

ECONOMIC and FINANCIAL

REVIEW



Office of the Vice-President
Strategy, Risks and Performance

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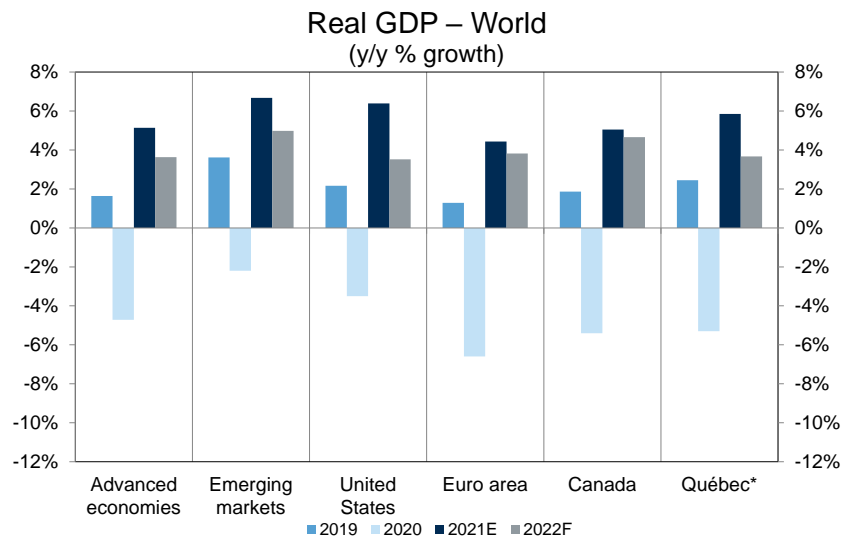
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HIGHLIGHTS

- More than a year after the start of the pandemic, global economic growth is picking up steam, driven by the United States and China.
- In the United States, the rapid vaccine rollout and the passage of an ambitious stimulus plan augur a reacceleration of the economic recovery in 2021.
- Despite the restrictions still in effect in many areas of Canada, the economy has proven to be resilient. The fourth quarter of 2020 ended with annualized GDP up 9.6%, a result far exceeding expectations.
- Québec's economy also performed well in the last quarter of 2020, posting annualized growth of 6.3%. In March, the unemployment rate stood at 6.4%, the lowest of all the Canadian provinces.
- The major stock market indices have posted substantial gains since the start of 2021, continuing the rebound initiated about one year ago.
- On the bond markets, long-term yields have been trending upward since the start of the year, reflecting improved economic conditions and a rise in inflationary pressures.
- Although the pandemic and lockdown measures delivered an unprecedented economic shock in Québec, 2020 was a record year for real estate market activity, and the upward trend has continued in the early months of 2021.



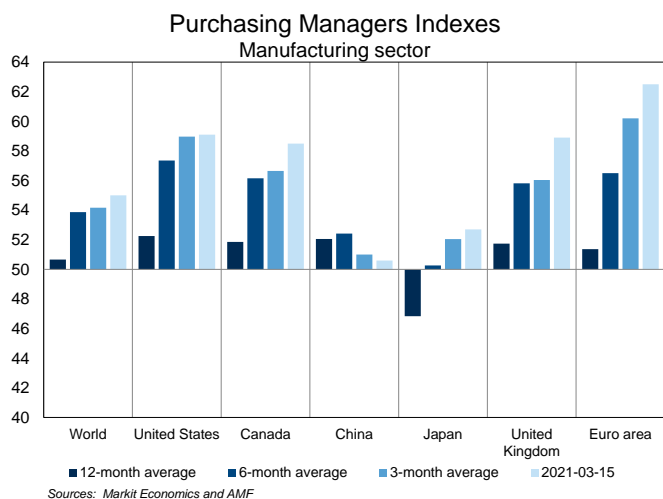
* For 2022, average of forecasts by major Canadian financial institutions
Sources: International Monetary Fund, Institut de la statistique du Québec and AMF

ECONOMIC CONTEXT

WORLD

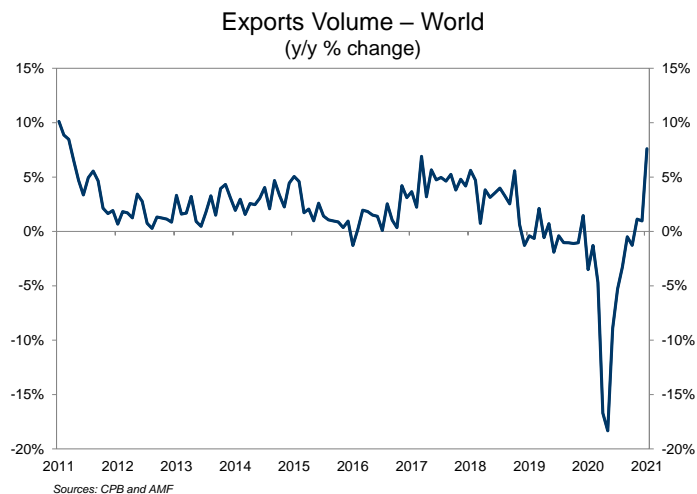
More than a year after the start of the pandemic, global economic growth is picking up steam, driven by the United States and China. Many international bodies and central banks have revised their economic forecasts upward owing to the rollout of vaccines worldwide and of the \$1.9 trillion stimulus package in the United States. With countries racing against the clock to curb the spread of more contagious and virulent variants, there is still a great deal of uncertainty moving forward. The International Monetary Fund is expecting global growth of 6.0% in 2021, after a drop of 3.3% last year.

