ECONOMIC and FINANCIAL REVIEW

Office of the Vice-President
Strategy, Risks and Performance

July 15, 2019

AUTORITÉ DES MARCHÉS FINANCIERS

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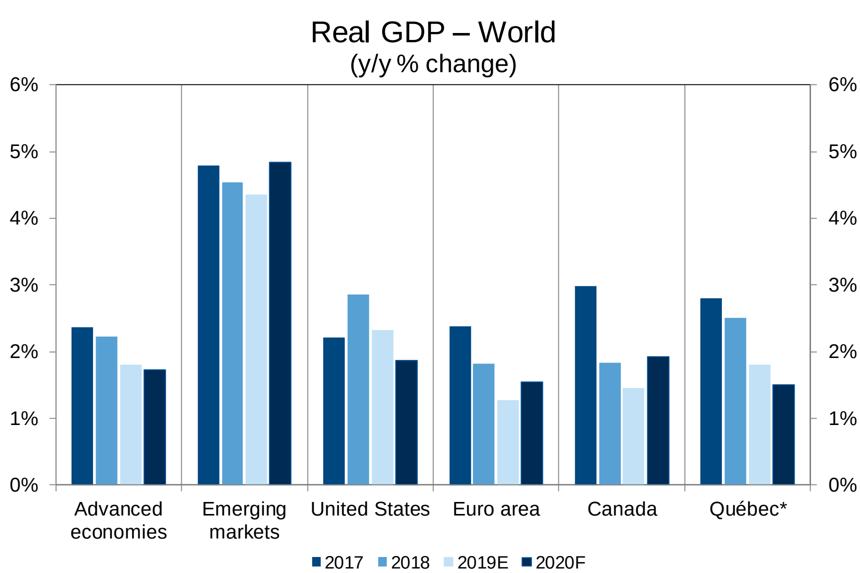
HIGHLIGHTS

- The global economic slowdown continued in the second quarter and is becoming increasingly synchronized against a backdrop of continuing trade tensions. Major international financial institutions further lowered their economic forecasts.
- The United States continued to lead the world's advanced economies in economic growth. The Federal Reserve left its key policy rate unchanged but opened the door to potential rate cuts.
- The Canadian economy continued to slow down in the first quarter of 2019 owing to challenges in the energy sector and the ongoing cooling of the residential real estate market.
- By contrast, the Québec economy got off to a solid start in 2019. GDP rose 2.4% on a year-over-year basis in the first quarter, bolstered, in particular, by consumer spending.
- The stock markets fluctuated in response to trade sanctions and retaliatory measures but nonetheless ended the second quarter in positive territory. Bond yields, meanwhile, dropped sharply, continuing their downward trend started in late 2018.
- With its economy doing well and an aging population, Québec is approaching full employment and the effects are beginning to show. The employment rate is at an all-time high; the unemployment rate is at an all-time low; and the job vacancy rate is rising steadily.



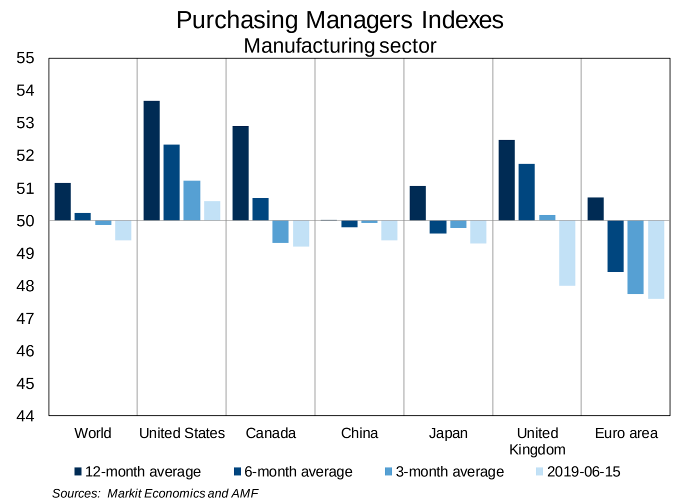
** For 2020, average of forecasts by major Canadian financial institutions*
Sources: International Monetary Fund, Institut de la statistique du Québec and AMF

ECONOMIC CONTEXT

WORLD

The global economic slowdown continued in the second quarter and is becoming increasingly synchronized against a backdrop of continuing trade tensions. Major international financial institutions further lowered their economic forecasts. They are calling on governments to introduce new fiscal stimulus measures, with some saying a recession is likely in 2020.

While trade and industrial production are showing signs of weakness, manufacturing purchasing managers indexes worldwide have generally been down for the past several months. This has particularly been the case in the euro area and Japan, where they have remained below the waterline of 50, suggesting a contraction in the manufacturing sector and a slowdown in the economy as a whole.



Trade tensions flared up again in May, when the U.S. administration increased its tariffs on US$200 billion worth of Chinese imports from 10% to 25% and threatened to levy tariffs on all remaining Chinese imports, worth approximately US$300 billion. Beijing retaliated by imposing tariffs on US$60 billion worth of U.S. imports.

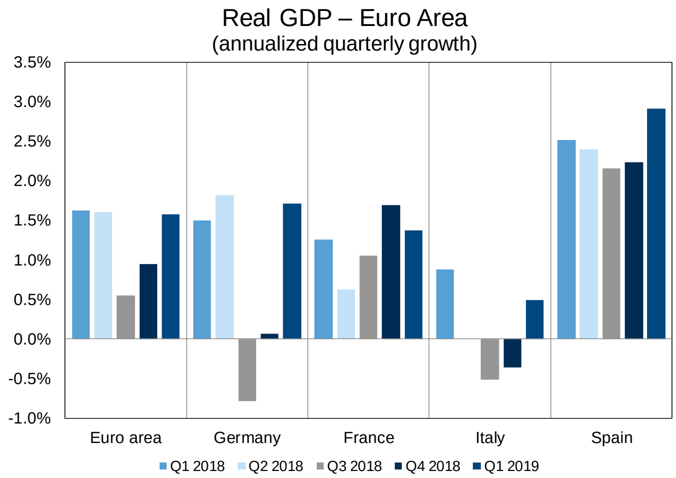
The United States is accusing China of reneging on commitments made in trade talks. It is demanding a reduction in its large trade deficit with China (US$378 billion in 2018) and substantial structural changes, including an end to the forced transfer of technology, the protection of intellectual property, and an end to Chinese subsidies to state-owned enterprises. Trade talks between the two countries resumed late in the quarter.

