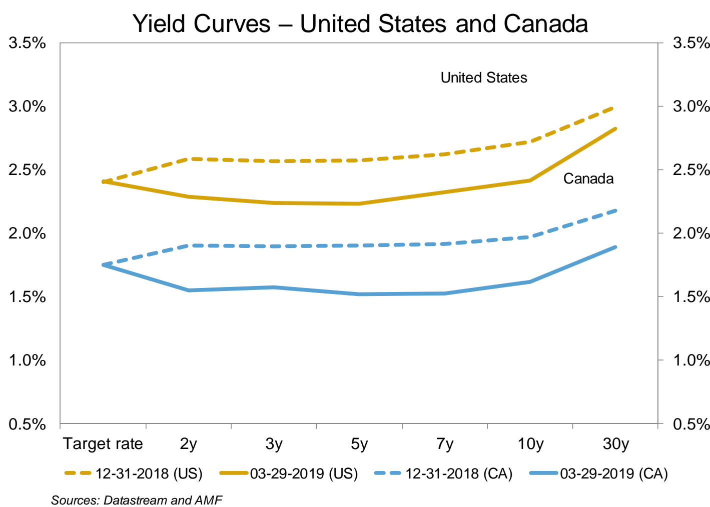
The Fed also announced that it would conclude its balance sheet reduction as of September of this year, much sooner than expected, and will therefore continue to reinvest heavily in Treasury securities.

The changes observed in bond yields also reflect, to some extent, the fear of a more significant slowdown in economic activity and even a recession. According to a New York Fed model based on term spreads, the probability of a recession in the U.S. over a one-year horizon is now 27%, compared with 11% a year ago.

An inverted yield curve often signals a recession up to one to two years ahead. In fact, every recession of the last 50 years in the United States has been preceded by an inversion of the yield curve. However, not all yield curve inversions, particularly brief and small ones, have been followed by a recession.

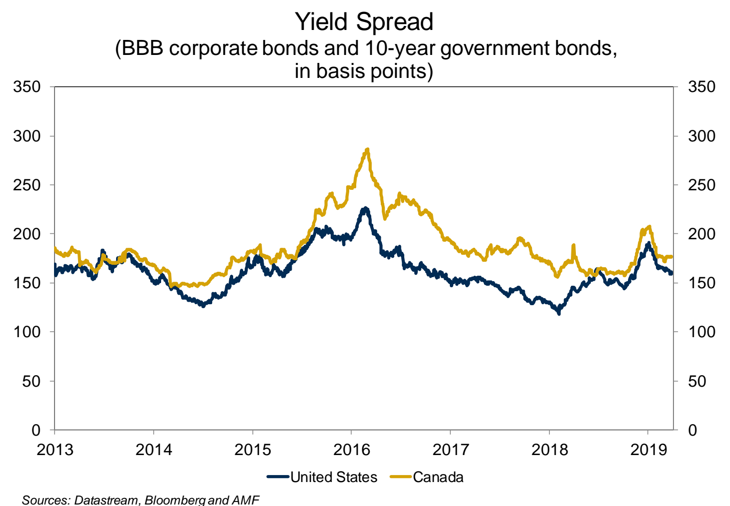


In the first quarter, the spreads between long- and short-term yields narrowed considerably. The spread between 3-month and 10-year yields even dipped briefly into negative territory, while the spread between 2-year and 10-year yields remained positive.



In Europe, bond yields have also fallen sharply in recent months. This decline has been compounded by the significant slowdown in the European economy and the European Central Bank's decision to keep its key policy rate unchanged until after the end of 2019. The last quarter also saw yields on 10-year German government bonds turn negative for the first time since 2016.

Canadian bond yields have followed a similar trend. Yields on 10-year Canadian government bonds ended the quarter at 1.6%, compared with 2.6% in October 2018, and spreads between Canadian and U.S. bond yields widened somewhat, reflecting the more pronounced slowdown in the Canadian economy. In addition to the impacts of the slowing global economy, the Canadian economy is currently facing a significant softening of the residential real estate market, difficulties in the energy sector, and a high level of household debt. Given these circumstances, the Bank of Canada is expected to remain on the sidelines this year.



