ECONOMIC and FINANCIAL REVIEW

Office of the Vice-President
Strategy, Risks and Performance

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AUTORITÉ DES MARCHÉS FINANCIERS

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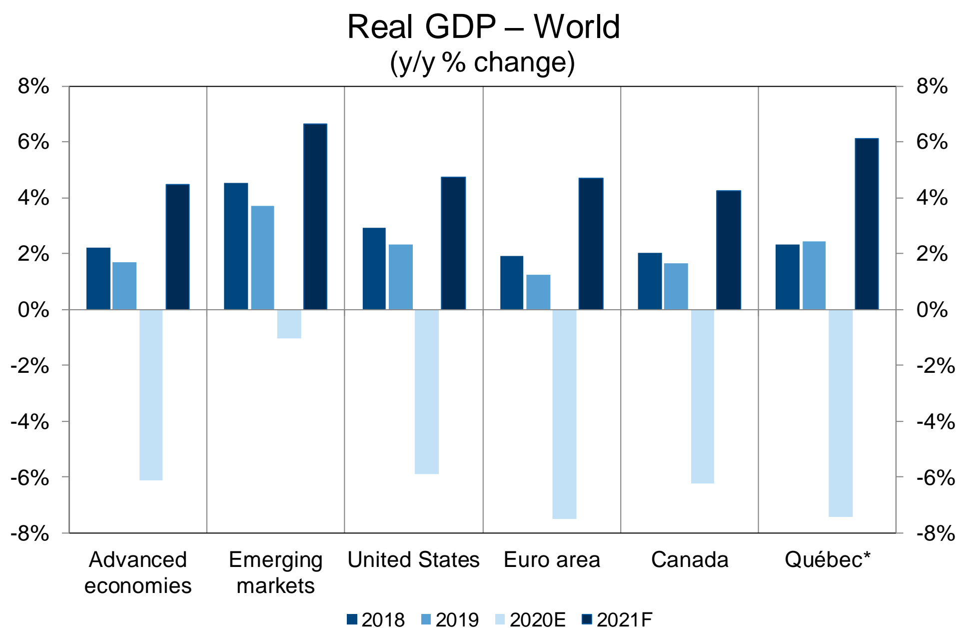
HIGHLIGHTS

- During the spring, the global economy fell without warning into a recession, pummelled by the COVID-19 pandemic. The unprecedented shock was sudden, intense and synchronized.
- In the United States, the economy shrank 5% in the first quarter, although shelter-in-place and social distancing measures did not begin until mid-March. The economy is expected to contract even further in the second quarter.
- Canada faced two shocks simultaneously: the pandemic and collapsing oil prices. The economy shrank an annualized 8.2% in the first quarter.
- Québec's economy reeled under lockdown measures, which, in some cases, were stricter and instituted more quickly than elsewhere in Canada. More than 820,000 people lost their jobs at the start of the spring, with the unemployment rate soaring to 17% in April.
- The pandemic sent a shock wave through the stock markets, triggering a steep worldwide correction. The speed of the correction was virtually unprecedented and volatility reached extreme levels. However, the decline was very quickly followed by a significant rebound.
- Growing risk aversion generated strong demand for government bonds, causing yields to fall. The downgrading of the growth and inflation outlook and the massive interventions by central banks were also key factors in the decrease in bond yields.

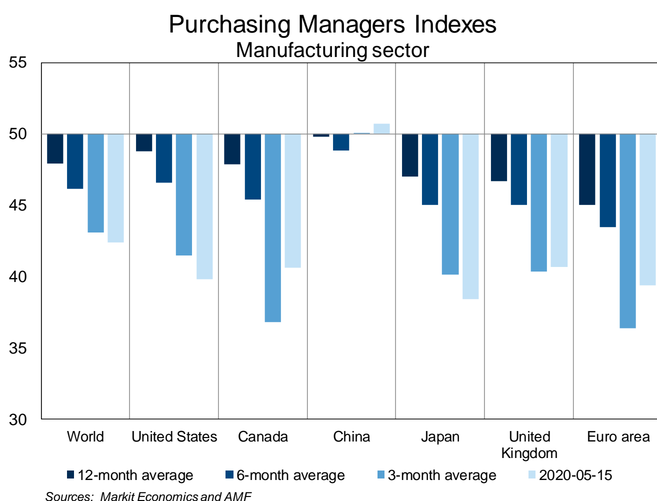


ECONOMIC CONTEXT

WORLD

During the spring, the global economy fell without warning into a recession, pummelled by the COVID-19 pandemic. The unprecedented shock was sudden, intense and synchronized. In order to contain the spread of the virus, most countries implemented lockdown measures, such as closing non-essential businesses, restricting travel and cancelling events, which put a large share of economic activity on hold.

