

ECONOMIC and FINANCIAL

REVIEW

Direction principale
des affaires internationales
et de la vigie stratégique

July 16, 2018



**AUTORITÉ
DES MARCHÉS
FINANCIERS**

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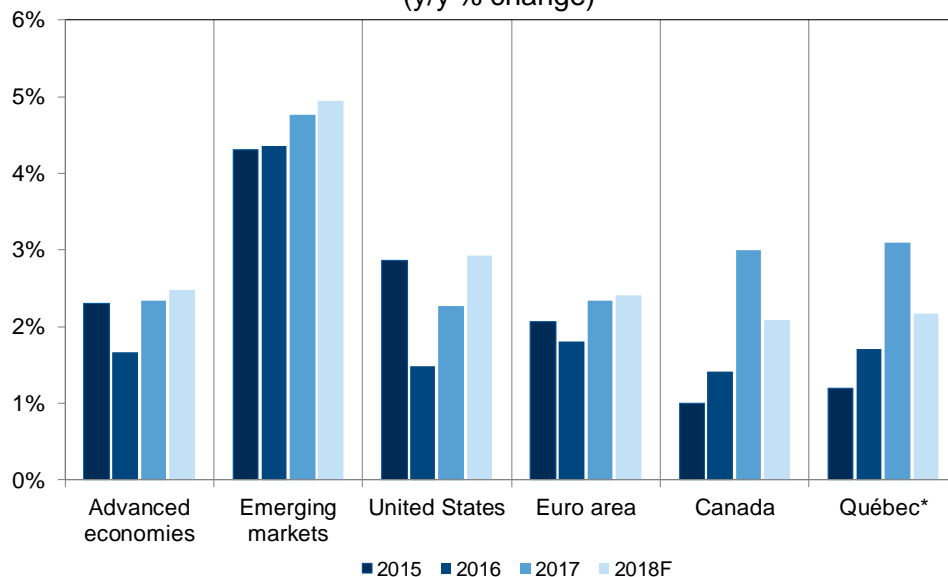
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HIGHLIGHTS

- Global economic growth slowed somewhat in the first quarter, particularly in Europe. Escalating trade tensions are causing concern and could derail the global economy.
- The U.S. economy is running at full capacity and indicators still point to acceleration in the months to come. The Federal Reserve continued to normalize its monetary policy with a 25-basis-point increase in June.
- In Canada, the economy has been losing steam since the second half of 2017, particularly due to slowing domestic demand. Ottawa responded to U.S. tariffs on steel and aluminum as NAFTA renegotiations stalled.
- After an exceptionally robust 2017, Québec's economy posted more subdued growth in the first quarter. The pace of job creation also slowed down.
- Stock markets in advanced economies were generally up in the second quarter. However, the major indexes dropped in the final weeks of June due to the growing risk of a trade war.
- In 2017, no Québec company launched an initial public offering, despite the recovery observed in Canada, the United States and Europe. In fact, the number of publicly traded Québec companies continued to fall.

Real GDP – World
(y/y % change)

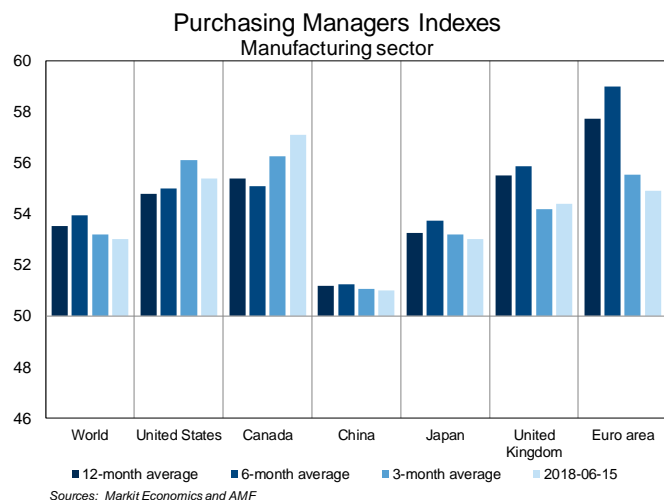


*For 2018, average of forecasts by major Canadian financial institutions
Sources: International Monetary Fund, Institut de la statistique du Québec and AMF

ECONOMIC CONTEXT

WORLD

The global economy continues to expand, although the pace of growth slowed somewhat in the first quarter, especially in Europe. Purchasing managers indexes have been falling since the beginning of the year and global trade volume is down.



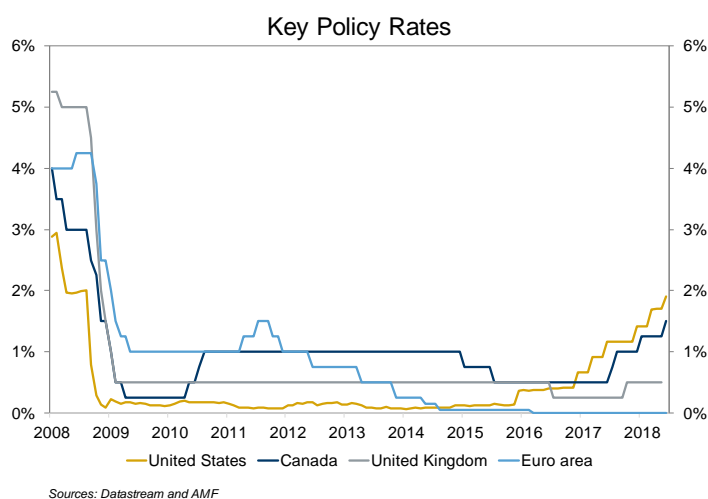
Despite recent and future key policy rate hikes this year, monetary policies remain accommodative overall and foster continued growth. The IMF and OECD are nevertheless worried about escalating trade tensions, which could derail the global economy.

The U.S. administration started to implement its protectionist trade policy, including against its allies, removing the exemption from customs tariffs of 25% on steel and 10% on aluminum enjoyed by Canada, Mexico and the European Union. Import tariffs of 25% were also announced on \$50 billion worth of Chinese goods, and others could follow. In turn, all these countries responded with equivalent tariffs on U.S. products.

NAFTA renegotiations remained bogged down, with discussions to resume this summer. The United States also suggested the possibility of imposing import tariffs on cars and car parts, which could have a potentially devastating effect on the Canadian industry.