The Americans are also blowing hot and cold with their other trade partners. Tariffs on steel and aluminum were lifted for Canada and Mexico but remain in place for the European Union. The decision to impose tariffs on the automotive industry was postponed for six months, averting a potential conflict with the European Union and Japan, but Washington is threatening to impose tariffs on the Europeans in response to aeronautics industry subsidies. Lastly, Washington briefly threatened to impose tariffs on all Mexican imports, forcing Mexico to step up efforts to curtail illegal immigration.

In the meantime, after an especially strong first quarter, it looks as if U.S. growth will be more moderate in the second quarter. The Federal Reserve left its key policy rate unchanged but opened the door to potential rate cuts. The Bank of Canada also kept its key policy rate the same.

In the euro area, the European Central Bank, faced with modest growth and political uncertainty, is considering the possibility of implementing new monetary policy easing measures.

Germany, the engine of the European economy, is idling as a result of global trade tensions and Brexit-related uncertainty. The German economy rebounded in the first quarter, narrowly avoiding a recession. However, the latest statistics point to a slowdown in the second quarter, as industrial production and exports, along with consumer confidence indexes, are down, especially in the manufacturing sector.



Sources: Eurostat and AMF

In the United Kingdom, Brexit remains in a deadlock after the date for leaving the European Union was extended twice, the second time to the current deadline of October 31. Following poor election results and failed negotiations with the opposition Labour Party, Theresa May stepped down as prime minister in June. Her replacement will be announced in July after a leadership contest involving contenders who are entertaining the possibility of a no-deal Brexit, which would negatively impact the British economy.

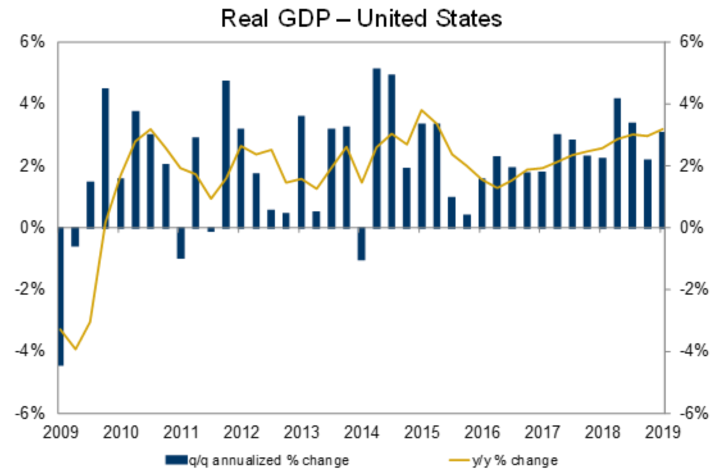
The slowdown is also affecting emerging markets. The Chinese economy is showing signs of weakness, with consumption, industrial production and investment experiencing decelerated growth at the very time when pressures from U.S. sanctions are building. Brazil and South Africa saw their economies contract in the first quarter.

The stock markets fluctuated in reaction to trade sanctions and retaliatory measures but nonetheless ended the second quarter in positive territory, while bond yields nosedived.

Oil prices fell from April's peak owing to higher inventory levels and the global economic slowdown. Rising Middle East tensions at the end of the quarter, however, reversed the trend.

United States

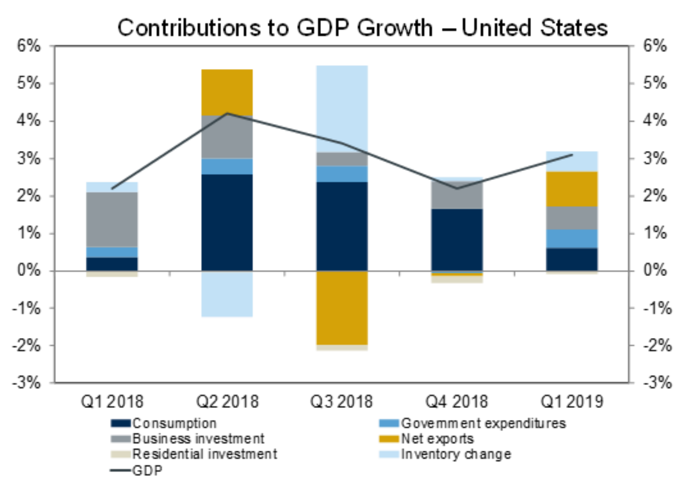
The United States continues to lead the world's advanced economies in economic growth. Against all expectations, it posted year-over-year growth of 3.1% in the first quarter. This pace will likely slow, however, in the coming quarters.



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

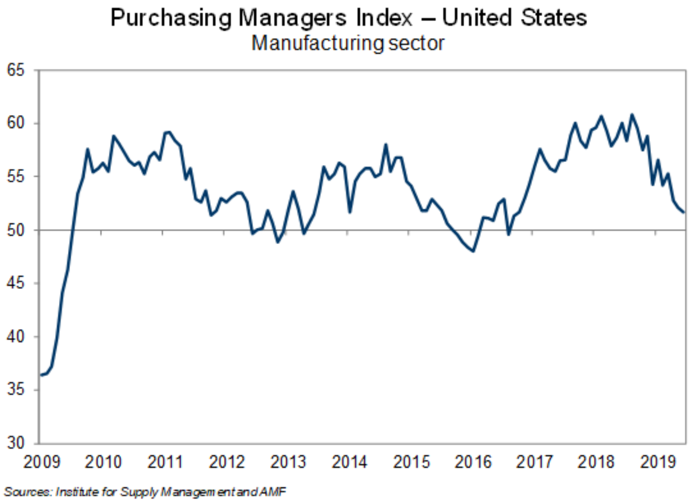
Nearly one-fifth of this performance is due to a buildup of business inventories, meaning production growth has outpaced demand growth.

Clearly, either demand will successfully absorb the surplus production or production will need to gear down and adjust to more moderate demand. The second of these two scenarios is the one most likely to play out.



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

Other signs are pointing to a slowdown in economic activity. The manufacturing Purchasing Managers Index has slowed considerably over the past 12 months, suggesting a less favourable environment for the manufacturing sector, which could, in turn, affect foreign trade.