The purchasing managers indexes of all major global economies are in growth territory (i.e., above the 50 level).



Global trade has also been making a solid recovery since the third quarter of 2020, despite some challenges. Many supply chains have been disrupted by shortages and skyrocketing raw material prices, particularly for steel, microprocessors and plastic. These shortages, which are hitting automobile manufacturing particularly hard, are due to the production shutdowns early in the pandemic and to a number of natural disasters, such as the severe cold waves that struck Texas in February. The United States and China are still waging a trade war and the customs tariffs remain in force. In Europe, the return of

border controls following Brexit has resulted in the collapse of trade between the United Kingdom and the European Union.



Global economic growth will not be synchronized. Advanced economies have a head start over emerging markets in accessing vaccines, which is already helping to drive a faster recovery. Furthermore, among the wealthy countries, the U.S. and European economies are decoupling.

The U.S. economy is benefiting from less stringent lockdown measures, which are already starting to be lifted, an effective, well-advanced vaccine rollout and the sweeping recovery plan adopted by the Democrats, in addition to the two previous plans. The Biden administration is now going a step further and proposing a \$2 trillion infrastructure plan.

In contrast, the recovery measures put in place in Europe appear to be less generous. In addition, the continent has been experiencing choppy vaccine rollout and is currently facing a third wave of infections dominated by variants. Whereas the United States is beginning to lift health restrictions, Europe is reinstating lockdown measures.

In 2020, euro area GDP fell 6.6% compared to a 3.9% decline in U.S. GDP. The euro area may fall back into a recession following a second consecutive quarter of negative growth in the first three months of 2021. The European Central Bank has therefore accelerated its asset purchasing in the face of a hesitant recovery and higher borrowing costs.

China, the only major economy to have prospered in 2020, is expected to surpass its target of 6% growth in 2021, despite high trade tensions with the United States and the situation in Hong Kong, Taiwan, Xinjiang and the South China Sea. Chinese officials expect domestic consumption to play an increasingly important role in the economy, despite the country continuing to be highly dependent on exports.

A third wave of infections is still the primary threat to the global economy. Although infections and deaths had been declining from their peak at the start of the year, they are rapidly rising again around the world, particularly in Brazil, India and Europe, and Québec is no exception. The reinstatement of health restrictions, which is already well underway, could jeopardize the anticipated recovery.

UNITED STATES

In the United States, the rapid vaccine rollout and the passage of an ambitious stimulus package augur a reacceleration of the economic recovery in 2021.

This fiscal stimulus package is, by far, one of the most ambitious in recent history. It includes direct payments to individuals and families, an unemployment insurance supplement, vaccination funds, and state and local relief. The effects of the \$1.9 trillion stimulus package should be almost immediate and will result in faster-than-expected growth this year.

As a result, consensus forecasts were revised significantly upward. The Federal Reserve followed suit, raising its GDP growth forecast for 2021 from 4.2% to 6.5%. At this pace, the U.S. economy should return to pre-pandemic levels this summer.

The recovery continues to be very uneven across the various sectors of the economy. Manufacturing output and residential construction, however, are faring very well. Home prices are increasing at a torrid pace not seen in the last 15 years.

Job creation has picked up in recent months. Last March, the economy added 916,000 jobs, the largest increase since late summer 2020, and the jobless rate fell to 6%.

At the height of the crisis one year ago, more than 20 million Americans had lost their jobs. Since then, nearly 14 million jobs, or 62% of the lost jobs, have been recovered. Unemployment insurance claims, while down significantly, remain very high, averaging more than 725,000 per week.

The Fed is holding the policy interest rate at the current effective lower bound and continuing its asset purchase program, buying \$120 billion per month. The majority of Federal Open Market Committee members do not expect interest rates to rise before 2023.

An accelerating recovery, almost unprecedented fiscal support and the continuation of very loose financial conditions are stoking investor fears of a resurgence of inflation.

It may be too soon to raise concerns about inflation in the United States. At a press conference, the Fed Chair indicated that he expects inflation to increase in the coming months but that the increase will only be transitory. The much higher jobless rate compared to one year ago and the huge excess production capacity that still exists appear to support the Fed Chair's point of view.

