



# Economic and Financial Review

July 14, 2023

Office of the Chief Economist



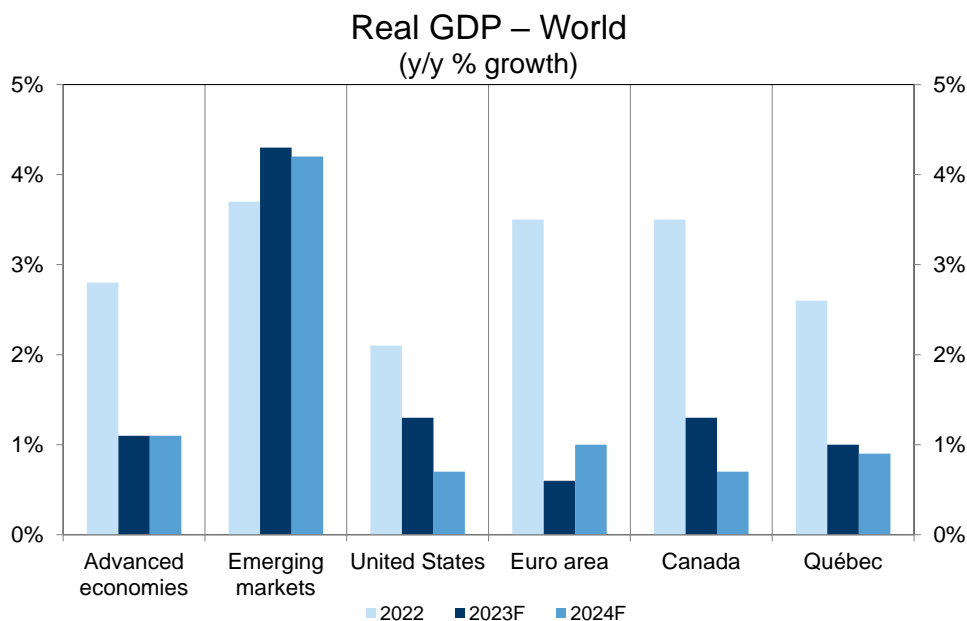
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# Highlights

- The global economy is appearing less and less synchronized, with growth and inflation beginning to diverge across countries. Monetary policy is heading in different directions: paused in the United States, tightened in Europe and loosened in China.
- In the second quarter, the United States was rattled by yet another bank failure and the debt ceiling crisis. Despite this, the U.S. economy remained relatively strong, posting 2% growth in the first quarter.
- In Europe, the 20-country euro area, pulled down by the German economy, entered a recession this past winter. The slide in GDP was largely due to reduced household consumption and government spending.
- The Canadian economy started the year on a positive note, with GDP growing 3.1% in the first quarter owing mainly to a rapid rebound in consumer spending.
- At 1.7%, Q1 economic growth was much weaker in Québec than in Canada as a whole. The rise in Québec GDP is largely due to a rebound in consumption, with investment showing signs of softening.
- Stock markets were generally up in the second quarter, buoyed by the solid performance of technology stocks.
- On the bond markets, yields resumed their upward trajectory in the face of a resilient global economy, persistent inflation and the increasing likelihood of further monetary tightening.



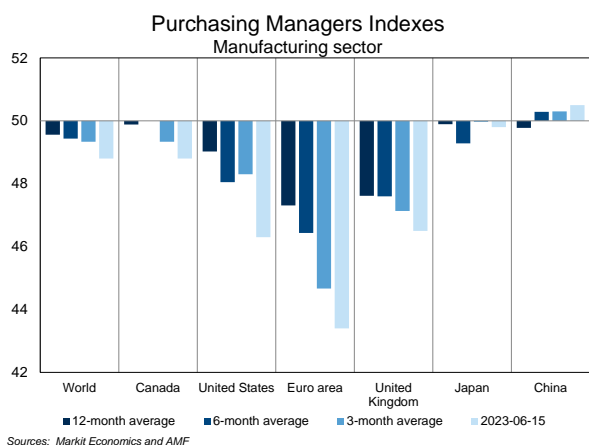
# Economy

## World

The global economy is appearing less and less synchronized, with growth and inflation beginning to diverge across countries. In the United States, the economy remains strong, and inflation has declined. Conversely, the euro area is in a technical recession, and inflation there is more persistent. In China, although inflation is not an issue, the economy is struggling to regain momentum. As a result, monetary policy is heading in different directions: paused in the United States, tightened in Europe and loosened in China.

Inflation in most advanced countries, while still above the central banks' target of 2%, continued to decline from the peaks reached in 2022. However, core inflation, which excludes more volatile items such as food and energy, is proving more persistent. The central banks have signalled that policy rates will stay higher for longer and that there may be further hikes between now and the end of the year.

