AUTORITÉ DES MARCHÉS FINANCIERS

Economic and Financial Review

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Office of the Chief Economist

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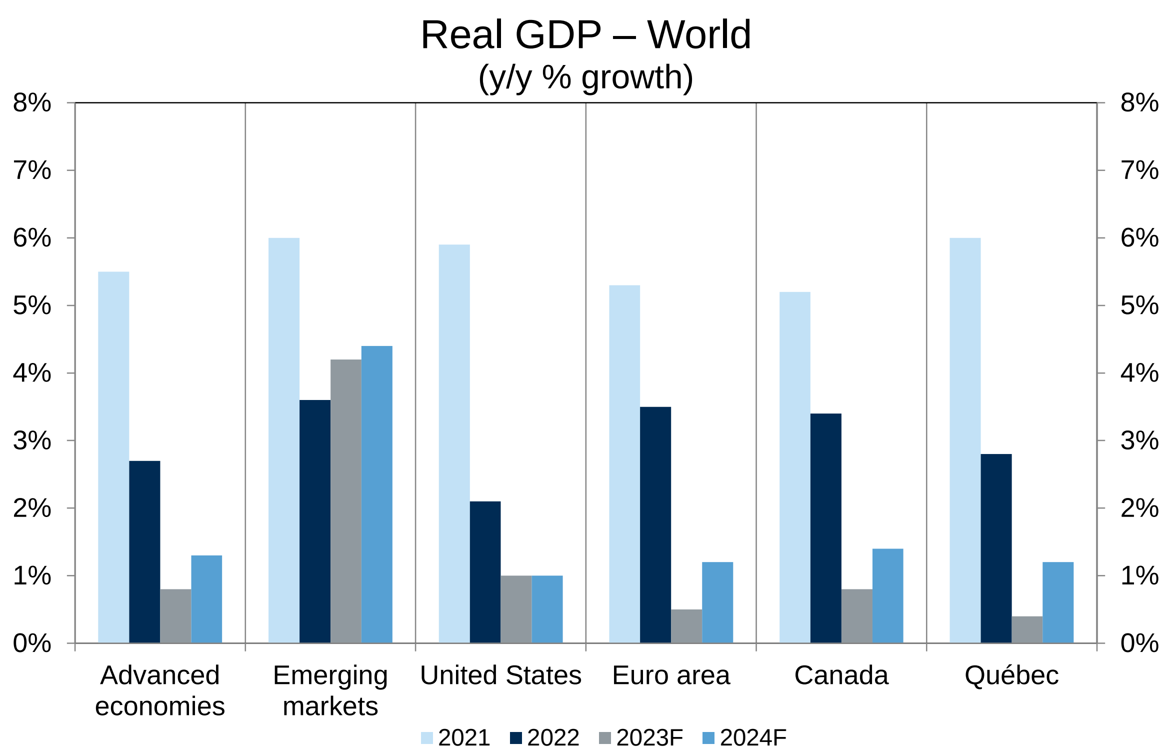
Highlights

- Although the rapid hikes in key policy rates by central banks are starting to have an impact on growth and inflation, they are also exposing certain vulnerabilities in the financial system, particularly in the banking sector.
- In March, U.S. and European authorities had to come to the rescue of distressed banks and take actions to prevent contagion in the banking system.
- The Canadian economy presents a mixed picture, exhibiting both signs of weakness and a still-robust labour market.
- After negative growth in the third quarter, the Québec economy rebounded in Q4, with growth reaching 2.8% for all of 2022. However, it, too, is showing increasing signs of weakness.
- The impact of banking sector turbulence on the stock markets has been limited, and the major stock market indices around the world ended the first quarter of 2023 in positive territory.
- Bond yields declined slightly during the period, with investors adjusting their monetary tightening expectations downward.



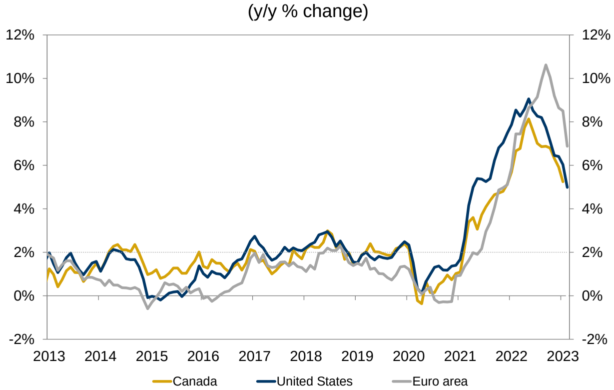
Sources : Consensus forecasts, Bloomberg and AMF

Economy

World

Although the rapid hikes in key policy rates by central banks are starting to have an impact on growth and inflation, they are also exposing vulnerabilities in the financial system. Most advanced countries have seen inflation starting to come down from the peaks reached in 2022. Their economies have also started to slow, although they are proving more resilient than expected.