CANADA

Despite restrictions that were still in effect in many areas of Canada in late 2020 and early 2021, the Canadian economy has proven resilient. The fourth quarter of 2020 ended with annualized GDP up 9.6%, far exceeding expectations.

Although household consumption declined in the fourth quarter, domestic demand posted significant growth, boosted by stronger residential investment. Residential construction was the only component of demand that was up at the end of 2020.

Business investment grew over the last two quarters but is still below pre-pandemic levels. Recent figures indicate that SME sentiment in Canada is improving, and private investment should continue trending upward as uncertainty related to the health situation dissipates.

The labour market experienced a pullback at the end of the year, although recent figures indicate that it is still in recovery mode. In March, 303,000 jobs were created and the unemployment rate now stands at 7.5%.

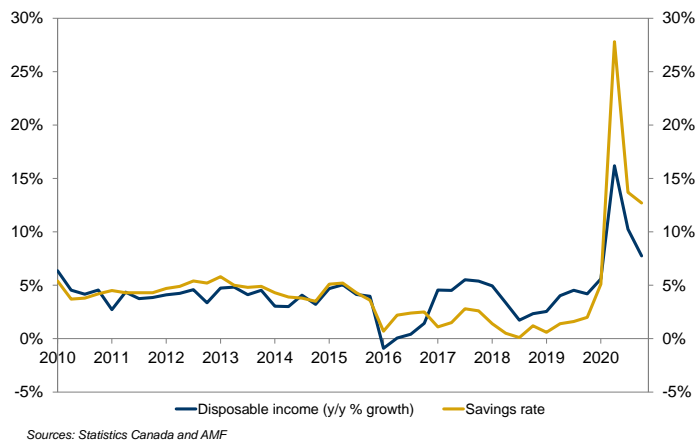


Both long-term unemployment and the labour underutilization rate declined. The pandemic has, however, impacted the labour market unevenly, with the most affected being women, low-wage workers and low-skilled workers. These structural changes could have a long-term effect on the economy.

In spite of the pandemic’s impact on the labour market, household disposable income rose significantly, mainly owing to generous government household support programs.

On a year-over-year basis, disposable income was up nearly 8% in the fourth quarter, whereas the average annual increase for the past 10 years was less than 4%. The savings rate also jumped, reaching a peak of almost 30% in the second quarter of 2020. At year-end, it was still relatively high, at 12.7%.

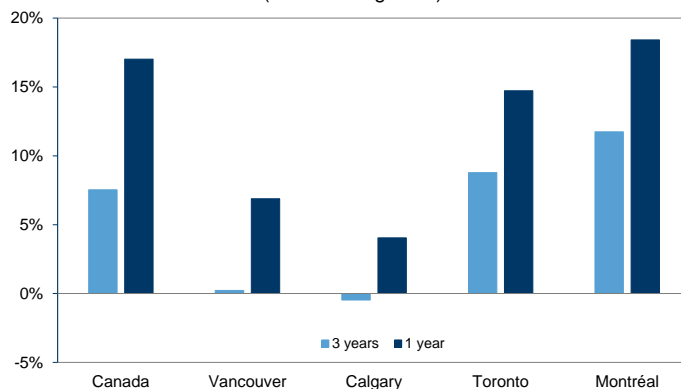
Disposable Income and Savings Rate
Canada



The rise in disposable income, along with lower interest rates and a shift in consumer preferences towards larger homes outside of major urban centres, contributed to the strength of the real estate market in 2020.

The Canadian real estate market continued to break records early in 2021. The number of sales reached an all-time high in February, with the number of months of inventory (MOI) (a measure of how long it would take to liquidate current inventories at the current rate of sales activity) standing at 1.8 months, a record low. Although up sharply, housing starts are insufficient to meet demand, and prices increased 17% in February, comparable to the levels observed in 2017.

House Price Index
(annualized growth)



Monthly figures show that GDP rose 0.7% in January, and according to provisional estimates for February, the carryover of growth for the first quarter is expected to be more than 5% on a year-over-year basis. After declining 5.4% in 2020, the Canadian economy could

return to pre-pandemic levels by the fall. The passage of a stimulus package and a new infrastructure plan in the United States will have positive repercussions on the Canadian economy. However, a high degree of uncertainty still exists, and growth continues to depend on how the pandemic unfolds and how successfully vaccines are rolled out over the coming months.