The job market has also slowed since the start of the year. Since January, the pace of monthly job creation fell from 245,000 to 171,000 (three-month moving average). The jobless rate nonetheless remains near its record low of 3.7%.

Moreover, the higher tariffs levied by the U.S. administration will have a definite impact on consumer spending and investment by driving up prices for consumer goods and equipment imported from China.

Despite a fairly robust, full-employment economy, inflationary pressures have been largely benign thus far, with core inflation standing at 1.5% in May.

Higher tariffs are adding to rising wage pressures, however, which could eventually have an impact on inflation. So far, though, consumer prices have been insensitive to upward pressures on input costs.

The Federal Reserve, much more concerned about the downside risks to the economic outlook than inflation, left its key policy rate unchanged at 2.25%-2.50% in June but opened the door to potential pre-emptive easing if conditions require it.

Faced with mixed economic statistics, rising geopolitical tensions and signs of a slowing global economy, investors are anticipating some easing of U.S. monetary policy this year and next.

Historically, pre-emptive monetary easing by the Fed during a period of economic expansion has been a fairly rare, situational phenomenon. It has occurred in more unfavourable economic situations than the current one.

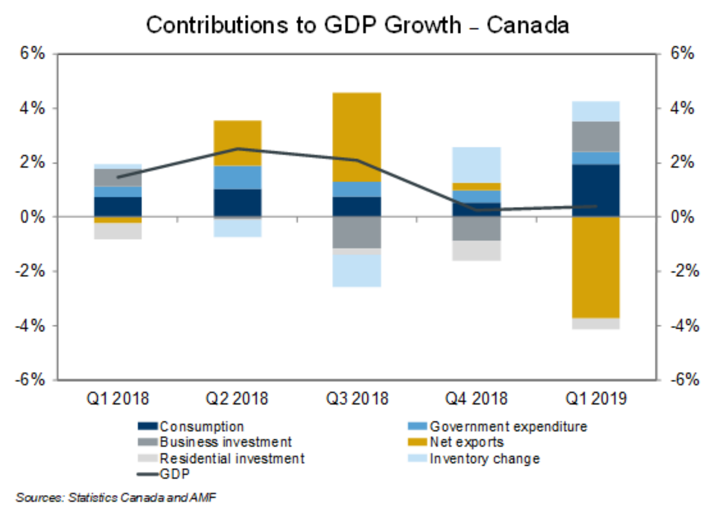
CANADA

The Canadian economy continued to slow in the first quarter of 2019 owing to challenges in the energy sector and ongoing cooling of the residential real estate market, with year-over-year quarterly growth standing at 0.4%.

Net exports also considerably dampened GDP growth in the first quarter. Exports posted a 4.1% decline owing mainly to declining Alberta oil exports, which were affected by the production curtailments that took effect in January.

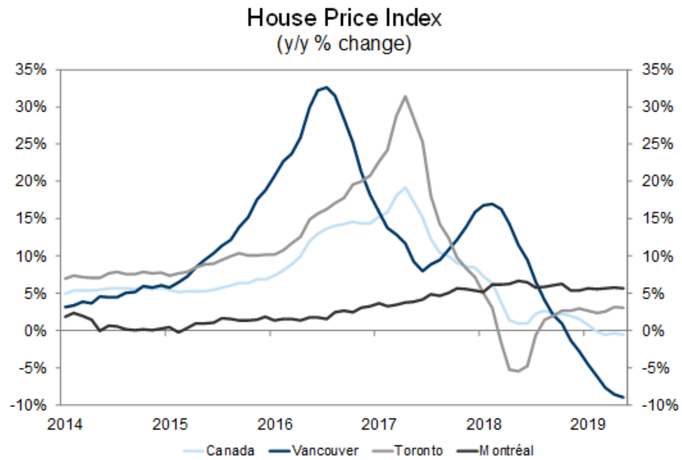
Imports increased 7.7%, spurred by the rebound in domestic demand. After three consecutive quarters of declines, domestic demand grew 3.3%.

Consumer spending strengthened compared with recent quarters, and business investment bounced back after declining for three consecutives quarters.



Residential construction continued its downward trend in Q1, the fifth consecutive quarter of declines.

The Toronto and Vancouver areas continue to evolve along different tracks. In Toronto, resale activity has picked up in recent months and the year-over-year change in prices is more stable. Although resale activity has also increased in Vancouver, prices there are continuing to come down.

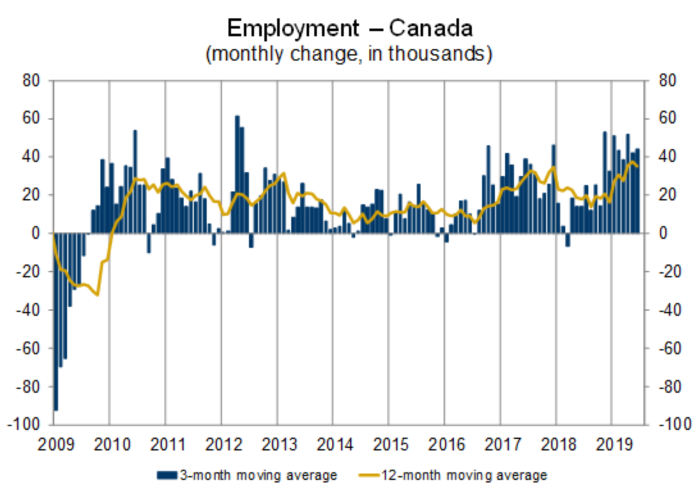


Sources: The Canadian Real Estate Association and AMF

Households are still adjusting to past interest rate hikes and macroprudential measures. The Bank of Canada noted in its most recent *Financial System Review* that, while imbalances in the housing market have declined, they remain a significant vulnerability.

Meanwhile, the quality of new mortgage loans has improved and credit growth has slowed. However, a large portion of Canada's debt is held by heavily indebted households and high household debt remains a key vulnerability for the Canadian economy.

Despite the slowing economy, the labour market experienced strong growth early in the year. Close to 250,000 jobs were created in the first six months of the year, more than during the whole of 2018. The unemployment rate remained at a historic low, standing at 5.5% in June.