The purchasing managers indexes provide a good idea of the extent to which global economic activity contracted. Most of the indexes fell to record lows in both the manufacturing and services sectors.



The Great Lockdown has had an impact at every level, with employment, consumption, investment, global trade and oil demand all down sharply. While the drastic measures put in place have helped save lives, they have also likely plunged the world into a severe, synchronized recession.

The uncertainty caused by escalating tensions between the West and China, the anti-racism protests in the United States, and the impasse in Brexit negotiations are exacerbating the situation.

To sustain the economy and ensure market efficiency, governments have introduced multiple stimulus plans, central banks have lowered their rates and injected liquidity, and financial regulators have provided regulatory relief.

Globally, budgetary measures to provide household income support and business loan guarantees are estimated at more than US$9 trillion. In Canada and the United States, key policy rates could remain very close to 0% for some time after the recovery begins.

The recovery will not be as sudden as the shutdown. It may, instead, happen gradually, as restrictions are lifted and production and trade resume.

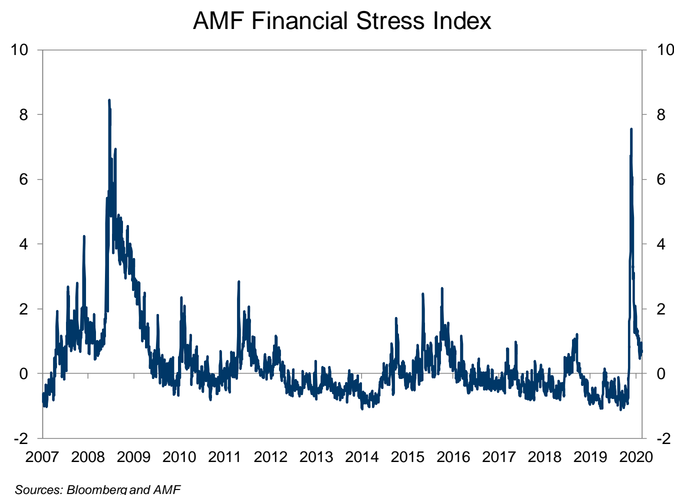
The shock wave caused by COVID-19 will also have lasting effects on the economy. Public health measures and social distancing will be maintained after activities resume, resulting in additional costs and decreased productivity. Periodic surges can be expected, which could trigger a return to temporary lockdown measures.

In addition to weak global demand and trade disputes, supply chain disruptions will also dampen the recovery in global trade. Lastly, it will be necessary to contend with a substantial increase in government, business and personal debt.

In brief, there could be many obstacles on the path to recovery, and it will take time for the economy to return to pre-pandemic levels.

The crisis has affected all financial markets. Stock markets have been highly volatile, plummeting in March before bouncing back on a wave of optimism that contrasted sharply with economic reality. From peak to trough, the S&P/TSX lost 37% of its value in the turmoil in March. Companies generally reported a sharp decline in earnings in the first quarter, cancelled dividend payments, and withdrew their forecasts for the remainder of the year amid significant uncertainty.

The shock has been brutal and is reminiscent of the 2008 financial crisis, as reflected below in the AMF financial stress index:



Sources: Bloomberg and AMF

However, with the combined support of governments, central banks and regulators, the financial markets have remained relatively resilient.

The oil markets took a particularly heavy beating amid the drop in global demand and the price war between Russia and Saudi Arabia. Oil prices plunged steeply, even falling into negative territory in the case of the WTI, then stabilized when the producer nations agreed to cut production by 9.7 million barrels per day. Global demand is now starting to show signs of recovery as economies reopen, and world oil prices have begun to turn around.