Consumer Price Index – World
(y/y % change)



Sources: OECD, Eurostat and AMF

In March, however, the disruptions in the banking sector in the United States and Europe created uncertainty in the financial markets and clouded the economic outlook. Although the central banks had already begun to reduce the magnitude of monetary tightening, further increases now appear more uncertain. A balance will have to be struck between fighting inflation and maintaining financial stability, especially in the banking sector. Nevertheless, interest rates are expected to remain high over the medium term, until inflation is brought back down to the 2% target.

In the United States, the economy is showing some signs of weakness, but remains resilient largely owing to household spending. The labour market remains strong, with robust job creation and an unemployment rate below 4%.

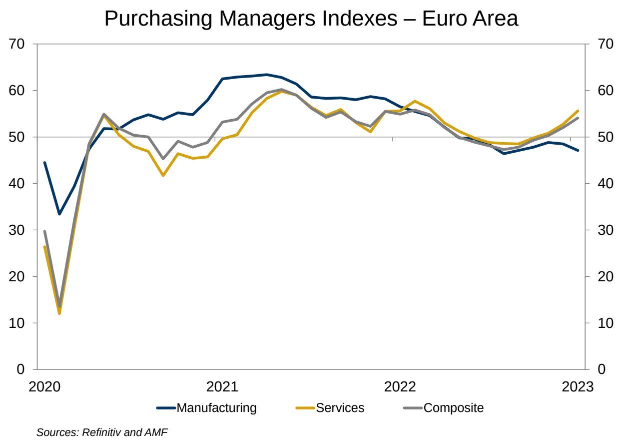
At 5% in March, inflation remains high but continues to abate. More worrisome is that core inflation, which excludes the more volatile items of food and energy, is resisting and is still above 5%.

In March, certain U.S. regional banks found themselves in a precarious financial position as a result of rapidly rising interest rates. First, Silicon Valley Bank (SVB) declared bankruptcy, as it was unable to cover massive withdrawals by customers. Then, the U.S. regulatory authorities took control of Signature Bank, which specialized in the cryptoasset sector, in order to prevent contagion in the U.S. banking system. The U.S. authorities also announced that they would guarantee all deposits at both regional banks, including deposits above the deposit insurance limit of US$250,000. Other vulnerable regional banks remain under close watch.

The U.S. Federal Reserve hiked its key policy rate by 25 basis points at the end of the quarter, taking it to a range of 4.75% to 5.00%, but was unclear about what it would do next.

In Europe, the economy also continues to be more resilient than one might expect given the war in Ukraine. Mild winter temperatures, lower energy prices and government subsidies have so far helped to avoid a recession. In fact, GDP rose 3.5% in the euro area in 2022, more than in the United States and China.

In early 2023, the composite purchasing managers' indexes are pointing toward expansion, particularly in the services sector, while manufacturing remains in contraction territory. The labour market remains tight, with an unemployment rate close to its historic low.



In March, following the collapse of certain U.S. regional banks, the Swiss government orchestrated the takeover of distressed Credit Suisse by its rival, UBS. In order to reduce the risk of contagion to other European banks, the European Central Bank (ECB) said it was ready to inject liquidity to ensure financial stability.

The disruptions in the banking sector, however, did not stop its drive to bring inflation back down to the 2% target. The ECB hiked its key policy rate twice by 50 basis points during the first quarter. After peaking in October, inflation declined to 6.9% in March. However, as in the United States, core inflation is not letting up.