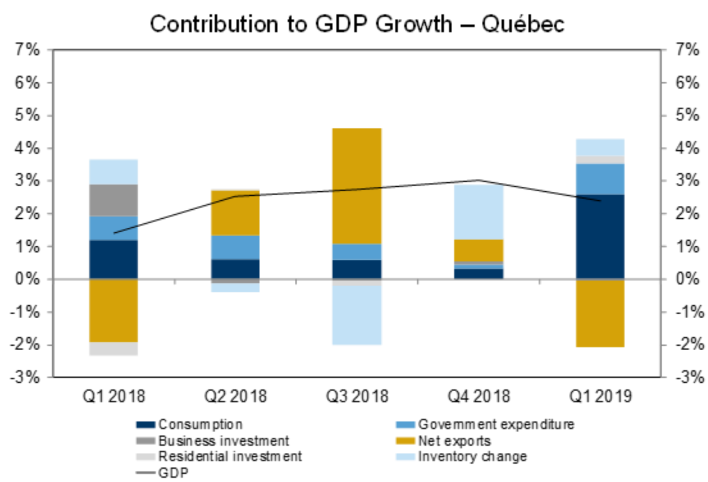
Sources: Statistics Canada and AMF

The slowdown in Canada's economy is expected to be short-lived. A number of indicators are pointing to a rebound in growth in the second quarter, particularly the strong labour market and the recovery in domestic demand.

Inflationary pressures appear to be contained for the moment, despite an uptick in inflation in May. The measures of core inflation have been fairly stable over the past several months, and the Bank of Canada is expected to leave the key policy rate where it is until the end of the year.

QUÉBEC

Québec's economy continued apace in early 2019, posting growth significantly above the Canadian average for a second quarter in a row. The province's GDP increased 2.4% on a year-over-year basis in the first quarter, bolstered, in particular, by growth in consumer spending and residential investment. However, despite less uncertainty in trade with the United States, foreign trade subtracted from GDP growth.



Sources: Institut de la statistique du Québec and AMF

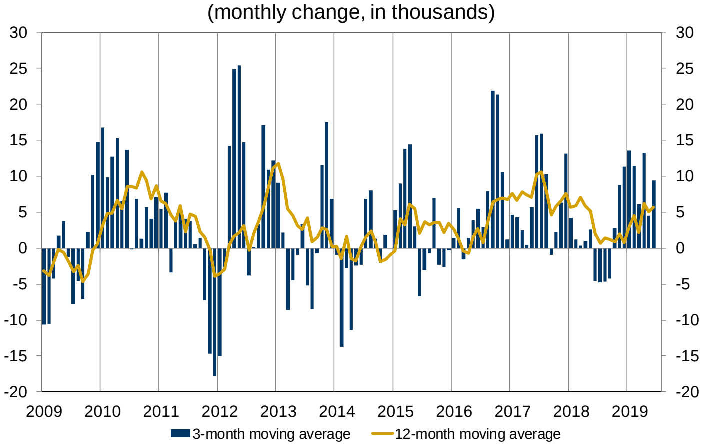
Early in the year, consumer spending accelerated sharply from previous quarters, spurred by higher wages and lower borrowing costs. Given recent months' job creation numbers, household spending should continue to grow but at a slower pace.

After retreating at the end of 2018, business investment continued its downtrend, affected by the slowdown in global growth and weak corporate earnings.

Foreign trade also declined. In fact, exports decreased more than imports, increasing the trade deficit. That being said, the elimination of tariffs on steel and aluminum should have a positive impact on Québec's international exports during the months ahead.

The labour market picked up slightly in 2019 and is nearing, if not already at, full employment. In the second quarter, 28,100 jobs were created, for a total of 46,500 new positions for the first six months of the year. The unemployment rate remains at its historic low of 4.9%.

Employment – Québec
(monthly change, in thousands)

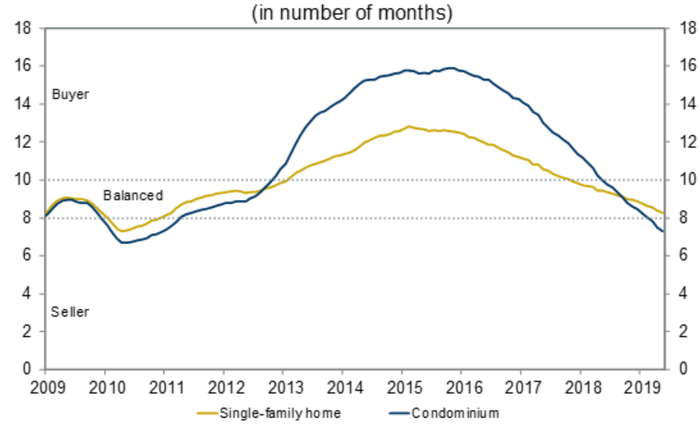


Sources: Institut de la statistique du Québec and AMF

The province's real estate market remains strong. Prices climbed close to 7% in the first six months of the year, mainly owing to solid economic fundamentals—particularly wage growth, which is higher in Québec than in the rest of Canada.

The real estate market is gradually tightening, with demand outstripping supply and signs of overheating beginning to emerge. Also, the proportion of foreign buyers is growing in Montréal and stood at 3.4% of all buyers in 2018. However, although the number of sales to foreign buyers is increasing, the impact on demand for properties remains marginal.

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



Sources: FCIQ Centris and AMF

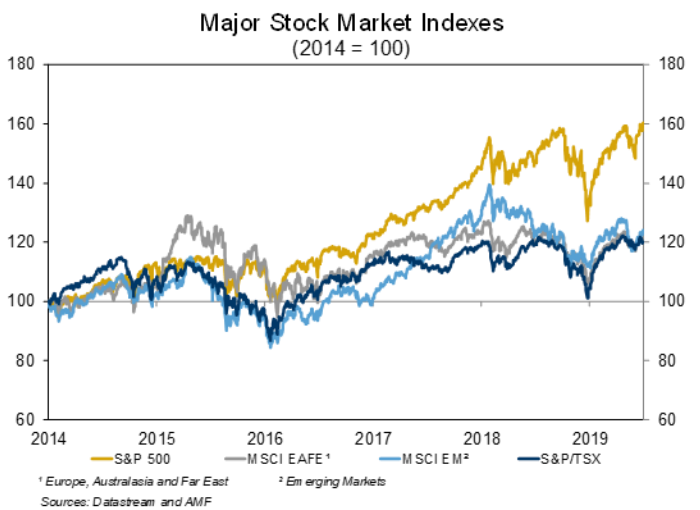
In the end, Québec fared relatively well in the first quarter despite the uncertain environment. Consumer spending offset the decline in business investment and exports, to the point where Québec outperformed Canada economically.