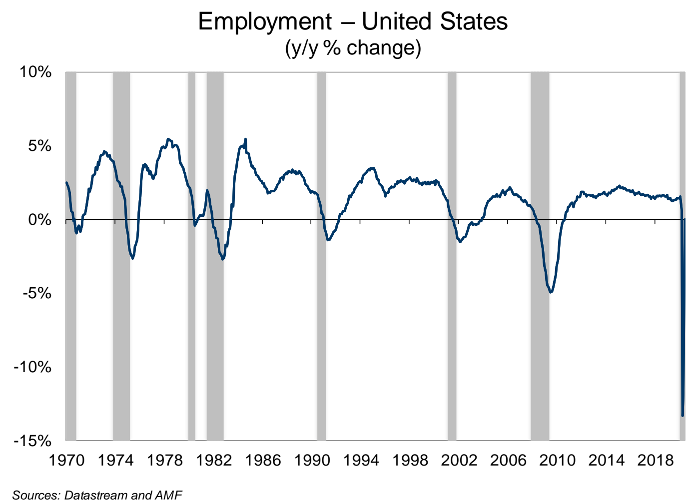
United States

The U.S. economy shrank 5% in the first quarter, despite the fact that shelter-in-place and social distancing measures began late in the third quarter, in the last two weeks of March. The economy is expected to contract even further in the second quarter. Analysts are forecasting a record decline in GDP of up to more than 40% on an annualized basis, for a 12% pullback from its peak at the end of 2019.

The U.S. government passed one of the most robust emergency relief and stimulus packages of any developed country. Estimated at more than US$2 trillion, the package provides direct support to individuals and families and financial support to businesses experiencing hardship.

The coronavirus pandemic brought a large part of the U.S. economy to a halt, leading close to 40 million Americans to apply for unemployment benefits. Forced to close temporarily, businesses cut staff to the strict minimum. As a result, consumer spending, residential construction and industrial production all fell dramatically and employment collapsed.

Skyrocketing layoffs caused an unprecedented drop in employment, with more than 22 million jobs being lost in March and April. The jobless rate hit 14.7% in April before declining slightly in May. Prior to the lockdown, the unemployment rate was just 3.5%, the lowest level in 50 years.



Sources: Datastream and AMF

As the labour market picks up again, millions of jobs will be added back, depending on the pace at which the economy reopens and recovers. This is what happened in May, for example, when employment rebounded with the addition of 2.5 million jobs. However, it is unlikely that all jobs lost will be recouped, as some businesses will be very slow to resume operations, while yet others may close permanently.

From the start of the lockdown, the Federal Reserve rolled out its full arsenal to minimize the damage to the economy and financial system. Specifically, it cut its key policy rate by 150 basis points to its rock-bottom target range of 0%-0.25%, provided liquidity, set up lines of credit to ensure financial market efficiency, and implemented a quantitative easing program involving massive purchases of public and private debt securities in order to ensure that households and businesses continued to benefit from highly flexible credit terms.

The measures seem to have paid off. Following the initial shock, the level of financial stress declined

quickly in the weeks after the measures were introduced.

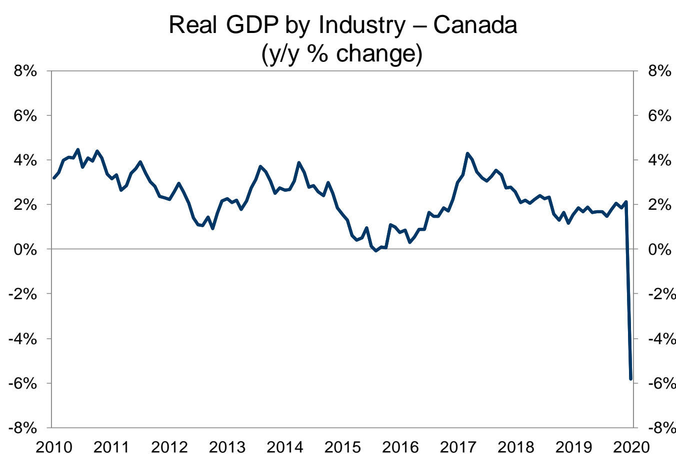
The Federal Reserve says it is prepared, if necessary, to use its full range of tools to their full potential until the crisis is over and the recovery is well entrenched. The policy rate should therefore remain at rock bottom for some time to come.

For the past several weeks, the country has, in phases and at rates that vary from state to state, been gradually reopening its economy. Economic activity is therefore slowly picking up and new unemployment insurance claims are continuing on a downward track. However, despite the pick-up in the economy, the jobless rate could still remain very high from now until the end of the year, and it may be a while before economic activity returns to pre-pandemic levels.

CANADA

Canada was confronted simultaneously with the effects of the lockdown and social distancing measures on production, demand and employment and with collapsing oil prices.