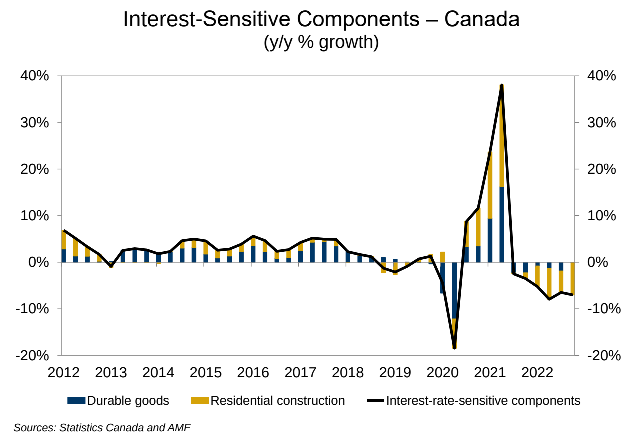
In the United Kingdom, inflation has been especially persistent and has remained above 10% for the past six months, unlike in other advanced economies, where it has declined. In response, the Bank of England announced an eleventh consecutive hike in February, increasing its key policy rate to 4.25%.

Following the lifting of its zero-COVID policy at the end of 2022, China is experiencing a slow economic recovery as disruptions related to strict public health measures recede. Industrial output and retail sales have risen moderately since the start of the year, and the central bank is maintaining an accommodative monetary policy.

The Chinese government has set an economic growth target for 2023 of 5%. This target is its most conservative in decades and highlights the challenges still facing China, including low domestic demand, a cooling real estate sector and trade tensions with the United States.

Canada

The Canadian economy presents a mixed picture, exhibiting both signs of weakness and a still-robust labour market.



Domestic demand has been weakening for several quarters, with interest-sensitive spending, such as residential investment and purchases of durable goods, declining significantly.

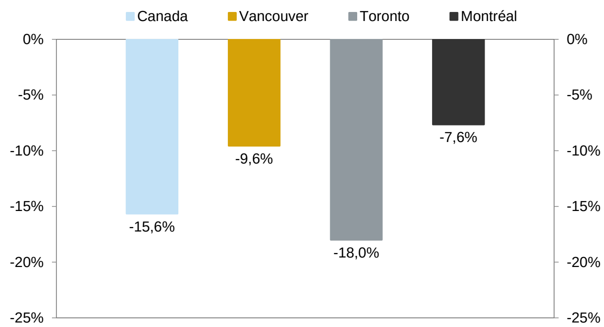
In this environment, gross domestic product stalled, thereby ending 2022 on a fairly lacklustre note. These mounting signs of weakness show that the Canadian economy is reacting to monetary tightening.

Despite these headwinds, the labour market has remained resilient so far. Over the past few months, the pace of job creation has continued to increase. With the unemployment rate currently at 5%, the Canadian economy has reached and is maintaining full employment.

However, job creation can be expected to eventually slow, as business leaders will shortly have to contend with shrinking profit margins and a potential earnings squeeze, which, among other things, will force them to put limits on hiring.

Rising mortgage rates had a major, and almost immediate, impact on the residential real estate market.

House Price Index – Canada
(correction from the peak)



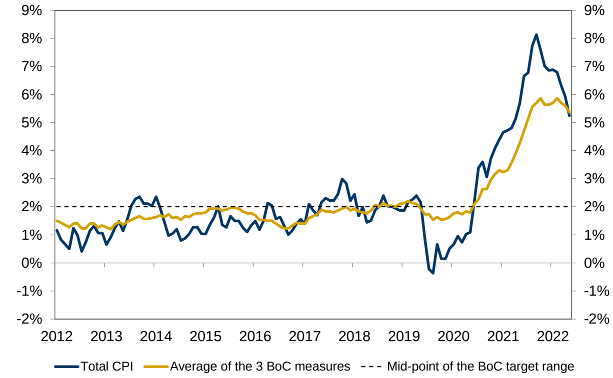
Sources : CREA and AMF

Home sales dropped 40% year over year, and prices fell 15.8% from the previous peak in February 2022. The sharp decline in home prices has especially affected the Greater Toronto and Vancouver Areas.

Moreover, the interest rate hikes of the past twelve months are still rippling through the economy. It will be a while for the full effects of the hikes to be felt and households are forced to adjust their budgets and reduce their spending. The most heavily indebted households will, of course, be the most hard-hit by the rise in monthly mortgage payments.

Inflation has been on a downward trend for the past few months. This decline, however, is largely the consequence of falling energy prices and has little to do with cyclical factors. The measures of core inflation are averaging 5.4% and are barely moving.