Québec is nevertheless expected to post more moderate growth in the coming quarters as a result of the global slowdown and continuing labour shortage. For the whole of 2019, growth is expected to move closer to the long-term potential growth rate.

FINANCIAL MARKETS

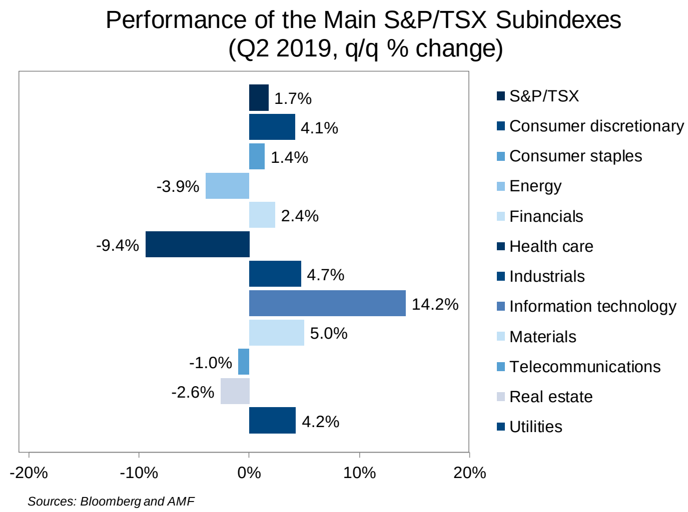
STOCK MARKETS

The major global stock markets posted positive returns in the second quarter, despite a significant decline in May against a backdrop of trade tensions. In the end, the MSCI All Country World Index returned 2.5% over the quarter and now stands very close to the highs observed in 2018.

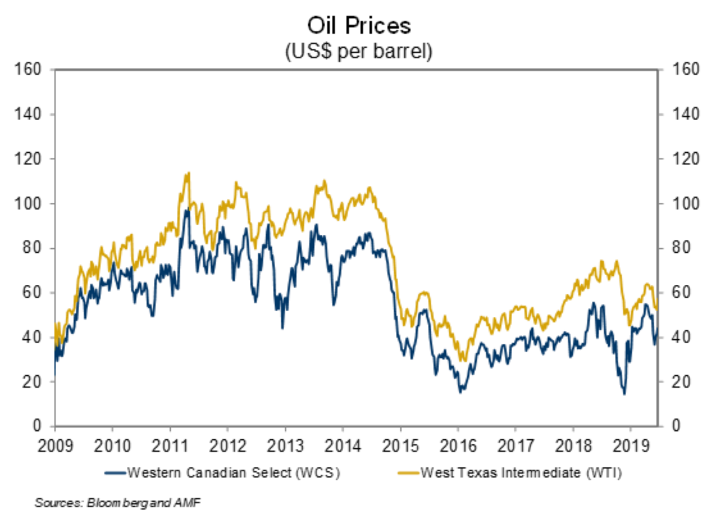


Overall, investors seem to have taken the continuing uncertainties weighing on the global economy in stride. They have taken comfort in the prospect of more accommodative monetary policies and the fact that there has been some stabilization of economic conditions. The declining yields in bond markets also tend to favour stock markets, where expected returns are typically more attractive.

In the United States, the S&P 500 posted a return of 3.8% in the second quarter. Corporate earnings per share have essentially been stagnant since the start of the year, but fears of a substantial decline have not materialized. Moreover, the U.S. economy continues to grow at a moderate pace, and the market analysts' consensus outlook is counting on higher corporate earnings in the coming quarters. An intensification of trade tensions could, however, cloud this outlook.



In Canada, the S&P/TSX generated a 1.7% return in the second quarter, despite the 3.9% decline in the energy sector. Oil prices are down quarter over quarter owing to relatively weak global demand, uncertainty resulting from trade tensions, and higher oil inventories. In addition, the price spread between West Texas Intermediate (WTI) and Western Canadian Select (WCS) has widened slightly but remains nonetheless contained, owing to measures taken by the Alberta government since the beginning of the year to curtail oil production and facilitate transportation. By contrast, the information technology sector stands out with a positive return of 14.2%.

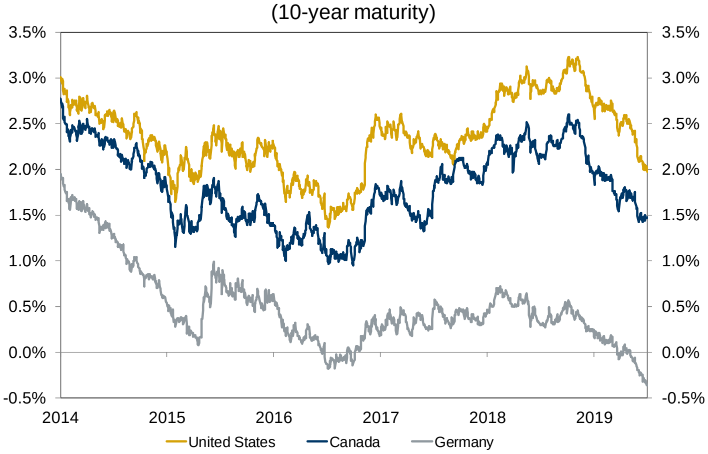


TSX-listed companies headquartered in Québec performed slightly better than S&P/TSX-listed companies as a whole in the second quarter. The Morningstar National Bank Québec Index posted a 3.0% return, bolstered, in particular, by the strong performance of the consumer discretionary and information technology sectors.

BOND MARKETS

Bond yields dropped sharply in the last quarter, continuing their downward trend from the end of 2018. The slowdown in the global economy, exacerbated by rising trade tensions, and the change in tone from central banks favoured a decrease in yields in the major bond markets.