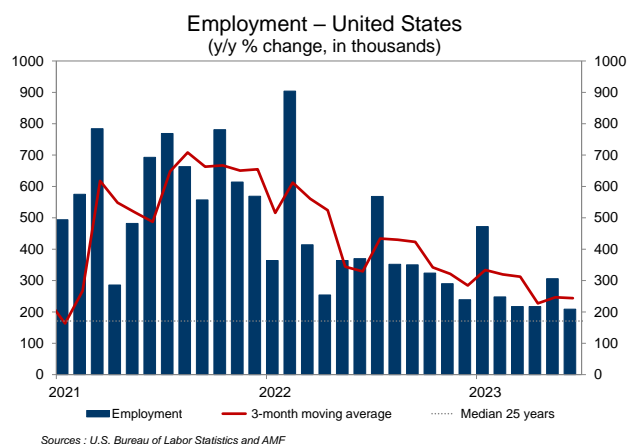
In June, the manufacturing purchasing managers indexes were down across all major advanced economies and were under 50, pointing to a contraction of economic activity.



In the United States, the economy remains relatively strong despite the crises that have shaken the country. The second quarter saw a continuation of the regional banking crisis, with the demise of yet another institution, First Republic Bank. Contagion to the entire banking system was avoided, however. Under the supervision of the regulatory authorities, the bank was seized and sold to JPMorgan Chase, which took over its deposits and acquired most of its assets.

In June, Congress struck a last-minute deal to raise the debt ceiling until the end of 2024, thereby avoiding default and the incalculable consequences it would have had. The deal includes caps on certain types of government spending.

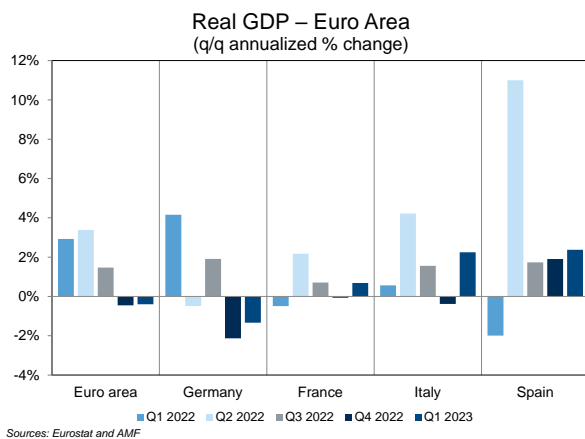
Despite this upheaval, economic activity continues to be steady. GDP was up an annualized 2% in the first quarter, buoyed by household spending and a strong job market. The jobless rate has been under 4% for over a year now, and jobs are still being created at a rapid pace. However, unemployment insurance claims have been on the rise for some time now.



Inflation fell to a two-year low of 3% in June, although core inflation continues to be high, at 4.8%. The Federal Reserve decided to pause its monetary tightening while it assessed the

impact of 10 consecutive hikes in its key policy rate, which continues to be within a range of 5% to 5.25%. However, the Fed is expected to tighten the monetary screws again during the next meeting of the Federal Open Market Committee at the end of July.

In Europe, the 20-country euro area entered a recession this past winter, pulled down by Germany, despite the fact the other three major euro-area economies (France, Italy and Spain) posted positive growth in the first quarter. The slide in GDP was largely due to a pullback in household consumption and government spending. Despite the slowdown in activity, job creation remained strong in the euro area, with the unemployment rate reaching a record low of 6.5%.



Inflation was 5.5% in June, down from last fall's peak of 10.6%. Core inflation in the euro area also continues to be above 5%. To address this situation, the European Central Bank (ECB) hiked its key policy rate 25 basis points to a 22-year high of 4% and signalled that further increases are still to come, despite the slowing economy. The ECB revised up its projections for inflation and withdrew the stimulus measures introduced in response to the pandemic.

In the United Kingdom, inflation, after spending more than six months above 10%, finally came down, falling to 8.7% in May, which is still high compared to other advanced economies. The

Bank of England went ahead with a thirteenth consecutive increase, raising the rate to 5%.

In China, the economic recovery is already starting to lose steam less than six months after the termination of the country's zero-COVID policy, which had paralyzed the economy for the past few years. Although growth reached 4.5% in the first quarter, the most recent economic indicators point to a slowdown.

After rebounding early in the year, Chinese household consumption is now growing at a more moderate pace. In the face of weak global demand, Chinese exports are struggling to take off. Manufacturing activity is declining. Residential investment is idling owing to household jitters caused by recent woes in the sector.

More broadly, the Chinese economy is being hampered by several structural issues, including household and local government indebtedness, population aging and trade tensions with the West.