After widening at the end of 2018, yield spreads between corporate bonds and government bonds have narrowed since the start of the year. More flexible monetary policies and the upswing in oil prices probably have helped to ease investor concerns about corporate financial health. Nevertheless, the spreads remain slightly above the lows of the past few years.

Market Performance

Stock Markets

	Level	% change							Last 12 months	
	2019-03-29	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index	594	1.3	11.7	-2.6	1.4	3.5	9.0	6.1	510	613
MSCI EAFE[1]	1,105	0.8	9.6	-4.1	-2.4	-0.1	5.5	3.1	990	1,178
MSCI Emerging Markets	58,488	1.2	9.5	0.9	0.0	-4.3	8.7	4.6	52,056	62,319
S&P 500	2,834	1.8	13.1	-2.7	4.3	7.3	11.2	8.6	2,351	2,931
S&P/TSX	16,102	0.6	12.4	0.2	-1.1	4.8	6.1	2.4	13,780	16,567
Morningstar National Bank Québec Index	296	2.5	13.6	2.6	1.3	7.9	8.7	10.1	252	299

Bond Markets

		Level								Last 12 months	
		2019-03-29	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.3	2.6	2.8	3.0	2.8	2.7	2.2	3.4	2.3	3.2
Ontario	10-year	2.4	2.7	2.8	3.0	2.8	2.7	2.2	3.3	2.3	3.2
Canada	10-year	1.6	1.9	2.0	2.4	2.2	2.1	1.2	2.5	1.5	2.6
United States	10-year	2.4	2.7	2.7	3.1	2.9	2.7	1.8	2.7	2.4	3.2
United Kingdom	10-year	1.0	1.3	1.3	1.6	1.3	1.3	1.4	2.7	1.0	1.7
Germany	10-year	-0.1	0.2	0.2	0.5	0.3	0.5	0.2	1.6	-0.1	0.6
	AA Corp. (10-year)	2.7	3.0	3.2	3.3	3.1	3.0	2.7	3.2	2.6	3.5
Canada	BBB Corp. (10-year)	3.4	3.7	4.0	4.0	3.8	3.8	3.7	3.9	3.3	4.2
	BBB - 10-year Gov. spread	1.8	1.7	2.1	1.6	1.6	1.8	2.5	1.5	1.6	2.1
	AA Corp. (10-year)	3.1	3.4	3.7	3.8	3.7	3.6	2.7	3.3	3.1	4.0
United States	BBB Corp. (10-year)	4.0	4.4	4.6	4.5	4.5	4.2	3.8	4.2	4.0	4.8
	BBB - 10-year Gov. spread	1.6	1.6	1.9	1.5	1.6	1.5	2.0	1.4	1.4	1.9

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

Sources: Datastream, Bloomberg and AMF

SPECIAL FEATURE

BENCHMARK REFORM

Benchmarks are integral to the functioning of the international financial system. They are used in a variety of financial instruments, especially derivatives, in order to determine a value or payment, at a specific time in the future, based on prices prevailing in the underlying market. The value of these financial instruments amounts to hundreds of trillions of dollars worldwide.

After cases of manipulation of some benchmarks—particularly LIBOR—were first brought to light in 2012, the Financial Stability Board (FSB) issued recommendations to reform major global interest rate benchmarks and called for their replacement, if necessary, through the development of new risk-free rates anchored in transactions.

At the same time, the International Organisation of Securities Commissions (IOSCO) published a series of principles addressing benchmark governance, quality and accountability. These principles promote the use of data from observable transactions in the construction of benchmarks. They also contain recommendations for better regulatory oversight of survey-based benchmarks.

The major improvements that have taken place worldwide in recent years have been guided by the FSB recommendations and the IOSCO principles. Initial work focused on the development of overnight risk-free rates. Officials are now turning to the development of term risk-free rates.

In anticipation of the announced discontinuation of LIBOR in 2021, several alternative benchmarks have been or are being created (including SOFR in the United States, SONIA in the United Kingdom and ESTER in the euro area). After 2021, the United Kingdom's Financial Conduct Authority will no longer require banks to contribute input data to LIBOR.