The measures introduced in an attempt to control the virus' spread resulted in an unprecedented decline in many activities. As in other countries, the air traffic, tourism, food and beverage services, accommodation and entertainment industries were among the hardest-hit sectors. Other sectors took a beating as well: manufacturing, construction and retail trade posted abrupt, unprecedented declines in activity.



Sources: Statistics Canada and AMF

The economy shrank significantly in the first quarter, with GDP falling an annualized 8.2%. Consumer spending declined 9%, while exports fell 11.3%. A much larger contraction of the economy is anticipated for the second quarter.

Business closures pushed the unemployment rate up from 5.5% in January to 13.7% in May, the highest unemployment rate recorded in Canada since the figure was first published. Employment fell by 3 million jobs from February to April, but the labour market bounced back in May, adding nearly 290,000 jobs. In addition to the people who lost their jobs, millions more saw their work hours reduced.

The various levels of government have introduced energetic measures, especially to offset the temporary loss of income suffered by households and businesses during the crisis. The purpose of these measures is to replace much of the income lost by workers and ease the pressure on personal finances.

The Bank of Canada lowered its key policy rate to its rock-bottom target range of 0%-0.25% in March. It also took a number of steps to ensure financial market efficiency and credit availability and reduce debt servicing costs. These included engaging in quantitative easing through various programs enabling it to make massive purchases of public and private debt—a first for the Bank of Canada.

The collapse of global oil prices is also weighing very heavily on the economy of Canada, especially Alberta. Oil prices hit a low in April and have recovered only gradually. Moreover, for the last few years, the oil sector has been grappling with limited transportation capacity, which is creating bottlenecks. As a result, production, employment and investment in this sector are down substantially, while expansion plans have repeatedly been revised downward.

Although Canada is now in the process of opening up, there is an unusual degree of uncertainty regarding the expected speed at which the economy will recover. How fast the recovery will be will depend on many factors that are difficult to foresee. It seems increasingly certain, however, that the Canadian economy will take several quarters to fully recover.

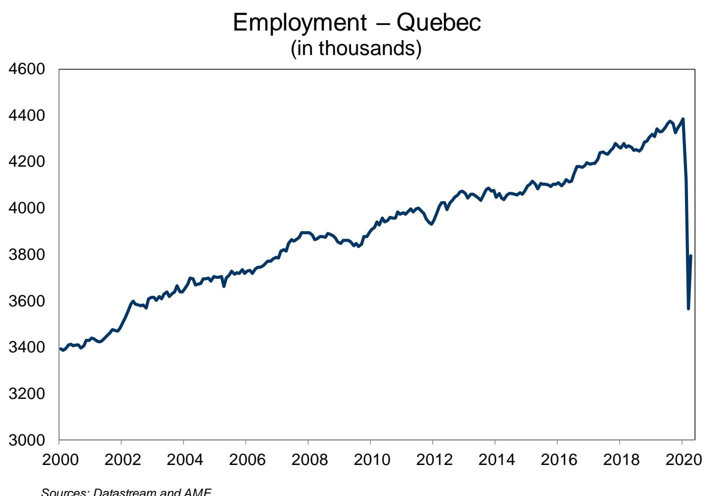
QUÉBEC

Before COVID-19 reached Québec, the economy was running at full tilt, the unemployment rate was at its lowest point in 40 years, and GDP growth was outpacing the rest of Canada.

Despite some already clearly identified vulnerabilities, such as the labour shortage, the aging of the population, and household debt, economic activity was supported by solid underpinnings and diversified growth areas. Contribution to GDP growth was broadly based across the various components of private domestic demand, the public sector and exports.

Québec's economy initially reeled under lockdown measures, which, in some cases, were stricter and instituted more quickly than elsewhere in Canada. The shutdown had an almost immediate impact on employment and the unemployment rate.

More than 820,000 people lost their jobs at the start of the spring, with the unemployment rate soaring to 17% in April. Montréal saw the largest drop in employment among major Canadian cities. The job market recouped some of its losses in May, with employment jumping by more than 230,000 jobs and the unemployment rate falling a few points to 13.7%, the same level as Canada as a whole. Still, despite this sizable rebound, employment remains well below its recent peak.



Sources: Datastream and AMF

The real estate market, which had been as robust as the economy as a whole prior to the pandemic, also came to a brief halt. Sales, listings and visits slowed sharply, while the temporary construction shutdown ordered by the government meant there were no housing starts in April. The latest data indicates that, while sales fell, prices nonetheless kept rising.