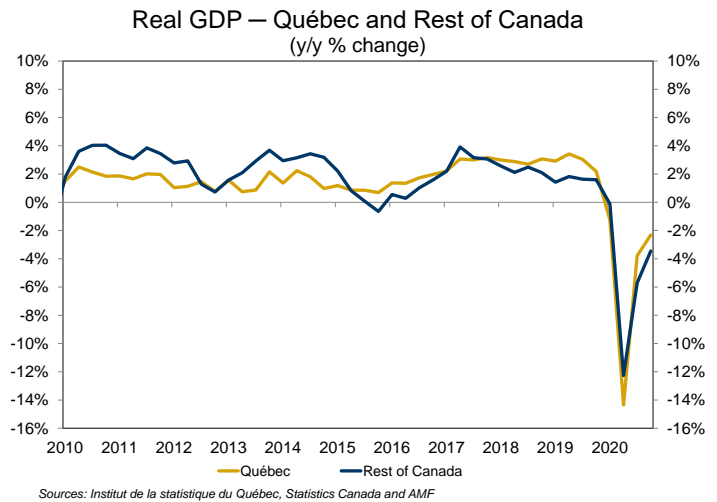
Despite the Canadian economy's encouraging performance, the Bank of Canada plans to hold interest rates at their current level until economic slack is absorbed and inflation achieves its target for a sustained period, which is projected to happen in 2023. The Bank will continue its quantitative easing program until the recovery is well underway.

Although inflation remains subdued for the time being, developments over the next few months will need to be monitored. Inflation will likely rise in April and May and could exceed 3% owing to the decline in oil prices during the same period last year, but this increase should be temporary. However, apart from these brief blips, the emerging inflationary pressures resulting from a faster-than-expected reabsorption of economic slack could force the Bank of Canada to raise rates earlier than expected.

QUÉBEC

The performance of Québec's economy was similar to that of the Canadian economy in 2020, and the last quarter of the year ended with annualized GDP up 6.3%.

The restrictions and lockdown measures that have been in effect in the province since October have had a much more limited impact on economic growth than those imposed in the spring of 2020.



Nonetheless, some sectors continue to be hard-hit by the pandemic. Household spending fell in the fourth quarter, dragged down by the decline in services consumption.

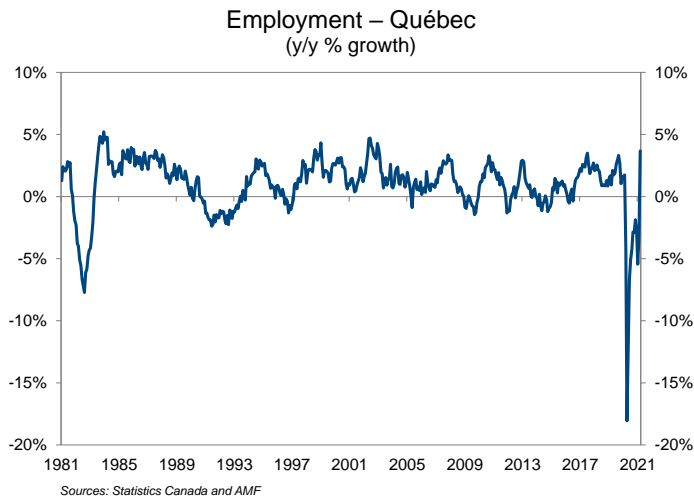
Business investment and foreign trade continue to be affected by uncertainty and the unfolding health situation. Private sector investment is still far below pre-pandemic levels.

Residential construction was up significantly at year-end. Construction starts reached their highest level in more than 30 years, and recent figures reveal that the upward trend has continued into early 2021.

In February, home sales rose more than 30% compared with the same period one year earlier. New listings are not sufficient to meet demand, and prices are climbing at a record pace. (The last section of the Review presents a detailed analysis of the Québec real estate market.)

The labour market has seesawed in recent months with changes in the health situation and lockdown measures. The province has seen three monthly declines in employment in the past six months.

The labour market situation is very uneven across the various sectors of the economy. The services industry accounts for more than 80% of the jobs losses, with huge losses in the entertainment, restaurant, accommodation and retail sectors.



However, with the gains in March, Québec’s labour market recouped more than 85% of the jobs lost as a

result of the pandemic. The unemployment rate stands at 6.4%, the lowest of all the Canadian provinces.

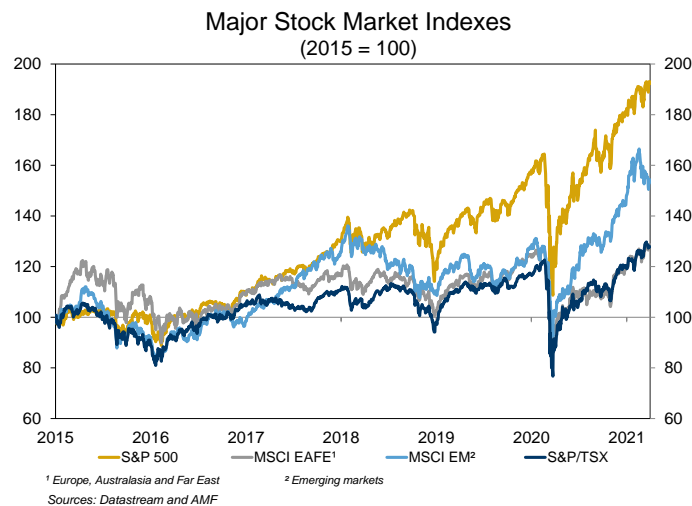
Like everywhere else, how the economy fares in the coming months will depend on how the pandemic unfolds, how large the third wave is and how fast vaccines are rolled out. The recent measures announced by the government should have a limited impact on the economy, given their specificity and one-time nature.