More broadly, U.S. actions are calling into question multilateralism and the role of the WTO, in favour of power-based relationships and protectionism.

During this time, the U.S. economy continues to operate at full throttle. The unemployment rate fell to an 18-year low. The Federal Reserve continued to normalize its monetary policy with a new 25-basis-point increase in June. Two further hikes are expected by the end of the year.



In Europe, the election of a populist government in Italy is weighing on the markets, worried about the financial stability of the euro area should Rome default on its obligations to its creditors. The new government has also said it may not ratify the Comprehensive Economic and Trade Agreement between the European Union and Canada, which could call into question the entire free trade agreement.

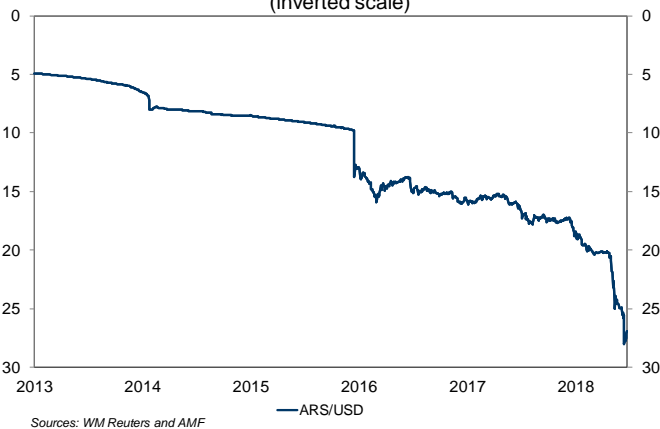
The Brexit negotiations continue to stumble along, less than a year before the withdrawal of the United Kingdom from the European Union in March 2019. London has yet to clearly communicate its expectations, and the issue of the Irish border is still not resolved.

In the euro area, economic growth downshifted slightly in the first quarter and inflation remained firmly under the 2% target. In June, the European Central Bank left its rates unchanged, but announced the end of its

quantitative easing policy. The asset purchase program will be scaled back from €30 billion to €15 billion a month in September and will wind up at the end of the year.

In emerging economies, the rise in U.S. interest rates and the strength of the greenback have begun to take a toll. In Argentina, the central bank hiked its key policy rate to 40% to prop up the falling peso and fight surging inflation. Buenos Aires also obtained emergency aid in the form of a US\$50 billion stand-by loan from the IMF to get its economy back on track. Turkey also finds itself in a difficult position due to the depreciation of its currency and rising inflation. Both countries have large current account deficits, and a substantial portion of their debt is in U.S. dollars. The situation appears more stable elsewhere, with many emerging markets having built up large currency reserves and reduced their exposure to the U.S. dollar.

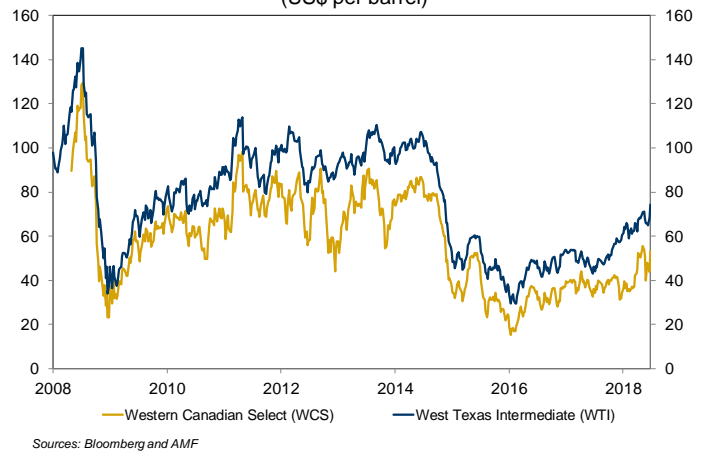
Argentine Peso Exchange Rate Against U.S. Dollar (inverted scale)



The North American stock markets ticked up during the quarter, despite the turbulence linked to rising trade tensions. Diplomatic developments, including the U.S. withdrawal from the Iran nuclear deal, the failure of the G7 meeting and the summit between Donald Trump and Kim Jong-un, have had little effect on the markets.

Global demand for oil has been increasing since the start of the year and has boosted prices. In June, OPEC member countries decided to raise production. Oil prices were trading at around US\$70 a barrel at the end of the quarter.

Oil Prices (US\$ per barrel)

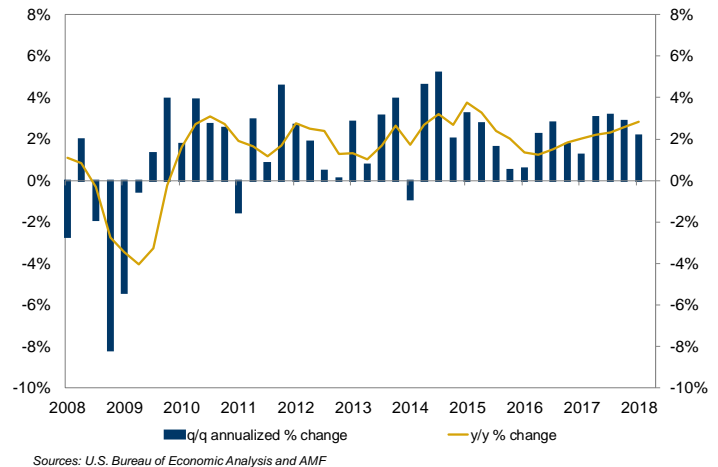


UNITED STATES

The U.S. economy is already running at full capacity, and yet a series of indicators is still pointing to acceleration in the months to come. U.S. economic growth could thus reach an over 10-year high in 2018.

In the first quarter, GDP growth was 2%, largely sustained by business investment and, to a lesser extent, consumer spending.