The type of recovery awaiting the residential housing market remains very uncertain. The easing of financial conditions is supporting the normalization and resumption of economic activity. However, labour market conditions will play a key role in determining the shape of the recovery.

Canadian and Québec households went into the crisis with high debt levels. The drop in income resulting from unprecedented job losses could push the household debt ratio even higher. Moreover, tighter qualification criteria for CMHC mortgage insurance could also slow the real estate market recovery.

As restrictions are lifted, the economy will recover. In fact, the economy began to bounce back in May and June as businesses and industries gradually reopened. In many cases, public health measures implemented to protect workers and customers will push up the costs of producing goods and delivering services.

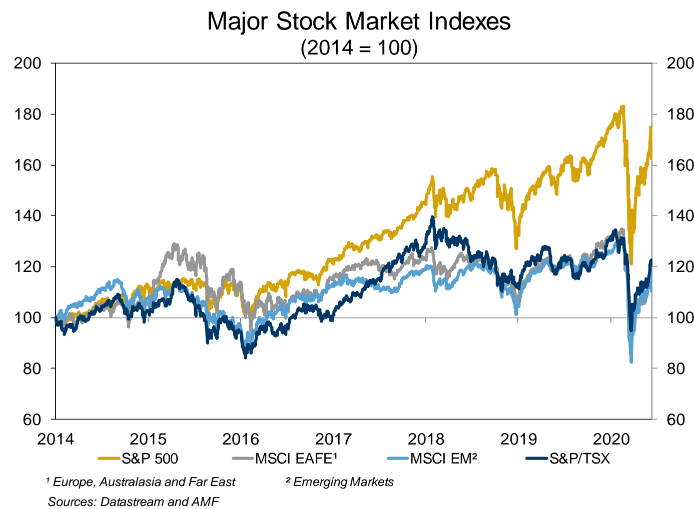
Amid generally weak private domestic demand, public sector support will play a vital role in the recovery. Maintaining flexible financial terms throughout the various phases of reopening will also be key.

FINANCIAL MARKETS

STOCK MARKETS

The pandemic sent a shock wave through the stock markets, triggering a steep correction. The speed of the correction was virtually unprecedented, and volatility reached extreme levels. However, from peak to trough, the decline was relatively limited in size, compared with other bear markets in recent history, and was quickly followed by a significant rebound.

Major Stock Market Indexes
(2014 = 100)



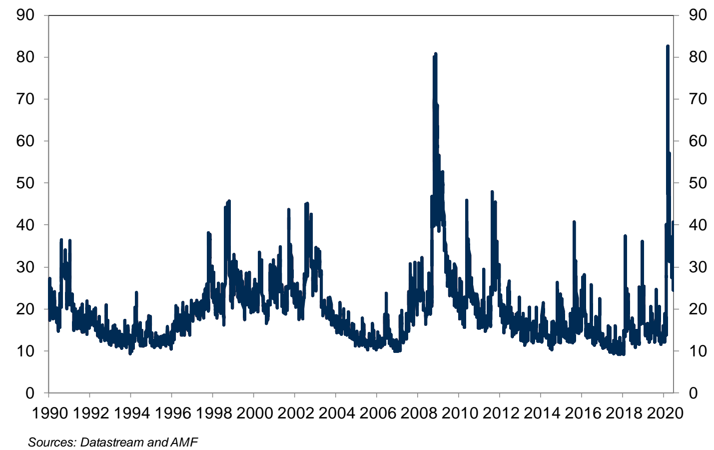
[1] Europe, Australasia and Far East [2] Emerging Markets

Sources: Datastream and AMF

The correction started in mid-February, when the number of COVID-19 cases outside of China began to rise, particularly in South Korea and Japan. When large numbers of cases appeared in Iran and Italy, investors had to come to face fairly quickly with the possibility of a global pandemic. As the virus gained a firm foothold in other European countries and North America, the stock markets plummeted, reaching a low on March 23.

Volatility increased significantlyy during this time. The CBOE Volatility Index (VIX), which had peaked at 80.9 points during the crisis of 2008, hit an all-time record of 82.7 points at the height of the current crisis. The circuit breakers introduced by regulators to ensure market efficiency, which temporarily put a halt to trading during highly volatile periods, were triggered a number of times. In Canada, market-wide circuit breakers were triggered four times in March, when volatility was at its highest levels.