The recovery is expected to pick up speed over the summer, with economic growth potentially reaching 6% in 2021, the highest level in the past 20 years. If that happens, Québec’s economy could return to pre-pandemic levels more quickly than expected.

FINANCIAL MARKETS

STOCK MARKETS

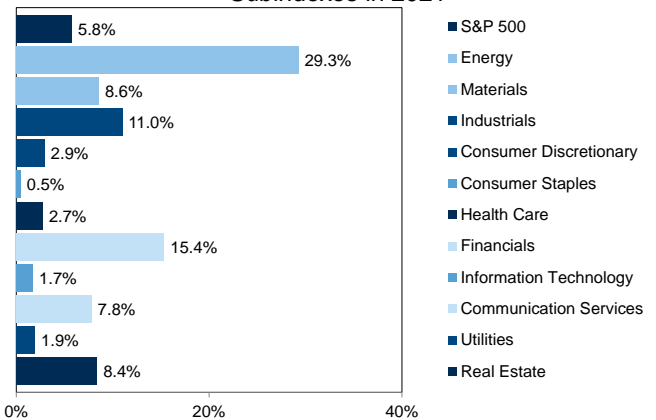
The major stock market indices have posted significant gains since the start of the year, continuing the rebound initiated about one year ago. Although many challenges remain, the overall economic situation continues to improve owing to government and central bank support measures, while the vaccine rollout augurs a gradual return to normality.



The stock markets and global economy will continue to benefit from unprecedented levels of support from central banks and governments in the coming quarters. Despite the improving economic situation, the major central banks are staying the course with their very loose monetary policies, and fiscal policies remain strongly expansionary.

Moreover, seemingly reassured by the success of some of the vaccine rollouts underway, particularly in the United States, where a substantial portion of the population has received a first dose, investors appear to be paying little heed to the concerns raised by the recent surge in cases.

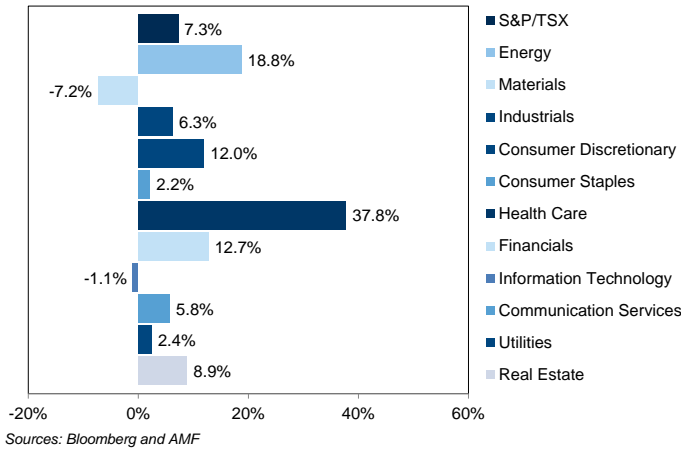
Performance of the Main S&P 500 Subindexes in 2021



Cyclical industries, which are better positioned to take advantage of the economic recovery and the easing of public health measures, have fared better than growth industries since the start of the year. In particular, Energy and Financials have benefited from rising oil prices and the steepening of the bond yield curve. However, rising bond yields have penalized the growth sectors, especially tech stocks with very high valuations.

As a result of this rotation into more cyclical sectors, the S&P/TSX has outperformed the S&P 500 so far this year. S&P/TSX Financials, which accounts for the lion's share of the index with about 31% of capitalization, posted a very respectable 13% return, while Energy, which represents about 12% of capitalization, posted 19% growth, driven by rising oil prices.

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



TSX-listed Québec companies have performed particularly well. The Morningstar National Bank Québec Index posted higher returns than the S&P/TSX as a whole since the start of the year. Like the rest of the TSX, Québec companies in Financials performed strongly, as did those in Health Care and Industrials, which were initially hit hard by the pandemic.

Other phenomena observed during the first quarter include a surge in stock market speculation linked to investors active on social media that sent the share prices of certain companies soaring even though there were no substantial changes to their profitability profile. Regulators are monitoring these speculative movements closely to make sure investors are protected and markets continue to operate efficiently. The quarter also saw the meteoric rise of Bitcoin's share price, which briefly topped US\$60,000 and whose market capitalization is now above US\$1 trillion.