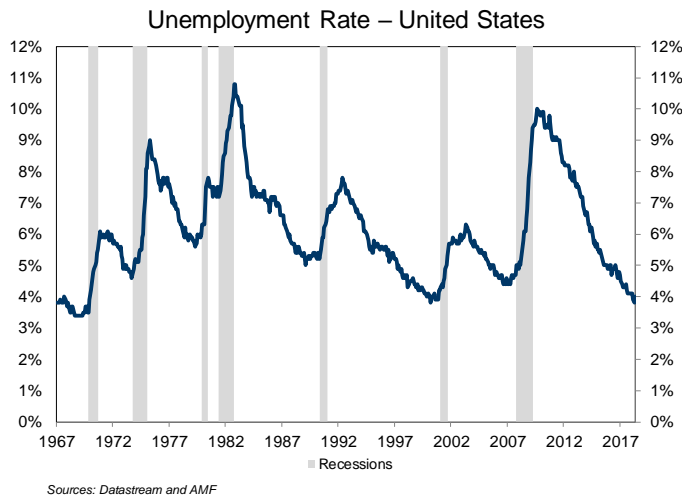
Real GDP – United States



After a more modest start to the year, consumption should regain the upper hand and once again become the main driver of growth. A pickup in retail sales has already been noted. Indeed, households are showing high confidence levels, taking advantage of a strong labour market and new tax relief measures.

Employment continues to post solid gains, with monthly increases averaging 215,000 over the past six months, and the labour market shows no signs of running out of steam.

The unemployment rate stood at 3.9% on average over the past three months. Over the past 50 years, such a level was only reached twice, i.e., in April 2000 and at the end of the 1960s, when it remained at this level for some time. In both cases, the U.S. economy was firing on all cylinders and was at the end of a cycle.



The labour shortage is becoming increasingly glaring. The number of job openings now exceeds the number of unemployed people, which is putting upward pressure on wages.

Should this situation continue, wage pressure will rise and push inflation higher. Inflation is currently up but is not a threat for now. The increase in customs tariffs and rising oil prices will also have an upward impact on consumer prices, but to a lesser extent in the short term.

It is in this context that the Federal Reserve continued to normalize its monetary policy with a 25-basis-point hike in its key policy rate in June, raising the target range to 1.75% to 2%. According to Federal Open Market Committee members, the Fed will hike its key policy rate two more times by the end of the year, and possibly three more times in 2019.

Furthermore, the strength of the economy and the stimulating effect of fiscal policy could compel the Federal Reserve to implement more hikes to contain runaway inflation.

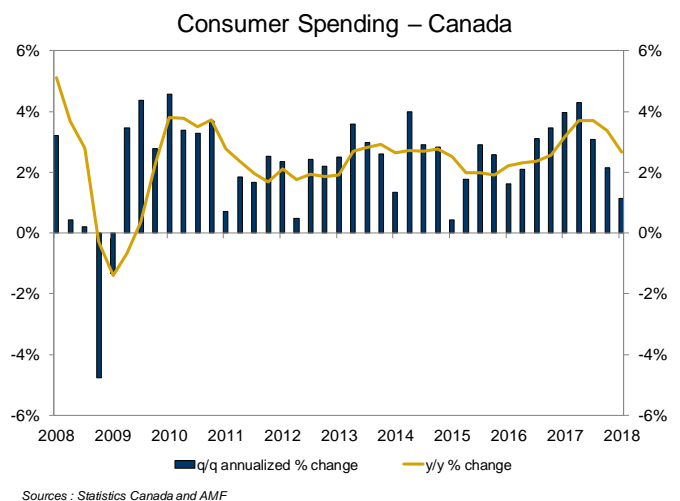
The U.S. administration continued to pursue its protectionist agenda during the second quarter, while NAFTA renegotiations made little headway. The proliferation of tariffs and threats to Canada, Mexico,

China and the European Union could negatively affect growth and inflation for these countries and the United States itself. A trade war could put the brakes on the U.S. economy and even cut short the current period of expansion.

CANADA

The pace of the Canadian economy has slowed since the second half of 2017, and the first quarter of 2018 ended with weak annualized growth of 1.3%.

This was caused by lower domestic demand due to a slowdown in household consumption and a pullback in residential construction. In fact, consumption growth fell from 4.3% to 1.1% in one year.



The Canadian economy is going through a transition period, as business investment and government expenditure are replacing consumption as the main growth drivers.

The recently begun recovery in investment continued and capital expenditures by businesses rose an annualized 10.9%.

Net exports continued to curb economic growth as shipments abroad stagnated in the last several quarters.

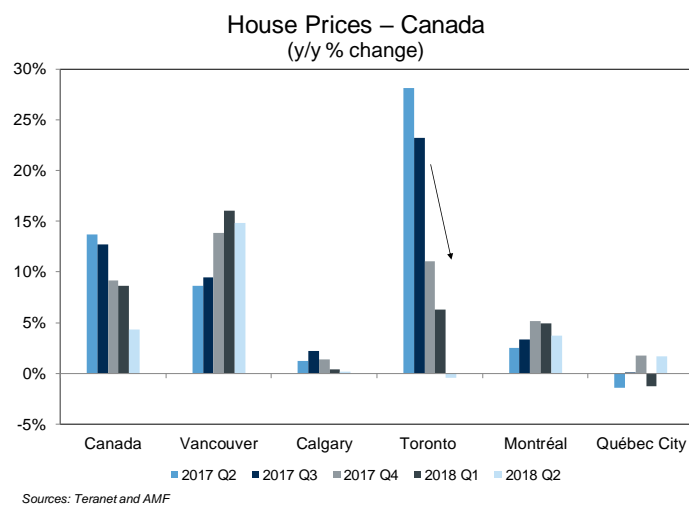
The strength of the U.S. economy should normally have a positive impact on Canadian exports, but the implementation of tariffs on Canadian steel and aluminum exported to the United States, as well as the difficulties surrounding NAFTA negotiations, could limit potential gains for Canadian exporters.

The residential real estate market is going through an adjustment period following the macroprudential measures implemented last year and interest rate hikes.

Residential investment hampered economic growth in the first quarter, decreasing by 7.2% on an annualized basis.

Moreover, residential sales have fallen steadily since the start of 2018, and home price deceleration continued for a 12th consecutive month in June.

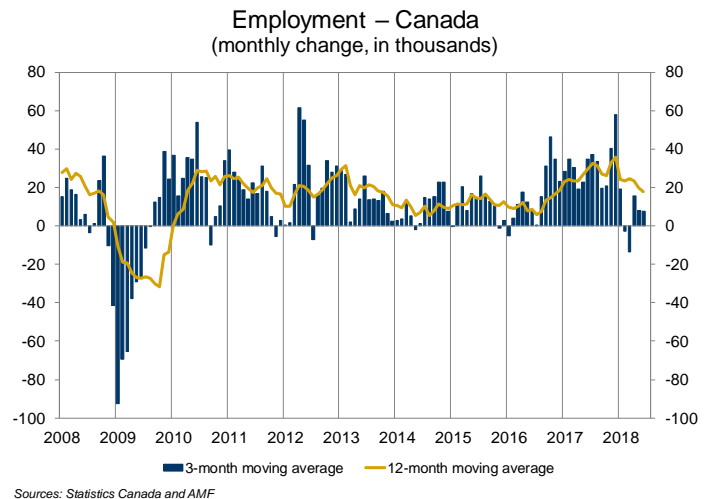
Nevertheless, significant imbalances persist in the Vancouver area as activity remains strong in the condo market.