Government Bond Yields
(10-year maturity)

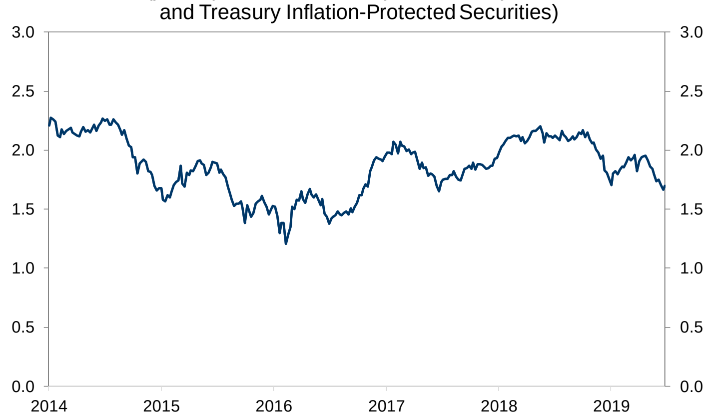


Sources: Datastream and AMF

The global economy continued to slow in the second quarter, while inflation remained low. In this context, central banks took a much more conciliatory stance and have all the room they need to ease their policies in the months ahead. In addition, the risk of escalating trade tensions triggered further risk aversion, which favoured the major bond markets.

In the United States, the federal government's 10-year yields ended the quarter at 2%, down roughly 40 basis points. As a result, U.S. yields are nearing the record low reached just before the election of Donald Trump in 2016, which resulted in higher inflation expectations. This time, inflation expectations in the United States have been declining, instead.

Inflation Expectations – United States
(yield spread between 10-year Treasury bonds and Treasury Inflation-Protected Securities)

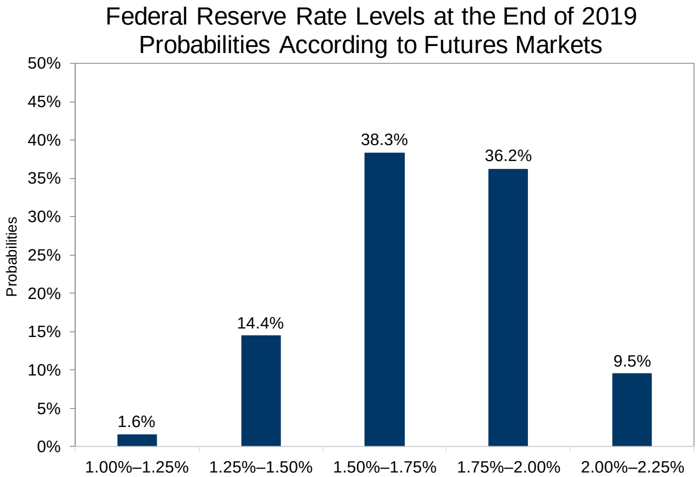


Sources: Federal Reserve and AMF

The U.S. economy continues to grow but at a more moderate pace. The risk of a recession is also higher. According to the New York Fed model, based on the yield curve, the probability of a recession over a one-year horizon is now close to 30%, compared with 11% the same time last year.

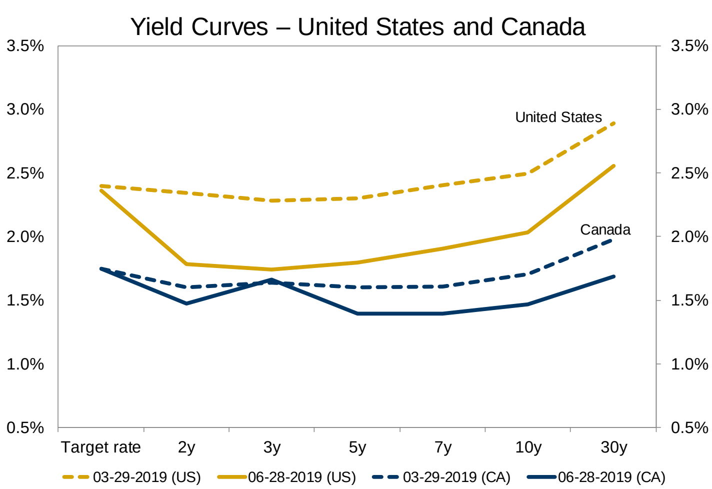
Changes in the yield curve are signalling, at the very least, a slowdown in the economy. The whole of the yield curve has flattened somewhat and reversed in some places. As a result, the spread between 10-year and 3-month yields is now slightly negative, while the spread between 10-year and 2-year yields, widely tracked in the markets as a leading indicator of a recession, remains positive.

Worsening global economic conditions and the absence of inflationary pressures have forced the Fed to adjust its aim. The markets are now expecting several rate cuts: the federal funds futures market is pricing in a 38.3% probability that cuts totalling 75 basis points will be announced between now and the end of the year.



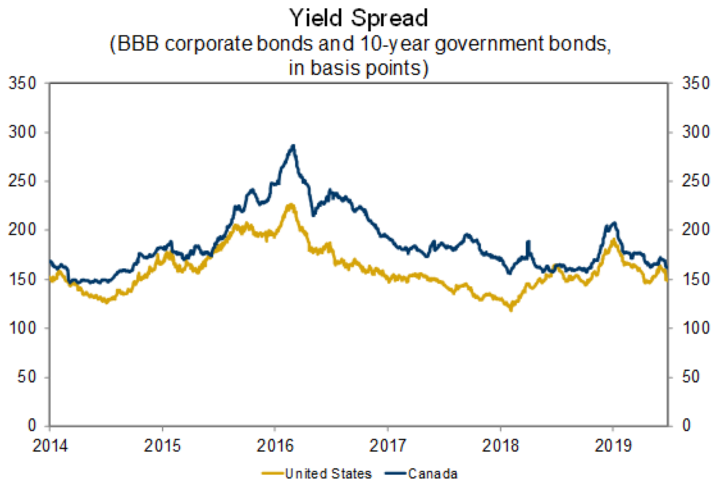
Sources: Bloomberg and AMF, data as of June 30 2019

In Canada, the yield curve followed the same trend, especially as the economic slowdown since the start of the year has been more pronounced here than south of the border. The Bank of Canada also clearly communicated that rate increases were no longer in the cards for the moment. Futures markets have priced in a 37% probability that the Bank will cut its key policy rate between now and the end of the year.



Sources: Datastream and AMF

In Europe, bond yields also declined steeply, at times even sliding into negative territory, reflecting anaemic economic growth and inflation. In addition, the European Central Bank, which had already committed to leaving its key policy rate at 0% until mid-2020, recently hinted at further easing of its monetary policy. In Germany, in particular, the yield curve was almost completely in negative territory at the end of the quarter; only bonds with maturities of 20 years or longer had positive yields. It cost approximately 30 basis points for the privilege of holding a 10-year German government bond.