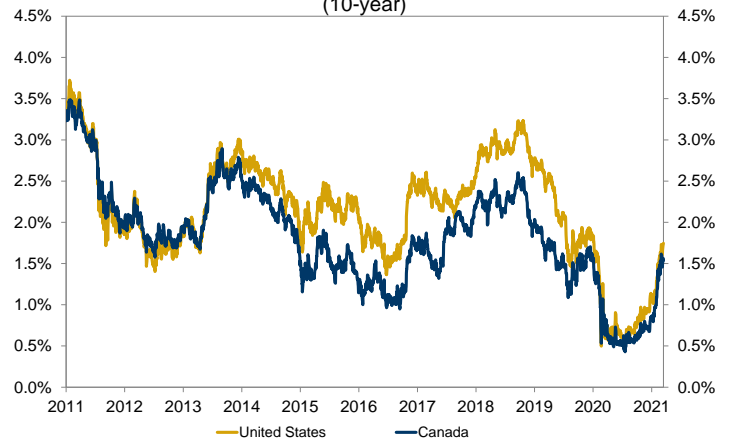
Finally, despite the relative improvement in the economic outlook and the hopes that are resting on the vaccine rollout, the evolving pandemic will continue to have a decisive impact on the stock markets in the coming quarters and to be a potential source of greater volatility.

BOND MARKETS

On the bond markets, long-term yields have been trending upward since the start of year, reflecting improved economic conditions and a rise in inflationary pressures. Short-term yields, which are largely

influenced by central bank policy rates, hardly budged, steepening yield curves considerably.

Yield on Government Securities (10-year)



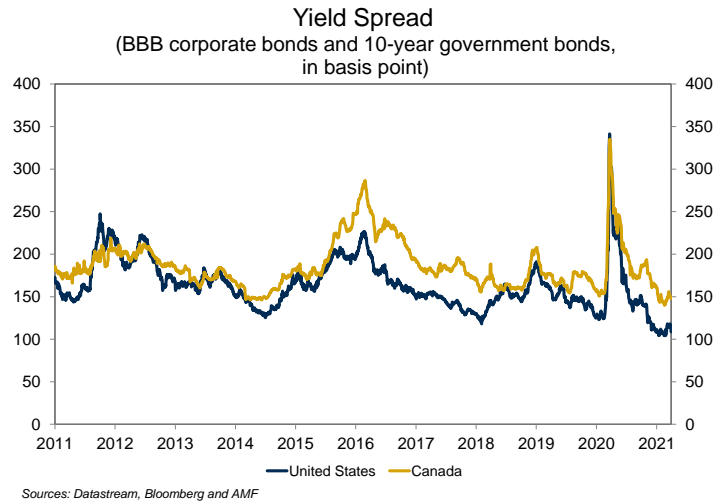
In the United States, 10-year government bond yields were up 83 basis points from the start of the year, ending the quarter at 1.7%, similar to levels seen just before the beginning of the pandemic. The normalization of U.S. bond yields reflects expectations of a robust economic recovery, bolstered by a rapid vaccine rollout and continued highly expansionary monetary and fiscal policies.

Despite the accelerating recovery, the U.S. Federal Reserve continues to signal that it will hold its rates essentially at zero until 2023. At the same time, the Biden administration has gotten a major stimulus package passed and is working on an even more generous infrastructure plan.

The convergence of these factors is fuelling fears of overheating and the emergence of inflationary pressures. Based on inflation expectations implicit in real return bond yields, investors expect inflation to run at 2.4% over 10 years in the United States, a level that is still subdued but also the highest rate since 2013.



expects to reduce the size of its asset purchases over the coming quarters.



In Canada, 10-year government bond yields were also up from the start of the year, ending the quarter at 1.6%, an increase of almost 90 basis points. The Canadian economy is well-positioned to benefit from the U.S. recovery and higher raw material prices. Although the vaccine rollout is progressing more slowly here than south of the border, Canada is also benefiting from high levels of fiscal and monetary support.

Finally, corporate bond spreads are still very narrow. They reflect strong investor demand for corporate bonds in a context where government bond yields are still relatively low—typically well below expected inflation rates. With the economic recovery underway, concerns about the quality of corporate bonds have waned, especially compared with the initial months of the pandemic.