Alongside the economy’s slowdown, the labour market has cooled since the start of the year, with a total of 17,100 jobs shed since January. This decline comes on the heels of robust job growth in 2017.

The slowdown in employment could be due in part to the labour shortages observed in certain sectors and provinces, contributing to the slower pace of job creation.

Nevertheless, even with an economy in full employment, the trend for the last three months appears relatively weak. The three-month moving average for job creation was 7,700 in June.



The Canadian economy thus lost steam at the start of the year and is now expected to post growth for the rest of 2018 that is more in line with potential output growth.

While inflation has been trending upwards so far this year, recent figures show that inflationary buildup will remain contained for the time being.

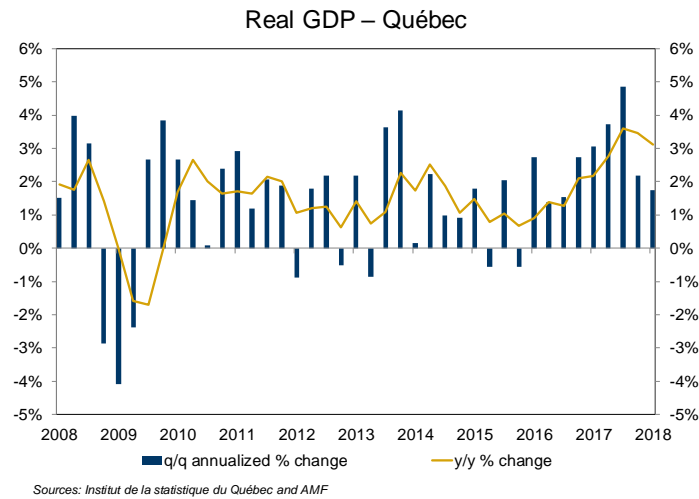
However, the Bank of Canada considered that a key policy rate hike was required to keep inflation near target, which led to it raising its rate in July.

It is expected that the slightly less favourable economic outlook in Canada than in the United States will lead to a more gradual key policy rate increase this side of the border in the coming months.

This may explain the loonie’s poor performance against the greenback. The Canadian dollar has been on a downward trend since the start of the year and even traded under US\$0.75 in June despite a major spike in oil prices.

QUÉBEC

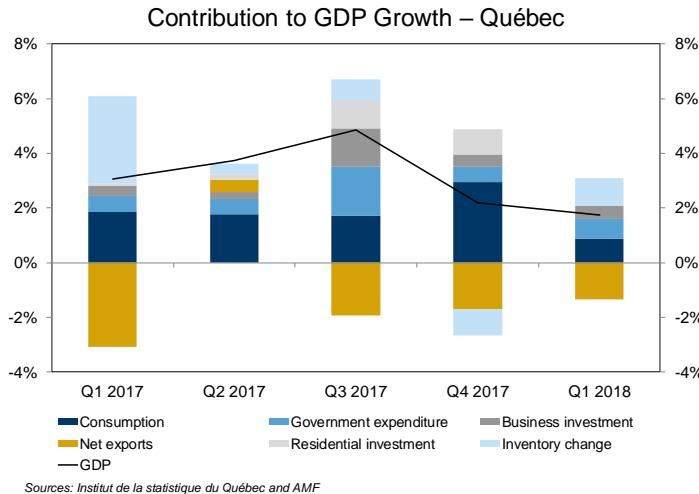
After an exceptionally robust 2017, Québec’s economy started to lose momentum. Annualized GDP growth was a more moderate 1.8% in the first quarter of 2018.



This decline was largely due to more restrained growth in domestic demand.

Consumer spending slowed considerably after a particularly robust end of year, while residential investment stagnated due to a downturn in renovation spending and exports retreated yet again.

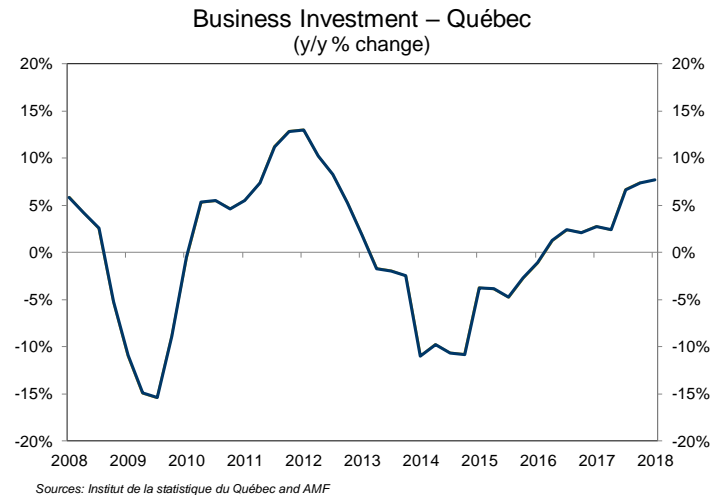
On a positive note, faster growth in business investment and government expenditure helped further strengthen domestic demand.



Business investment continued to recover in early 2018. The economy, which is now operating at full production capacity and posting a strong overall performance, is fuelling business leader confidence and spurring investment.

The labour shortage may also have encouraged businesses to modernize their equipment, accelerate the automation of certain tasks and make the shift to robotics.

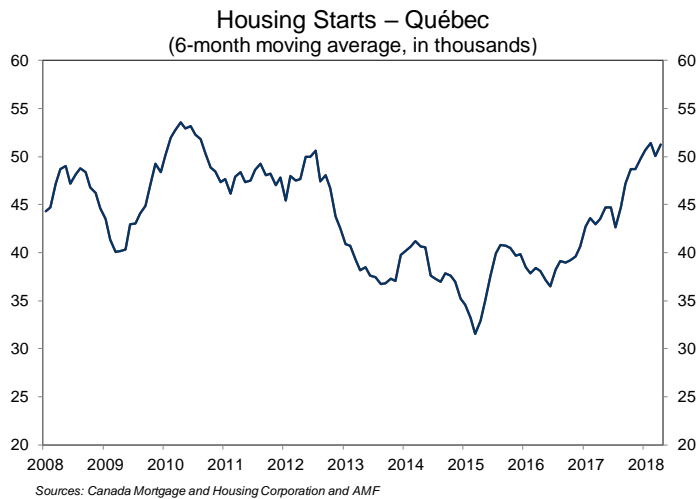
In addition, companies will want to take advantage of the still very loose financial conditions to finance expansion projects in the face of gradually increasing interest rates. Lastly, the upward trend in commodity prices tends to favour a recovery in investment in the mining sector.