Sources: Datastream, Bloomberg and AMF

Corporate bond yields also decreased in the last quarter and spreads with government bonds held relatively steady despite the fears of an economic slowdown. High corporate debt also continues to raise concerns. In the most recent edition of the *Financial System Review*, the Bank of Canada pointed out that non-financial corporate debt relative to income, at 315% in 2018, is well above the historic average and that some riskier companies are vulnerable to changes in investor sentiment.

Market Performance

Stock Markets

	Level	% change							Last 12 months	
	2019-06-28	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index	610	5.6	2.5	14.6	-0.2	4.0	9.7	5.8	510	615
MSCI EAFE[1]	1,123	4.1	1.6	11.4	-2.5	-0.8	6.8	3.0	990	1,165
MSCI Emerging Markets	58,072	4.1	-0.7	8.7	0.2	-0.8	8.5	3.6	52,056	60,394
S&P 500	2,942	6.9	3.8	17.3	1.0	8.2	11.9	8.5	2,351	2,954
S&P/TSX	16,382	2.1	1.7	14.4	1.9	0.6	5.2	1.6	13,780	16,669
Morningstar National Bank Québec Index	305	2.3	3.0	17.0	5.7	4.4	9.9	9.6	252	308

Bond Markets

		Level								Last 12 months	
		2019-06-28	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.1	2.2	2.3	2.8	3.0	2.8	2.0	3.2	2.1	3.2
Ontario	10-year	2.1	2.2	2.4	2.8	3.0	2.8	1.9	3.1	2.1	3.2
Canada	10-year	1.5	1.5	1.6	2.0	2.4	2.2	1.1	2.2	1.4	2.6
United States	10-year	2.0	2.1	2.4	2.7	3.1	2.9	1.5	2.5	2.0	3.2
United Kingdom	10-year	0.8	0.9	1.0	1.3	1.6	1.3	0.9	2.7	0.8	1.7
Germany	10-year	-0.3	-0.2	-0.1	0.2	0.5	0.3	-0.1	1.2	-0.3	0.6
Canada	AA Corp. (10-year)	2.4	2.5	2.7	3.2	3.3	3.1	2.5	3.0	2.4	3.5
	BBB Corp. (10-year)	3.1	3.2	3.4	4.0	4.0	3.8	3.4	3.7	3.1	4.2
	BBB - 10-year Gov. spread	1.6	1.7	1.8	2.1	1.6	1.6	2.4	1.5	1.6	2.1
United States	AA Corp. (10-year)	2.7	3.0	3.1	3.7	3.8	3.7	2.4	3.1	2.7	4.0
	BBB Corp. (10-year)	3.5	3.8	4.0	4.6	4.5	4.5	3.3	3.8	3.5	4.8
	BBB - 10-year Gov. spread	1.5	1.6	1.6	1.9	1.5	1.6	1.8	1.3	1.4	1.9

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

Sources: Datastream, Bloomberg and AMF

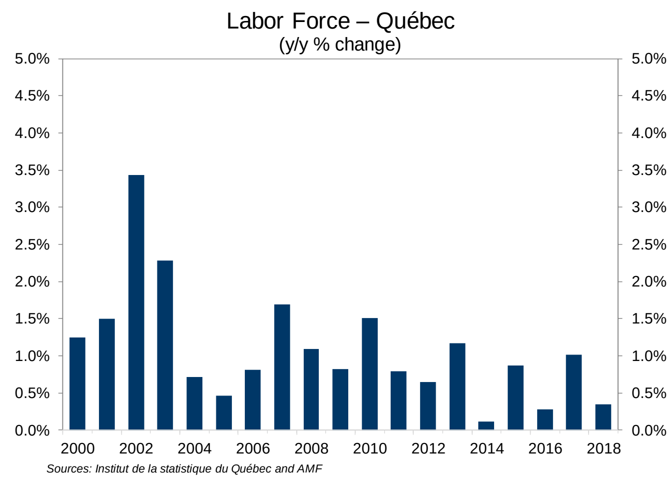
SPECIAL FEATURE

TENSIONS IN QUÉBEC'S LABOUR MARKET

With its economy doing well and an aging population, Québec is nearing, if not already at, full employment, and the effects are beginning to show. The employment rate is at an all-time high; the unemployment rate is at an all-time low; and the job vacancy rate is rising steadily.

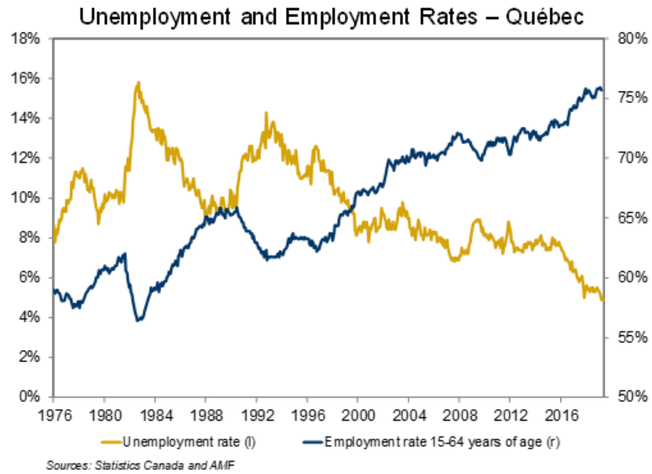
For a fourth straight year, employment continued to rise in 2018, up 0.9% or 38,900 additional jobs. The employment rate for people aged 15 to 64 peaked at 75.4%, one of the highest among OECD members.

Despite its aging population, Québec's labour force is still growing but at a slower pace—a trend begun approximately 15 years ago that has gathered momentum. The labour force stood at 4.5 million people in 2018, up 13,800. However, while the number of people in the 55-64 age group increased (+28,600), the number of people in the 15-24 and 25-54 age groups decreased (-2,800 and -12,000 respectively), reflecting the aging of the labour force.