Inflation – Canada



Sources : Datastream and AMF

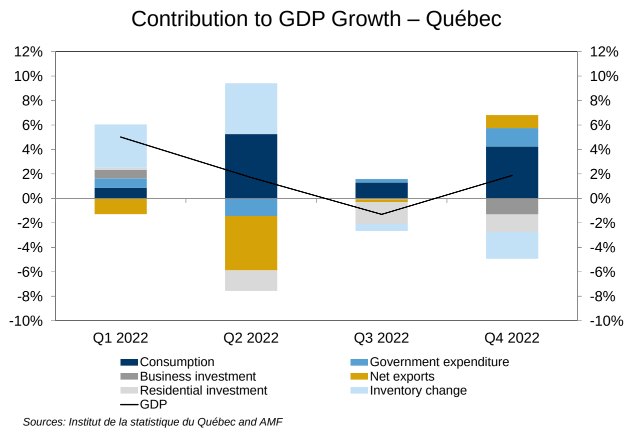
The Bank of Canada has hiked its key policy rate 425 basis points since March 2022. However, it kept the rate unchanged at its meeting in April 2023, in keeping with the pause it had announced at the start of 2023. More remains to be done to bring inflation back to the Bank's target range of 1% to 3%. It is worth remembering that it can take as long as 18 or even 24 months for the full effect of monetary tightening to be felt.

The next monetary policy decisions will have to factor in the impact of the U.S. regional bank crisis, the repercussions of the crisis on global financial conditions and the increasing likelihood of a U.S. recession.

The Canadian economy remains in a situation of excess demand despite the slowdown of the past few quarters. In other words, the economy will have to slow further to help ease upward pressures on prices and wages. Although a recession remains probable, it will likely be mild and short-lived.

Québec

In Québec, 2022 ended on a positive note. After posting negative GDP growth in the third quarter, the economy rebounded in Q4, with annualized GDP growth of 1.9%, bringing growth for all of the year to 2.8%.



Household spending remained firm, bolstered by a robust labour market, wage growth and government assistance provided to address the rising cost of living.

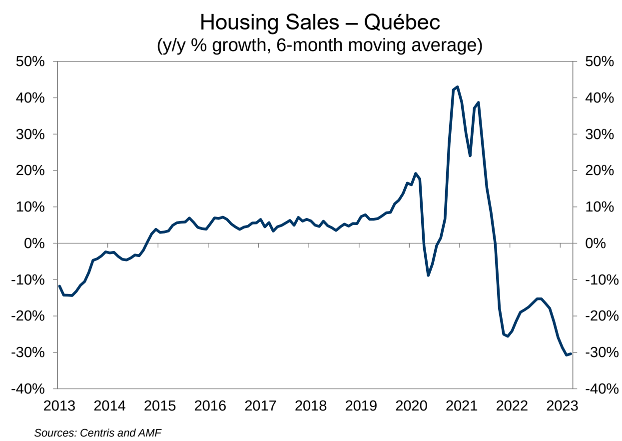
The Québec economy, however, is showing some signs of weakness. Both low business investment and the pullback in residential construction have weighed on economic growth, shaving a few percentage points off the GDP rate along the way. The rapid rise in borrowing costs and the more somber economic outlook have dampened the enthusiasm of business leaders and builders in the housing sector.

The labour market remains tight despite the recent slight slowdown in job creation. Between January and March, 30,300 jobs were created, compared to 40,000 for the same period in 2022. At 4.2%, the unemployment rate is still exceptionally low, but it is slightly above its record of 3.9%.

The job vacancy rate declined from 6% to 5.1% year over year, and annual wage growth continues to be stronger in Québec, at 6%, than in Canada as a whole. Although the number of job vacancies has decreased, it is still very high, a sign that the labour shortage remains a major issue.

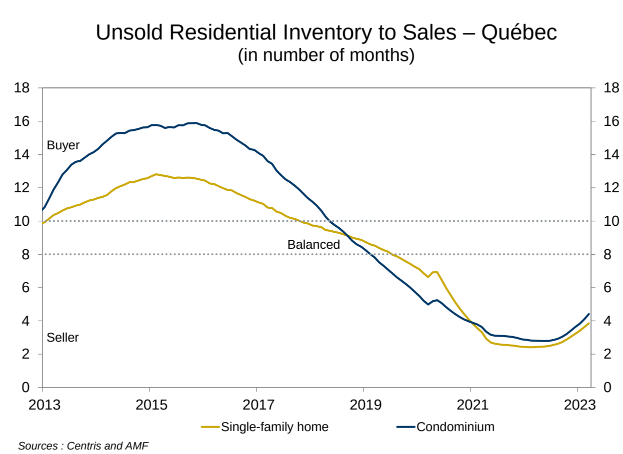
The residential real estate sector underwent a correction in the past twelve months. The composite benchmark price for properties in Québec was $452,000 in February, 7.5% below its spring 2022 peak.