Foreign trade once again hindered GDP growth as the increase in interprovincial trade did not fully offset the drop in international exports.

The looming uncertainty surrounding NAFTA renegotiations and the imposition of new tariffs will undoubtedly continue to hurt foreign trade and is one of the main risks currently facing Québec's economy. U.S. tariffs on steel and aluminum will also have a considerable negative impact, as aluminum is one of Québec's major exports.

The residential real estate market kept pace with the economy, posting a stronger performance than in recent years. The resale market grew at a sustained pace and housing starts remained high, particularly in the condo market segment.



The six-month moving average of housing starts remained at around 51,000 units, a year-over-year increase of 17.8%, with the majority in the collective dwelling sector. This increased activity was underpinned by a buoyant condo market and increased sales.

The new mortgage rules did not have a significant impact in Québec in the first half of 2018, unlike what was seen in Ontario. However, tightened mortgage rules could be one of the reasons for the resurgence of activity in the generally more affordable condo sector.

The new rules encourage households to make a higher down payment or to look for properties that are relatively less expensive.

After two strong years, the pace of job creation in Québec slowed considerably, with the province shedding 20,000 jobs in the first six months of 2018. As the fundamentals of Québec's economy remain relatively sound, the slowdown in hiring may be due to the labour shortage.

In fact, according to the latest figures from Statistics Canada, the number of job openings has jumped twice as quickly in Québec as in Canada as a whole. Available jobs that businesses are unable to fill thus represent 2.6% of all positions. With an unemployment rate of 5.4%, the labour shortage could hinder some companies, as they may be forced to cancel expansion projects or refuse contracts.

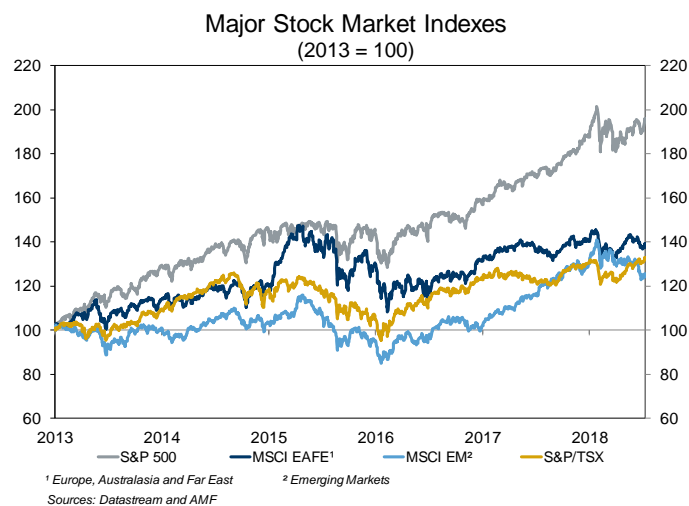
Ultimately, after a period of very strong growth, Québec's economy has decelerated according to expectations. It is already operating at the limits of its capacity, and this is reflected in the difficulties in filling vacancies. Under these circumstances, GDP growth will be more restrained this year and the next.

Furthermore, foreign trade is still struggling in the face of intense competition from abroad and the risk of an all-out trade war between Canada and the United States. The uncertainty surrounding the renegotiation of NAFTA and the risk of a trade war are weighing heavily on Québec, a small economy that is very dependent on trade.

FINANCIAL MARKETS

STOCK MARKETS

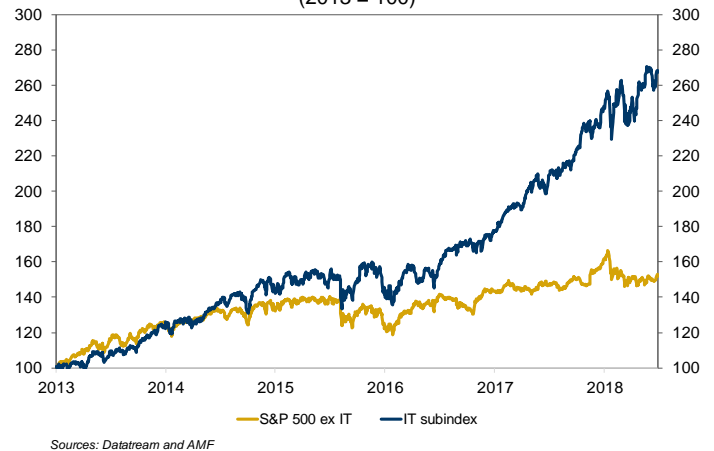
After a challenging first quarter, which was marked by two significant pullbacks, stock markets in advanced economies were generally up in the second quarter. However, the growing risk of a trade war eventually rattled investor confidence and the main indexes dropped in the last weeks of the quarter. Nevertheless, volatility was down significantly from February's peak levels.



In the United States, stock markets ended in positive territory despite the turbulence in the last weeks. The S&P 500 was up 2.9% in the second quarter and 1.7% since the start of the year. The fundamentals remain solid: corporate profit growth is healthy, sustained by an economy operating at full throttle and major tax cuts. With a return of 6.7% in the second quarter and 10.2% since the start of the year, the information technology sector continued to push up the S&P 500.

The IT sector, dominated by the Web giants, has significantly outperformed the index as a whole for several years, as shown in the graph below. The sector's share of the index is growing and it now accounts for 28% of total market capitalization. Despite its relatively high valuations and concerns about the protection of personal information, the sector continues to perform well.