Volatility Index
(VIX on S&P 500)



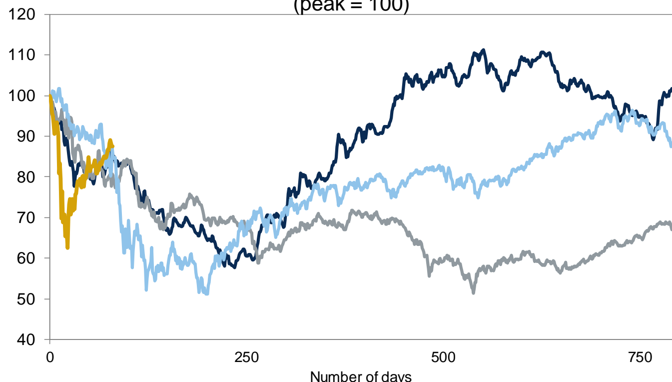
Sources: Datastream and AMF

The decline was steep and sharp, but was followed by an equally steep and sharp rebound. The rapid, unprecedented response by governments and central banks quickly calmed the situation. Investors were subsequently heartened as the spread of the virus stabilized somewhat and several major economies gradually reopened. Declining bond yields made the stock markets more appealing, helping to push up valuation indicators such as the price-earnings ratio.

At the time of writing, the major indexes have recouped much of the ground lost since the start of the crisis. The S&P/TSX has rebounded 34% from its March low and is now 16% below its February peak. The S&P 500 has bounced back 34% and is 11% below its peak.

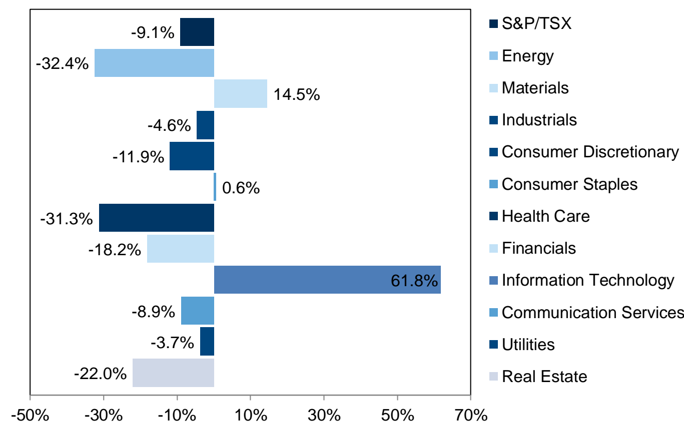
The Nasdaq, which includes many technology companies, is currently close to its pre-crisis high.

From a historical perspective, this bear market is, for now, within the average for bear markets in terms of peak-to-trough index variations. In the case of the S&P/TSX, for example, the bear markets during the 2008 financial crisis, the 2000 tech bubble, and the 1981 recession posted much steeper declines and it took several years to recoup the losses. The current bear market stands out because of the speed at which stock prices have fallen and then rebounded.



The current market rebound may seem surprising given that economic and public health situations are still fragile. Some analysts are talking about a bear market rally, a short-lived rise followed by another correction. With many past bear market rallies, such as those in 1981 and 2000, there was a lull and then a second correction.

Investors nevertheless seem to have excercised considerable judgment in assessing the different sectors and companies. There is a significant performance disparity between the sectors hit hardest by the pandemic, such as Energy and Financials, and less-hard-hit sectors like Information Technology.



Moreover, large-cap companies, which are typically in a better position financially to weather a crisis, outperformed small caps.

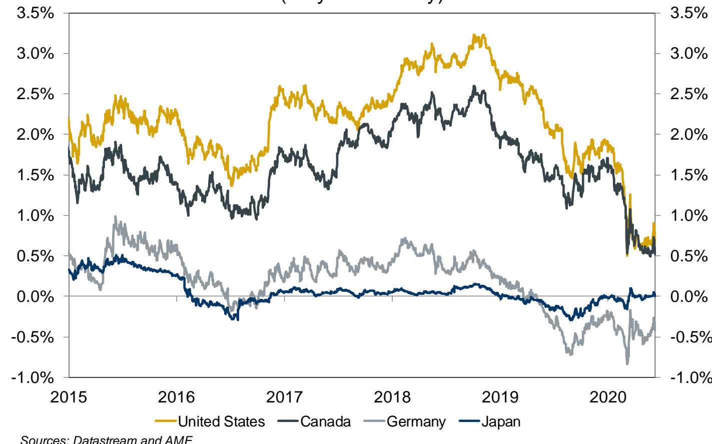
Lastly, TSX companies headquartered in Québec underperformed the companies making up the S&P/TSX index as a whole. The Morningstar National Bank Québec Index has returned -19% since the start of the year, compared with -12% for the S&P/TSX index. Québec companies in the Consumer Discretionary, Industry and Financials sectors underperformed total companies in those sectors.