Existing home sales and average price, however, recovered slightly at the start of the year. Nevertheless, they remain considerably below their levels from one year ago, notably with housing sales six-month moving average down 30%.



Housing starts are also down sharply. On average, there were 47,500 housing starts over the past six months, down 27% from the same period last year.

Market conditions continue to improve for buyers. The ratio of unsold residential inventory to sales increased for a fourth consecutive quarter. However, these conditions are still far from those of a balanced market.

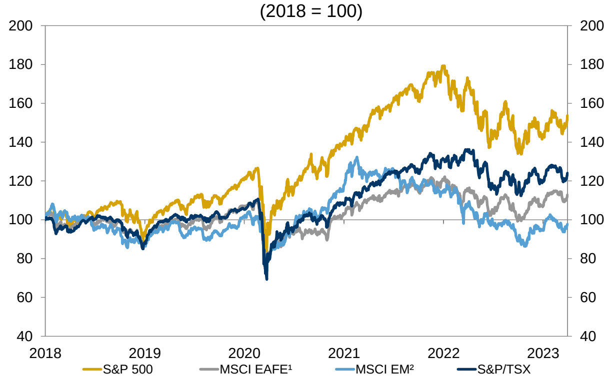


Québec has a small, open economy and will therefore be affected by the vagaries of economic conditions in Canada and the United States. Moreover, the delayed effect on the economy of a year's worth of interest rate hikes will continue to dampen residential construction and consumer spending. In this environment, Québec is expected to experience a significant economic slowdown in 2023.

Financial markets

Financial market volatility resurfaced in the first quarter of 2023 as a result of the turbulence in the banking sector and uncertainty about the direction of monetary policy. Despite the relatively uncertain climate, stock markets ended the quarter in positive territory, while bond yields declined slightly.

Major Stock Market Indices
(2018 = 100)



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

The stock markets started the year on a solid footing, bolstered by an easing of inflationary pressures that enabled investors to see the end of monetary tightening.

However, the major stock market indices then lost some of their lustre, with investors having to reassess the trajectory of interest rates and, more recently, contend with disruptions in the banking sector.

The turbulence resulting from the financial difficulties of SVB and Signature Bank in the United States and Credit Suisse in Europe sent tremors through the stock markets, albeit only temporarily. To date, the most significant disruptions have been confined to just a few banks, and the repercussions on financials as a whole and the major stock market indices have been relatively limited.

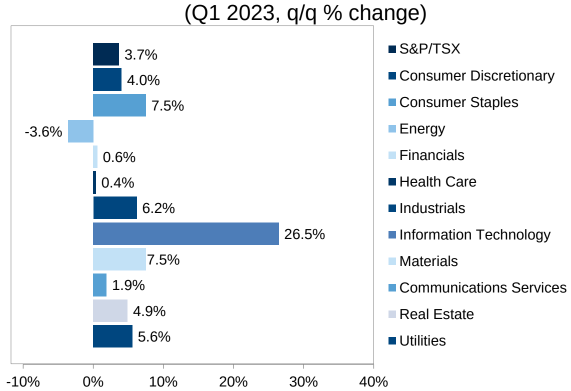
Despite this turbulence, the S&P 500 has risen 7.0% since the beginning of the year. Technology stocks have performed very well, owing, in particular, to a slight decline in bond yields, which helped push up risky-asset valuations.

Accordingly, the NASDAQ rose close to 17% from the beginning of the year. During that period, S&P 500 Financials declined about 6%, weighed down by the disruptions in the banking sector.

For the time being, corporate earnings are proving to be relatively resilient, reflecting a global economy that is also showing resilience. Earnings are down only slightly, in contrast to the decreases typically observed during a bear market. If the economy deteriorates or there is a recession, the downturn in corporate earnings could be more significant.