S&P 500 : Information Technology Subindex
(2013 = 100)



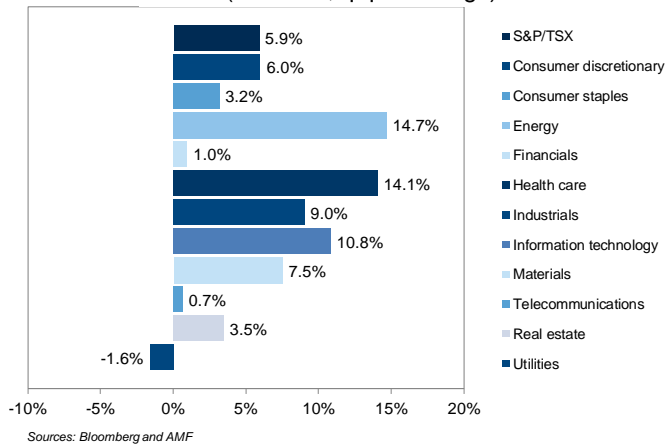
Elsewhere in the world, results were mixed. In Europe, markets were somewhat shaken by political uncertainty in Italy and slower economic growth since the start of the year. The MSCI Europe Index ended the second quarter up 2.5%, but was down 2.5% since the start of the year.

Emerging markets had a challenging second quarter. In general, the relative appeal of their assets and currencies was eroded by rising interest rates in the United States. Argentina and Turkey were particularly affected, as both have a considerable current account deficit and a high level of debt in foreign currencies. Moreover, escalating trade tensions and the slowdown of the Chinese economy contributed to very significant declines on the main Chinese stock indexes.

In Canada, the S&P/TSX returned a handsome 5.9% in the second quarter, but was nearly unchanged from the start of the year. The rebound in the second quarter was due in large part to the positive performance of the energy sector, as oil prices firmed up on strong global demand and disruptions in supply.

The rising U.S. dollar and a slight decrease in the discount associated with Alberta oil were also a boon to the Canadian oil industry. Health care, information technology and industrials also posted significant gains in the second quarter.

Performance of the Main S&P/TSX Subindexes (2018 Q2, q/q % change)



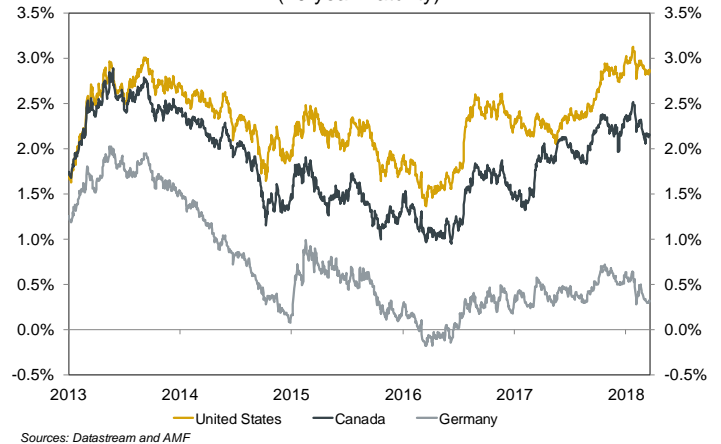
Lastly, Québec companies listed on the TSX had an overall performance similar to that of the index, with the Morningstar National Bank Québec Index posting a return of 6.5% in the second quarter. As was the case elsewhere in Canada, Québec companies in health care, information technology and industrials fared well. Furthermore, as none of the Québec listed companies are in the energy sector, this fine performance was in no way dependent on it.

BOND MARKETS

Bond yields in the major markets seesawed in the second quarter. A slight rise in inflation and anticipation of tighter monetary policies initially lifted bond yields in the major markets. However, increased political instability in Europe and the growing threat of a trade war favoured risk aversion, causing bond yields to drop at the end of the quarter, particularly in the United States.

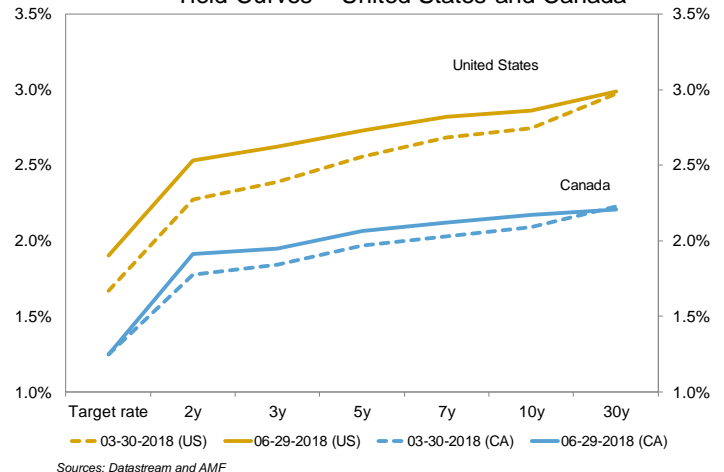
In fact, 10-year yields on U.S. government bonds briefly rose to 3.1% in May—their highest level since 2011—but ended the quarter at 2.85% due to mounting political uncertainty and protectionism.

Government Bond Yields (10-year maturity)



Short-term yields climbed as investors scaled up their expectations of the scope of monetary tightening by the Federal Reserve. As a result, the yield curve flattened but remained positive, with the spread between 2-year and 10-year yields at its lowest level since 2007.

Yield Curves – United States and Canada



In Canada, bond yields fell in the second half of the quarter across the entire term structure against a backdrop of trade tensions with the United States. The outcome of NAFTA negotiations appears increasingly uncertain and the threat of U.S. tariffs on the auto industry is fuelling fears that worse is to come for the Canadian economy.

Furthermore, other economic risks continue to loom, particularly the high level of household debt and the rebalancing of the residential real estate market. The Bank of Canada is therefore expected to take a cautious approach.

Ultimately, the spread between Canadian and U.S. bond yields widened somewhat, contributing to the loonie's decline against the greenback despite a rise in oil prices.

Keep in mind that for roughly two decades, there has been a strong correlation between the value of the Canadian dollar and crude prices, which reflects the growing importance of oil as a Canadian export product.

The numerous uncertainties surrounding the Canadian economy and the recently released data that point to a slowdown in growth erased oil's positive effect on the Canadian dollar.