Investors in Canada and elsewhere are banking on a gradual economic recovery and effective monetary and fiscal policy support. They are heartened by how well the re-opening has gone so far. How the markets fare will depend on the speed at which the economy recovers and how the earnings growth outook evolves. The biggest risk facing the markets is a potential second wave of the pandemic.

BOND MARKETS

Bond yields fell sharply as a result of the COVID-19 crisis. Growing risk aversion generated strong demand for government bonds. The downgrading of the growth and inflation outlook and massive interventions by the central banks were also key factors in the decrease in long-term yields.

With economies gradually reopening, yields have bounced back slightly in the last few weeks, but, at the time of writing, they are still close to their lows.



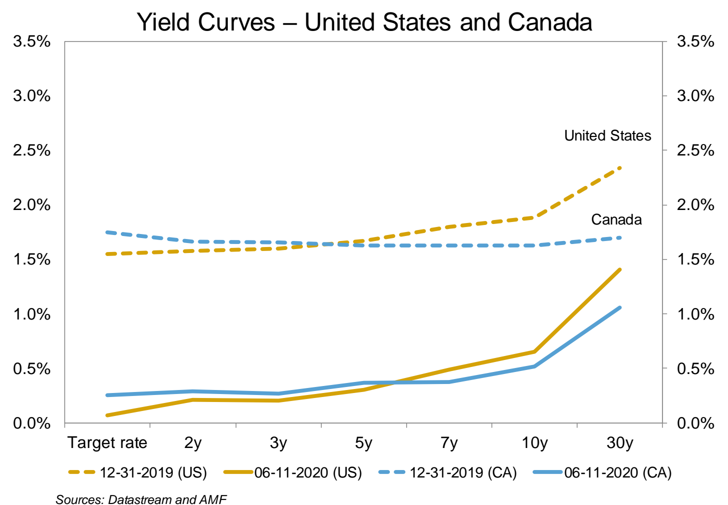
In the United States, U.S. government 10-year yields are currently around 0.7%, compared with 1.9% at the start of the year. It is worth noting that yields were extremely low by historical standards even before the public health crisis began.

In March, when uncertainty was at its height, yields were very volatile, with sudden, steep increases occurring over a number of days despite a basic downward trend.

In the U.S., as elsewhere in the world, the low yields reflect an expectation of weaker economic growth and an output gap that will likely last for a while. Calculated using real return 10-year bonds, inflation expectations have declined significantly since the start of the pandemic and are now at around 1.2%. Given this, the Fed will keep its rates at rock-bottom levels and will continue to buy large quantities of bonds for several more quarters.

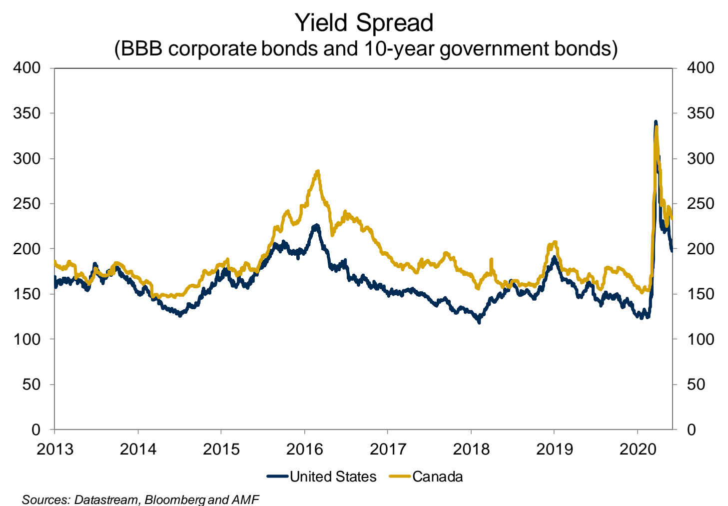
In Europe, major countries' bond yields, which, in some cases, were already in negative territory before the crisis, have also declined or remained extremely low. Southern European countries, where public finances are generally shakier, initially saw their bond yields rise, but those increases were quickly reversed due, in particular, to massive interventions by the European Central Bank.