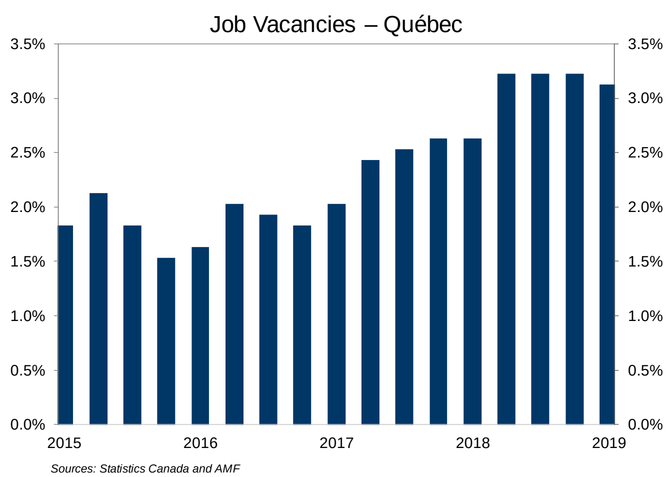


The unemployment rate has been on a downward course since its 2009 high of 8.6%. In 2018, it dropped to 5.5%, 0.6 percentage points below 2017 and its lowest level since 1976. The number of unemployed people thus fell below the 250,000 mark, declining 25,200 in one year to stand at 247,300. The average duration of unemployment decreased as well, from 20 weeks in 2017 to 18.7 weeks in 2018. The unemployment rate in Québec was lower than in Ontario (5.6%) and Canada as a whole (5.8%) in 2018, a notable reversal of the pattern of recent years.

This situation is explained by the fact that, since the recession ended, close to 410,000 jobs have been created in Québec, while the labour force has increased by 290,000. The province's unemployment rate has continued to fall in 2019, reaching a historic low of 4.9% in June.



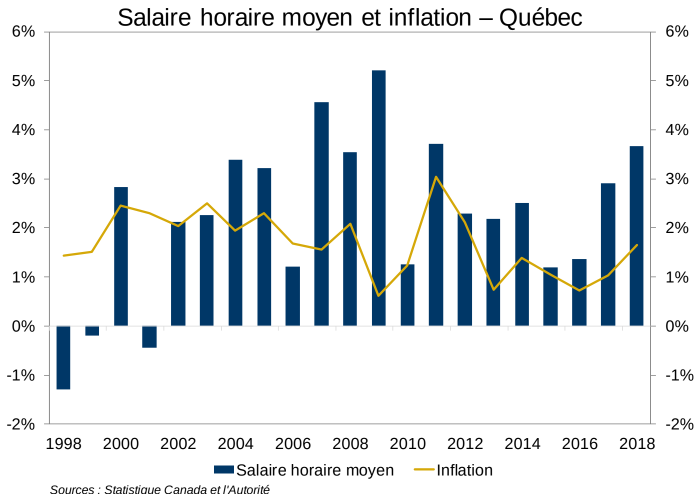
At the same time, the number of job vacancies has been rising in Québec over the past few years and totalled 114,215 in the first quarter of 2019, according to Statistics Canada. The situation is more pronounced in some regions, sectors and professions. Generally, hiring difficulties are most acute for lower-paying positions requiring minimal skills, education or experience and positions requiring a non-university certificate or diploma. The percentage of long-term job vacancies (i.e., positions vacant for more than the 90 days normally needed to fill a position) also climbed from 8.9% to 14.8% in three years.



In Québec, the job vacancy rate was 3.1% in the first quarter of 2019, the same level as for Canada as a whole. Of the Canadian provinces, only British Columbia has a higher rate, at 4.4%. What sets Québec apart, however, is that the number of job vacancies has increased almost four times faster than in the rest of Canada over the past 12 months.

The most glaring labour shortages are in the Chaudière-Appalaches, Abitibi-Témiscamingue, Côte-Nord/Nord-du-Québec, Capitale-Nationale and Montérégie regions, in terms of job vacancy rates. However, Montréal, due to its significant demographic weight, has the largest number of job vacancies, close to 40,000.

More than half of all job vacancies are concentrated in the following five sectors: manufacturing, health care and social assistance, accommodation and food services, retail trade, and professional, scientific and technical services. In the finance and insurance sector, the job vacancy rate is 3.2%, representing close to 5,000 vacant positions. These are skilled jobs paying higher-than-average wages.



The scarcity of labour has been affecting wage growth for some years now. Since 2011, wages have been rising faster than inflation in Québec. In 2018, the average nominal hourly wage grew 3.7%, while inflation was 1.7%, which translates into an increase of 2.0% in the average real hourly wage. In fact, for the past few years, wages have been rising faster in Québec than in the rest of Canada, while inflation in Québec is lower than in the other provinces.

Emploi Québec predicts that, all told, some 1,400,000 job vacancies will need to be filled from 2017 to 2026, more than 80% of which will result from retirements. The Conference Board of Canada anticipates Québec's natural population increase (i.e., the difference between births and deaths) to become negative in 2028, six years earlier than for Canada as a whole. This will significantly affect the province's economic outlook by limiting potential GDP growth and exerting pressure on public finances.

Various solutions are being considered to meet the demand for workers. Education, efforts to reduce the dropout rate, and workforce training could result in a better match between qualifications sought by employers and those offered by workers. Automating production is another possible solution, even with business investment stagnant for want of workers. In addition, an immigration policy aimed at addressing skills needs and supported by measures facilitating the integration of newcomers into the labour market would also help alleviate the labour shortage.

There are many challenges to integrating immigrants into the labour market. The recognition of foreign credentials, bureaucratic red tape, and the mismatch between skills sought and skills offered by the immigrant population appear to be barriers to the integration and increased participation of immigrants in the labour market. Lastly, the vast majority of immigrants (85%) choose to settle in Montréal, whereas a large number of job vacancies are found outside the greater Montréal area.

* * *

Québec's labour market has been so robust in recent years that the unemployment rate has fallen to an all-time low and has been below the Canadian average for a while now, with the gap even tending to widen.

The health of the Québec economy accounts only partly for the current strength of the labour market. The current labour shortage also reflects the accelerated aging of the labour force.

This situation transcends purely economic considerations and tends to limit the economy's current and future performance: it limits the economy's potential. In concrete terms, the labour shortages observed in the various sectors of the economy mean that businesses cannot move ahead with expansion plans or seize opportunities because they do not have the necessary workforce.

There are many possible solutions available. They aim to address the lack of available labour by increasing productivity (automation, process optimization) or by seeking to offset the slowdown in labour force growth through training, efforts to reduce the dropout rate, and immigration.