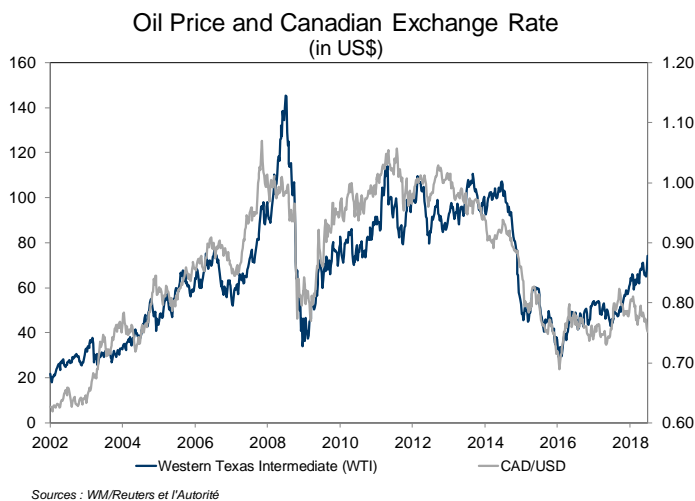
In Europe, bond yields in the main European countries, particularly Germany, remained at historic lows and even dipped slightly over the quarter.

Nevertheless, the European Central Bank announced its intention to wind up its quantitative easing program by the end of the year. It also intends to continue reinvesting all maturing securities for an extended period of time and keep interest rates unchanged at least through the summer of 2019.

In the face of political tensions, bond yields in Germany, France and the United Kingdom fell as investors fled to safe havens, at the expense of Italian bonds.

In the corporate bond market, spreads with government bonds remained relatively stable, both in the United States and Canada.

Increased risk aversion could have widened these spreads, but corporate earnings remained strong and higher oil prices, in particular, were a boon to companies in the energy sector.



Market Performance

Stock Markets											
	Level	% change							Last 12 months		
		2018-06-29	1 month	3 months	6 months	9 months	1 year	3 years ²	5 years ²	Min.	Max.
MSCI All Country World Index	586	-0.2	2.0	-0.3	4.7	8.7	6.4	8.6	538	622	
MSCI EAFE ¹	1,132	-0.5	2.3	-2.7	0.5	3.3	2.3	6.1	1,085	1,207	
MSCI Emerging Markets	58,513	-2.9	-4.2	-3.9	1.2	8.0	5.1	6.0	53,977	65,823	
S&P 500	2,718	0.5	2.9	1.7	7.9	12.2	9.6	11.1	2,410	2,873	
S&P/TSX	16,278	1.3	5.9	0.4	4.1	7.2	3.8	6.1	14,952	16,450	
Morningstar National Bank Québec Index	293	1.2	6.5	1.7	8.2	11.3	8.4	14.0	259	299	
Bond Markets											
	Level	% change							Last 12 months		
		2018-06-29	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.8	2.9	2.7	2.6	2.8	2.4	2.6	3.6	2.4	3.1
Ontario	10-year	2.8	2.9	2.7	2.6	2.7	2.4	2.6	3.5	2.4	3.1
Canada	10-year	2.2	2.2	2.1	2.0	2.1	1.8	1.7	2.4	1.8	2.5
United States	10-year	2.9	2.9	2.7	2.4	2.3	2.3	2.4	2.5	2.0	3.1
United Kingdom	10-year	1.3	1.2	1.3	1.2	1.4	1.3	2.0	2.4	1.0	1.6
Germany	10-year	0.3	0.3	0.5	0.4	0.5	0.5	0.8	1.7	0.3	0.8
Canada	AA Corp. (10-year)	3.1	3.2	3.0	3.1	3.3	2.9	2.8	3.4	2.8	3.4
	BBB Corp. (10-year)	3.8	3.9	3.8	3.8	4.0	3.6	3.6	4.2	3.6	4.1
	BBB - 10-year Gov. spread	1.6	1.6	1.8	1.7	1.9	1.8	1.9	1.8	1.6	2.0
United States	AA Corp. (10-year)	3.7	3.7	3.6	3.1	3.1	3.1	3.3	3.3	2.9	3.9
	BBB Corp. (10-year)	4.5	4.4	4.2	3.7	3.7	3.7	4.2	4.3	3.5	4.6
	BBB - 10-year Gov. spread	1.6	1.5	1.5	1.3	1.4	1.4	1.8	1.8	1.2	1.7

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

SPECIAL FEATURE

SPOTLIGHT ON QUÉBEC LISTED COMPANIES

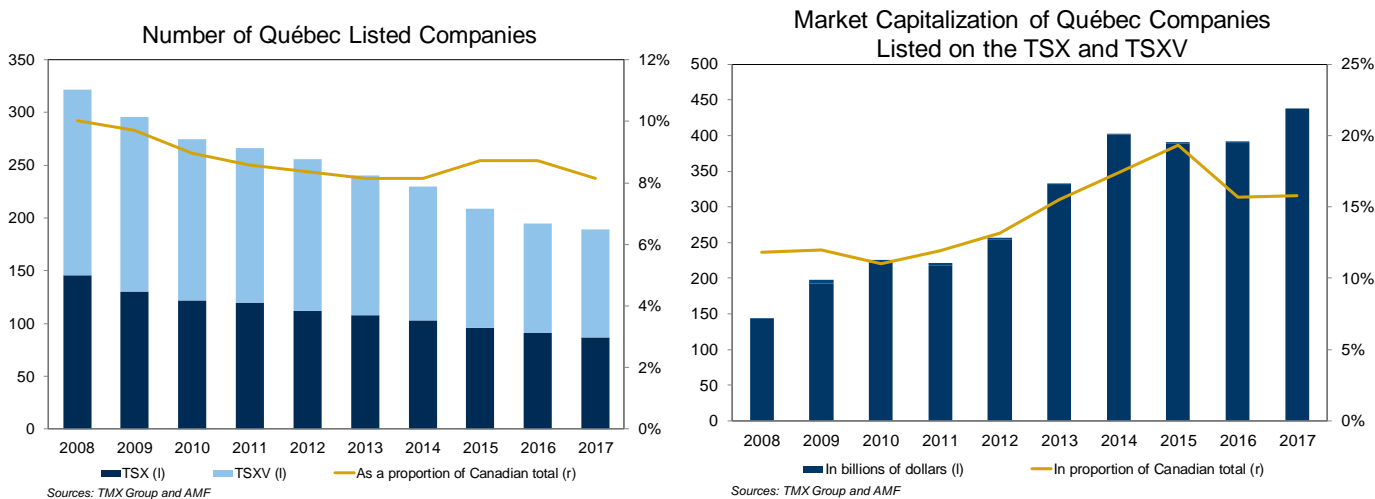
As in many advanced economies, the number of companies listed on stock exchanges has been declining in Canada for years. Notably, the drop is even more pronounced in Québec than in the rest of Canada. And while the trend reversed in 2017 in Canada, the United States and Europe, that was still not the case in Québec.