Bond yields have followed the same trend in Canada. The Government of Canada 10-year yields are currently at around 0.5%, down from 1.6% at the beginning of the year. The Bank of Canada quickly introduced an array of measures to support the economy, including Government of Canada bond, provincial bond and Canadian corporate bond purchase programs. These interventions, along with the economic environment, exerted downward pressure on bond yields.



Sources: Datastream and AMF

The pandemic has led virtually all countries in the world to reassess risk, particularly in relation to corporate bonds. Yield spreads between corporate and government bonds jumped at the start of the crisis but have stabilized more recently owing, in particular, to unprecedented interventions by governments and central banks. Liquidity levels dropped significantly in the corporate bond market, but the situation has since improved.



Sources: Datastream, Bloomberg and AMF

In Canada and elsewhere, corporate debt has risen considerably over the last decade, a trend that could deepen in some sectors due to the effects of the pandemic.

Many investment funds are exposed to corporate debt and may have been negatively impacted by tensions in the bond markets. Last month, to help facilitate a more orderly liquidation of fixed income securities, the Canadian Securities Administrators temporarily

increased the short-term borrowing limits for mutual funds investing in fixed income securities.

At the start of the crisis, some fixed income exchange-traded funds (ETFs) were trading on the markets at prices that diverged from their net asset value. This situation, a result of difficulties in calculating net asset value when the underlying markets are less liquid, reversed fairly quickly. The ETF market was also able to accommodate a substantial increase in trading volume during that period.

The low-rate situation caused by the public health crisis is likely to prevail for at least several more quarters. Even though the crisis should continue to subside, the economic impacts are expected to, at best, fade gradually, giving the central banks reason to remain highly accommodating.

Market Performance

Stock Markets		Level	% change							Last 12 months	
		2020-06-11	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index		603	3.7	8.7	-6.1	-2.2	0.3	3.5	3.9	460	683
MSCI EAFE[1]		1,042	5.4	7.4	-10.9	-8.0	-6.5	-2.2	-0.9	842	1,219
MSCI Emerging Markets		56,948	6.3	5.4	-3.6	-0.3	-0.8	1.7	2.3	44,713	63,411
S&P 500		3,002	2.4	9.5	-4.4	0.0	4.0	7.3	7.3	2,237	3,386
S&P/TSX		15,051	-0.3	5.5	-11.1	-9.4	-7.4	-0.9	0.3	11,228	17,944
Morningstar National Bank Québec Index		262	2.2	-1.6	-18.5	-15.3	-12.9	0.3	2.3	201	337

Bond Markets		Level								Last 12 months	
		2020-06-11	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	1.4	1.5	1.6	2.2	2.1	2.2	2.1	2.7	1.3	2.3
Ontario	10-year	1.4	1.5	1.6	2.2	2.1	2.2	2.1	2.6	1.4	2.3
Canada	10-year	0.5	0.6	0.7	1.6	1.4	1.5	1.4	1.8	0.5	1.7
United States	10-year	0.7	0.7	0.9	1.8	1.7	2.1	2.2	2.4	0.5	2.1
United Kingdom	10-year	0.2	0.3	0.3	0.8	0.6	0.9	1.0	2.0	0.2	0.9
Germany	10-year	-0.4	-0.5	-0.7	-0.3	-0.6	-0.2	0.3	0.9	-0.9	-0.2
	AA Corp. (10-year)	1.7	1.8	1.9	2.5	2.5	2.5	2.5	2.9	1.7	2.8
Canada	BBB Corp. (10-year)	2.7	2.9	2.9	3.2	3.2	3.2	3.2	3.6	2.6	4.2
	BBB - 10-year Gov. spread	2.1	2.3	2.2	1.7	1.8	1.7	1.8	1.8	1.5	3.3
	AA Corp. (10-year)	1.7	2.1	2.1	2.4	2.5	2.9	3.0	3.3	1.7	3.3
United States	BBB Corp. (10-year)	2.5	3.1	2.7	3.1	3.2	3.7	3.7	4.2	2.3	4.2
	BBB - 10-year Gov. spread	1.8	2.4	1.8	1.4	1.5	1.6	1.5	1.8	1.2	3.4

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

Sources: Datastream, Bloomberg and AMF

NOTE

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