In particular, the Bank of Canada is indicating that it will hold its target rate at the effective lower bound until economic slack is reabsorbed around 2023, although it

Market Performance

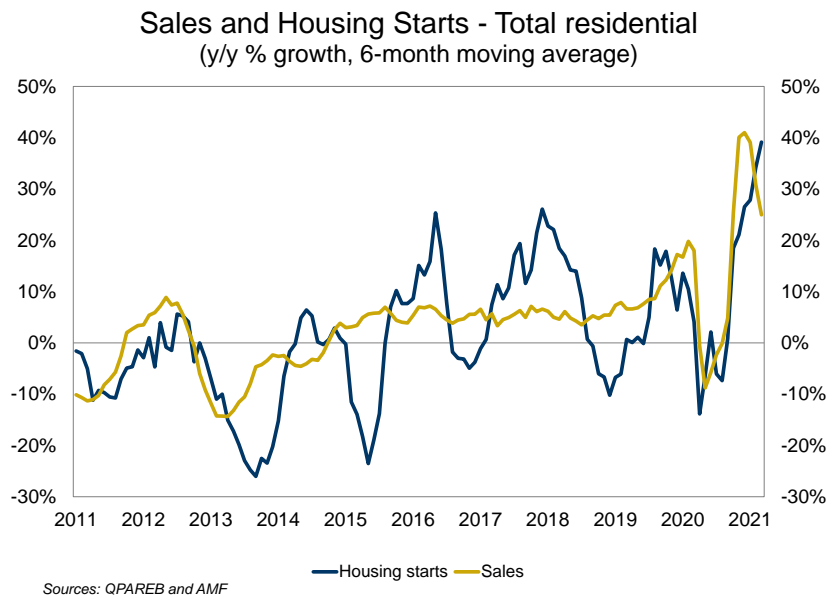
Stock Markets											
	Level	% change								Last 12 months	
		2021-03-31	1 month	3 months	6 months	9 months	1 year	3 years ²	5 years ²	Min.	Max.
MSCI All Country World Index		780	3.3	5.5	18.6	26.3	48.7	10.7	11.2	505	785
MSCI EAFE ¹		1,255	4.8	6.9	18.8	19.5	33.7	4.3	5.9	905	1,262
MSCI Emerging Markets		74,289	-1.1	3.6	19.9	29.2	49.8	6.7	10.3	48,520	80,514
S&P 500		3,973	4.2	5.8	18.1	28.1	53.7	14.6	14.0	2,471	3,975
S&P/TSX		18,701	3.5	7.3	16.0	20.5	39.8	6.8	6.7	12,876	18,983
Morningstar National Bank Québec Index		361	4.9	9.5	26.5	36.0	51.9	9.5	9.4	228	364
Bond Markets											
	Level	% change								Last 12 months	
		2021-03-31	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.2	1.9	1.3	1.3	1.3	1.9	2.7	2.2	1.2	2.2
	Ontario	2.2	1.9	1.3	1.3	1.3	1.9	2.7	2.2	1.2	2.2
	Canada	1.6	1.4	0.7	0.6	0.5	0.7	2.1	1.2	0.4	1.6
United States	10-year	1.7	1.4	0.9	0.7	0.7	0.7	2.7	1.8	0.5	1.7
United Kingdom	10-year	0.8	0.8	0.2	0.2	0.2	0.4	1.3	1.4	0.1	0.9
Germany	10-year	-0.3	-0.3	-0.6	-0.5	-0.5	-0.5	0.5	0.2	-0.6	-0.2
Canada	AA Corp. (10-year)	2.5	2.2	1.5	1.7	1.7	2.4	3.0	2.7	1.4	2.5
	BBB Corp. (10-year)	3.0	2.8	2.3	2.4	2.6	3.8	3.8	3.7	2.3	3.8
	BBB - 10-year Gov. spread	1.5	1.4	1.6	1.9	2.1	3.1	1.8	2.5	1.4	3.1
United States	AA Corp. (10-year)	2.3	2.0	1.4	1.5	1.6	2.2	3.6	2.7	1.2	2.3
	BBB Corp. (10-year)	2.8	2.5	2.0	2.2	2.4	3.5	4.2	3.8	1.9	3.6
	BBB - 10-year Gov. spread	1.1	1.1	1.1	1.5	1.7	2.8	1.5	2.0	1.0	3.0

¹Europe, Australasia and Far East ²Annualized returns
Sources: Datastream, Bloomberg and AMF

SPECIAL FEATURE

QUÉBEC'S BOOMING REAL ESTATE MARKET

Although the pandemic and related lockdown measures delivered an unprecedented economic shock in Québec, 2020 was a record year for real estate market activity. After an initial rebound spurred by the pickup in residential construction following a nearly four-week shutdown in April 2020, activity has remained brisk and the early months of 2021 point to a continued upward trend.



The year ended with sales at an all-time high, with close to 112,000 transactions closed in 2020, up more than 15% from 2019. With housing supply subdued, prices are also rising at a sustained pace. The year-over-year change in the average price at the end of 2020 was 20%, the largest increase on record. National figures show that Montréal saw the highest price increases of any of Canada's major cities.

The current real estate market boom can be explained by several factors. Although the pandemic has caused record job losses and pushed unemployment to unprecedented levels, the government's financial support programs significantly increased household disposable income and the household savings rate. Furthermore, the Bank of Canada cut its policy rate to the effective lower bound last March and bond yields dropped, bringing down mortgage financing rates. Finally, the switch to teleworking appears to have caused a shift in the preferences of many households and encouraged the search for larger, more spacious homes outside the major centres.