In Canada, the S&P/TSX posted slightly more moderate growth (3.7%) from the beginning of the year.

Performance of the Main S&P/TSX Subindexes
(Q1 2023, q/q % change)



Sources : Bloomberg and AMF

The two most heavily weighted sectors of the Toronto index, Financials and Energy, returned 0.6% and -3.6%, respectively. By contrast, Information Technology, which accounts for approximately 7% of the index's capitalization, returned an impressive 26.5%.

TSX-listed Québec companies fared well. The Morningstar National Bank Québec Index rose 10.4% owing, in part, to the solid performance of Industrials.

On the bond markets, yields fluctuated sharply and ended the quarter down slightly. U.S. government 10-year yields stood at 3.5% at the end of the quarter, down approximately 40 basis points from the beginning of the year, while Canadian 10-year yields ended the quarter at 2.9%.

Although corporate yield spreads widened at the end of the quarter, they remain far from levels typically seen in times of crisis. Moreover, bond market volatility has increased considerably since the start of the monetary tightening campaigns and, more recently, the onset of turbulence in the banking sector.

Following the issues encountered by U.S. regional banks, the MOVE Index, which measures U.S. government bond market volatility, reached its highest level since the 2008 financial crisis.

Sources : Datastream and AMF

The turbulence in the banking sector has led to a downward adjustment in investors' rate hike expectations. Based on expectations factored in by the market, investors are now expecting that there will be no more than a single additional rate hike by the Fed and possible monetary policy easing in the second half of the year. Overall, however, financial conditions have tightened slightly.

Investors will nonetheless have to continue to grapple with a difficult environment for the rest of the year. Although the monetary tightening campaigns are likely coming to an end, the full effect of the rate hikes on economic and financial conditions will be felt over the next few quarters.

The disruptions in the banking sector have been contained to date, but they could contribute to tighter financial conditions and thereby act as a damper on economic growth.

Market Performance

		Level				% change				Last 12 months	
Stock Markets		2023-03-31	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index		775	2.19	6.55	14.01	7.94	-7.31	13.89	6.16	678	845
MSCI EAFE[1]		1,315	-0.07	6.68	15.65	10.69	0.99	11.90	3.50	1,135	1,334
MSCI Emerging Markets		59,416	1.86	3.37	9.66	-0.34	-9.33	6.22	-0.56	52,493	66,572
S&P 500		4,109	3.51	7.03	14.61	8.56	-9.29	16.71	9.25	3,577	4,583
S&P/TSX		20,100	-0.60	3.69	8.98	6.57	-8.18	14.53	5.52	18,206	22,086
Morningstar National Bank Québec Index		398	1.51	10.37	18.16	20.08	1.91	18.78	7.71	323	398

		Level								Last 12 months	
Bond Markets		2023-03-31	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	3.65	4.01	4.03	3.94	3.95	3.07	1.86	2.73	3.07	4.47
Ontario	10-year	3.65	4.03	4.06	3.95	3.99	3.08	1.92	2.74	3.08	4.49
Canada	10-year	2.90	3.33	3.30	3.17	3.22	2.40	0.69	2.09	2.40	3.67
United States	10-year	3.47	3.92	3.88	3.83	3.02	2.34	0.67	2.74	2.34	4.24
United Kingdom	10-year	3.49	3.82	3.66	4.08	2.23	1.61	0.35	1.35	1.55	4.50
Germany	10-year	2.29	2.65	2.57	2.11	1.33	0.55	-0.47	0.49	0.50	2.75
	AA Corp. (10-year)	4.19	4.62	4.57	4.54	4.55	3.60	2.41	3.04	3.60	5.07
Canada	BBB Corp. (10-year)	5.04	5.30	5.37	5.46	5.33	4.34	3.80	3.85	4.34	6.01
	BBB - 10-year Gov. spread	2.15	1.97	2.08	2.29	2.11	1.93	3.11	1.76	1.89	2.40
	AA Corp. (10-year)	4.27	4.77	4.72	4.93	4.07	3.17	2.17	3.58	3.17	5.33
United States	BBB Corp. (10-year)	5.29	5.70	5.73	6.04	5.14	3.90	3.51	4.19	3.90	6.47
	BBB - 10-year Gov. spread	1.82	1.77	1.85	2.21	2.12	1.56	2.84	1.45	1.53	2.28

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

Sources: Datastream, Bloomberg and AMF

NOTE