Concurrently, some securities regulators have adopted new regulatory frameworks. In June 2016, the European Union adopted the Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds. Most of the requirements related to this regulation came into force on January 1, 2018.

In Canada, the benchmarks have raised similar issues. Over the past five years, Canadian regulatory authorities have implemented various measures to better regulate Canadian benchmarks and have recently stepped up their efforts. In 2014, Thomson Reuters Benchmark Services Limited, now known as Refinitiv Benchmark Services Limited (RBSL), was appointed to administer, calculate and distribute Canada's two benchmark rates.

The Canadian Dollar Offered Rate (CDOR) is the most widely used of the two Canadian benchmarks. CDOR is based on a daily survey of the six major Canadian banks and is the rate at which submitters are willing to lend to corporate clients. CDOR is used, in particular, in derivatives contracts, including the BAX (the Montréal Exchange's flagship product), and floating-rate notes and loans.

Although it is based on a still relatively large underlying market, bankers' acceptances, CDOR is a survey-based benchmark and therefore relatively more vulnerable to manipulation. This vulnerability has been mitigated somewhat in recent years through the rules implemented by OSFI in its Guideline E-20 pertaining to the processes of banks' rate submissions for CDOR and through the code of conduct developed by RBSL in cooperation with the submitting banks.

The other key benchmark in Canada, the Canadian Overnight Repo Rate Average (CORRA), is the benchmark rate used for overnight index swaps, among others. To the extent that CORRA is based on transactions, not a

survey, it is less likely to be manipulated. So far, however, the volume of transactions used for the determination of CORRA has been relatively small.

According to recent Bank of Canada estimates, the two Canadian benchmarks are used in financial instruments totalling CA$12,300 billion.

In March 2018, the Bank of Canada created the Canadian Alternative Reference Rate Working Group (CARR), whose mandate is to strengthen the existing overnight risk-free rate and develop a Canadian dollar term risk-free rate benchmark.

So far, CARR has been working on an enhanced CORRA, which would be calculated using a larger volume of transactions than the current CORRA. The group published a consultation paper that proposes enhancements such as expanding the set of transactions upon which daily CORRA calculations would be based, including overnight repo transactions conducted between all types of counterparties and collateralized by Government of Canada treasury bills or bonds. The proposals include a new calculation methodology. CARR has also issued principles to inform the development of the language used in documents related to benchmark-based products and contracts in order to ensure a smooth transition from current benchmarks to alternative benchmarks.

CARR has noted that there are currently no plans to discontinue CDOR as a reference rate in the Canadian market, particularly for the key one- and three-month tenors. However, CARR has indicated that, as CDOR is a voluntary, survey-based measure, it is potentially subject to the same type of discontinuation risk as other global interbank offered rates.

Concurrently with the work of CARR, the Canadian Securities Administrators (CSA) is currently developing Regulation 25-102 respecting Designated Benchmarks and Benchmark Administrators, which will further strengthen the framework for benchmarks. This draft regulation was published for comment in March 2019. As indicated in the notice of consultation, the current intention of the CSA is to designate only RBSL as an administrator, and only CDOR and CORRA as its designated benchmarks (which are each expected to be designated as a critical benchmark and an interest rate benchmark), under the draft regulation. At the same time, certain regulators must also amend their legislative frameworks. Some of the required amendments were adopted in Québec in June 2018, and the regulations are in the process of being passed.

Going forward, special attention will have to be paid to various issues in order to ensure a smooth transition to new benchmarks, both at the national and international levels. Transitioning to new benchmarks could be problematic, particularly in the case of long-term contracts based on benchmarks that are to be replaced by alternative benchmarks with slightly different features. Transitional measures will have to be found. International coordination will also be essential given the significant volume of international transactions and the existence of products using multiple benchmarks. Lastly, the transition—particularly adapting trading systems, risk management practices and the related administrative systems—involves substantial operational risks. IOSCO intends to provide support during the transition process.

NOTE

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