We believe that some of the factors driving activity in 2020 were temporary. The wrapping up of government financial support programs will limit the growth in disposable income, and a reopening economy could see household spending redirected to activities that were restricted until now (restaurants, travel, etc.), reducing the share of income allocated to real estate. The recent rebound in bond yields will continue to put upward pressure on fixed mortgage rates and, combined with higher home prices, will help curb the demand for housing.

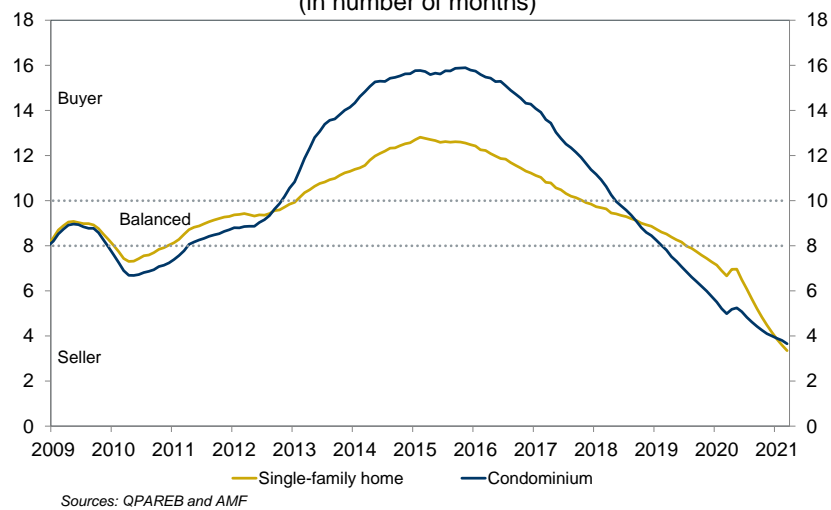
The following table presents our assessment of the Québec real estate market's vulnerabilities in 2020, based on four risk factors: overheating, price acceleration, overvaluation and overbuilding. For each of these risk factors, we propose indicators for which we analyze the magnitude and persistence of historical variations. The overall risk level for 2020 is deemed medium to high.

Quebec's Housing Market Vulnerability Analysis – Summary		
	Level of risk	
	2019	2020
Overall Assessment	Low	High
Overheating		
Ratio of inventory of unsold properties to sales level	Low	High
Vacancy rate	Low	Moderate
Price Acceleration		
Average house price (y/y % growth)	Moderate	High
Overvaluation		
House price to income ratio	Low	High
Affordability Index	Low	Low
Overbuilding		
Housing starts (6-month moving average)	Moderate	Low
Ratio of completed and unsold units per 1,000 population	Low	Moderate

Legend: Low Moderate High

Signs of overheating intensified in late 2020. The inventory of unsold properties compared to sales is at an all-time low, with sales growth outpacing new listings throughout the year. The vacancy rate rose, however, due to lower immigration and the suspension of in-person university courses, alleviating pressure on the market.

Ratio of Inventory of Unsold Properties to Sales Level – Québec (in number of months)



The growth in prices also accelerated due to the subdued housing supply and strong demand. As regards the overvaluation indicators, the home price to income ratio increased. Price acceleration could become a concern if prices were to significantly outpace the rise in household disposable income. CMHC and Bank of Canada analyses indicate that signs of speculation and overvaluation are limited for the time being. Although housing starts are very high, demand is such that the risks of overbuilding are low for now.

While recent figures indicate that the housing market is continuing its upward trajectory in 2021, the temporary factors that have been driving real estate are expected to wane in the coming months. The sustained growth in prices will also have an impact on affordability, which should help lower demand. Nevertheless, the signs of overvaluation and overheating will need to be monitored closely.

Given that the level of household debt was high before the crisis, a continuing increase in mortgage credit will render households more vulnerable to a shock or a faster-than-expected rise in interest rates. The pandemic initially resulted in a decrease in household debt, but Canadian figures reveal that debt began to climb again in the second half of 2020. In addition, mortgage credit in Canada grew at its fastest rate in 10 years.

The macroprudential measures implemented in 2018 through Guideline B-20 and applied in a similar manner by the AMF have resulted, however, in borrowers being required to qualify at the contractual rate plus 2%, or at the benchmark rate published by the Bank of Canada. The benchmark rate was lowered twice in the past year and is now 4.79%. In principle, borrowers would therefore be able to deal with an eventual rise in interest rates. The Office of the Superintendent of Financial Institutions has proposed that the minimum qualification rate for uninsured mortgages be set at 5.25%, reevaluated annually, instead of 4.79%. A decision in this regard is expected to be rendered in May 2021, in which case it will be effective June 1, 2021.

Additional macroprudential measures may be necessary if signs of speculation become evident.

NOTE

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