Despite some fluctuations, Québec has seen its share of companies listed on the Toronto Stock Exchange (TSX) and the TSX Venture Exchange (TSXV) drop for many years. Initial public offerings (IPOs) are down too and are not enough to offset the mergers, acquisitions, bankruptcies and going-private transactions of listed companies. Only the total market capitalization of Québec companies continues to increase, meaning that listed companies, although fewer, are on average larger.

Ultimately, Québec is under-represented with respect to both listed issuers and market capitalization compared with its weight in the Canadian economy of 19%.

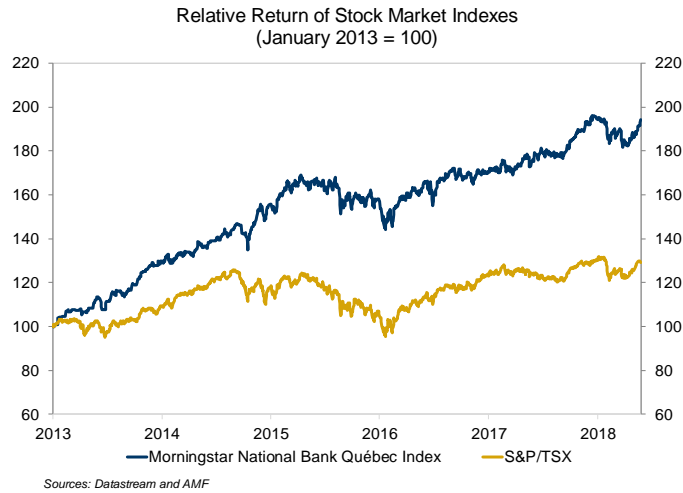
As at December 31, 2017, Québec had 189 issuers listed on the TSX and TSXV exchanges, representing 8.1% of the Canadian total. At the end of 2008, there were 322, for a proportion of 10%. In nine years, the total number of Québec issuers dropped more than 40%. The pullback was steeper on the TSXV, which lists smaller market cap companies. There has also been a notable decline in the mining sector due to the drop in commodity prices in recent years.

Canada also saw a decrease in the number of listed companies these past few years, from 3,212 in 2008 to 2,323 in 2017. However, the decrease was not as steep and the number of listed companies started increasing again in 2017.



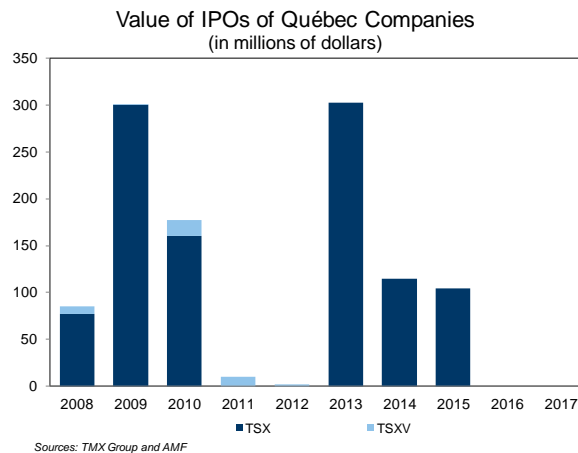
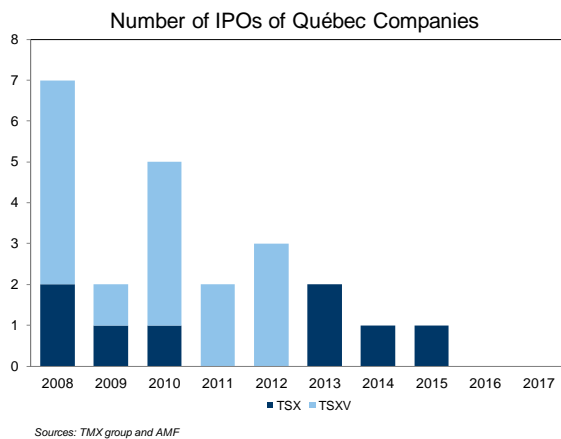
During the same period, the market capitalization of Québec companies followed a reverse trend. As at December 31, 2017, total market capitalization on both exchanges was \$440 billion, or 16% of the Canadian total, compared with \$145 billion or 12% nine years ago.

Québec companies have posted clearly superior performances in recent years, comparing the Morningstar National Bank Québec Index with the S&P/TSX Composite Index. Like Québec's economy, Québec companies have a diversified sector allocation, more so than Canadian companies overall. The absence of energy sector companies also helped boost the Québec index in recent years.



As regards IPOs in Québec, the trend is clearly negative. During the past decade, 2008 was the most prolific year, with seven IPOs, which is relatively few from a historical perspective. Since then, the number has been trending down: there was only one IPO in 2014 and 2015, none in 2016 and 2017, and still none to date in 2018. On average, over the past few years, Québec IPOs only represented 5.5% and 4.2% of all Canadian IPOs in terms of number and value, respectively.

Outside Québec, the downtrend observed over several years seemed to have reversed in 2017. Companies once again started using the stock markets as a source of financing in greater numbers. Globally, 2017 was the most active year for IPOs in the past decade. In Canada overall, there were 28 IPOs in 2017, amounting to \$6.1 billion in capital raised, compared with 4 IPOs and \$1.6 billion in 2016.



The reasons for the declining number of listed companies and IPOs in Québec are generally the same as elsewhere. These include: the low interest rate environment favouring debt financing, the growth of alternative financing, the growth through acquisition of large companies and the increasing regulatory burden.

Moreover, the ecosystem of stock exchanges and financial services is increasingly concentrated in Toronto and Vancouver as a result of the consolidation of the brokerage industry by the large banks and the specialization of stock exchanges. It should also be noted that organizations providing public and private financing are especially numerous and active in Québec (tax-advantaged funds, Caisse de dépôt et placement du Québec, Business Development Bank of Canada, etc.) and constitute an appealing, even rewarding, alternative to stock exchanges.

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It remains to be seen if the recovery in IPOs observed in Canada as a whole and elsewhere in the world will also extend to Québec in the coming years. Time will also better tell which factors have a decisive influence on these fluctuations and whether measures to reduce the regulatory burden, especially for the smallest issuers, are having noticeable effects

NOTE

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