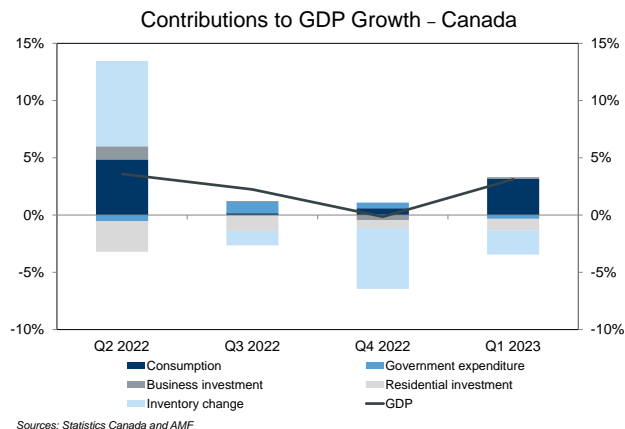
To breath new life into its economy, the Chinese central bank cut its key policy rate in June in a surprise move designed to, among other things, stimulate household consumption. Unlike the rest of the world, inflation in China is close to zero.

## Canada

The Canadian economy started the year on a positive note, with GDP growing 3.1% owing mainly to a rapid rebound in consumer spending. This was somewhat surprising given the expectation that increasing interest rates and tightening financial conditions would slow the economy.

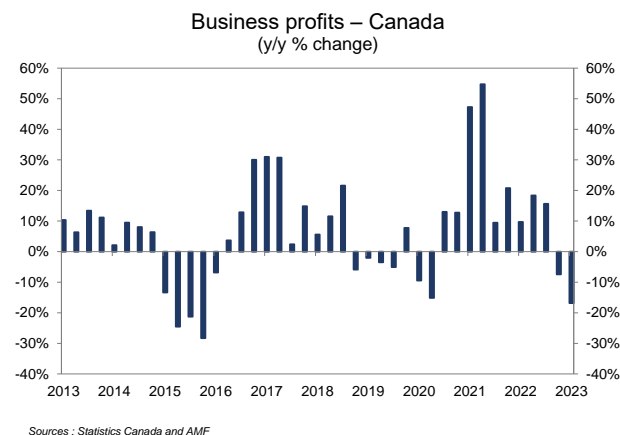
Aside from consumption, the other segments of domestic demand were more subdued. The contraction of business investment and the

residential sector stands in contrast to consumer resilience.



The performance of the economy has helped keep the labour market at full employment and is a prime example of the situation of excess demand in which the Canadian economy finds itself. Although the pace of job creation has eased since the beginning of the year, it continues to be robust.

However, job creation is expected to slow in the coming months in tandem with the economy as a whole. Employers are struggling with low productivity, significantly higher wages and unit labour costs and a consequent profit squeeze. After three consecutive quarterly declines, profits shrank 16.8% in the first quarter.



Given the situation of excess demand and full employment, it is not surprising that inflation is proving to be more stubborn than expected.

After pausing for several months while it assessed the state of the Canadian economy, the Bank of Canada hiked its key policy rate a further 25 basis points in both June and July, bringing it to 5%.

The monetary authorities are maintaining a restrictive stance, signalling that further policy rate increases may be needed to calm demand and ease inflationary pressures if the strength of the economy proves persistent.

It usually takes 18 to 24 months for the full effect of rate hikes to play out in the economy. Higher borrowing costs are expected to eventually impact growth, employment and consumption.

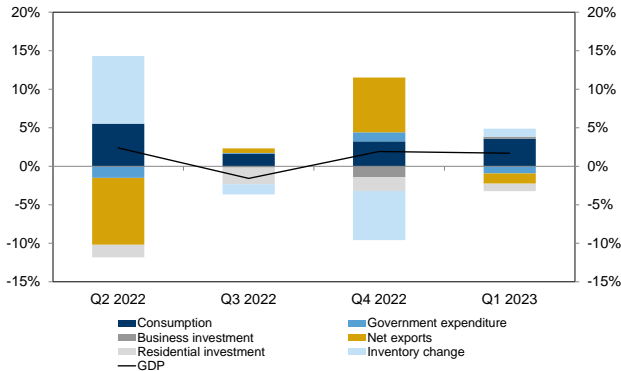
Many households have already renewed their mortgages at higher interest rates, and other households will have to do so during this and coming years. The resulting reduction in disposable income will force them to make saving and consumption choices and slow their discretionary spending.

In these conditions, the Canadian economy is expected to slow, and possibly even contract, in the coming months. The weaker growth will potentially translate into higher unemployment and bring about conditions for a gradual decline in inflation.

## Québec

Economic growth in the first quarter, at 1.7%, was much lower in Québec than in Canada as a whole. The rise in Québec's GDP is largely due to rebounding consumption, with investment showing signs of softening.

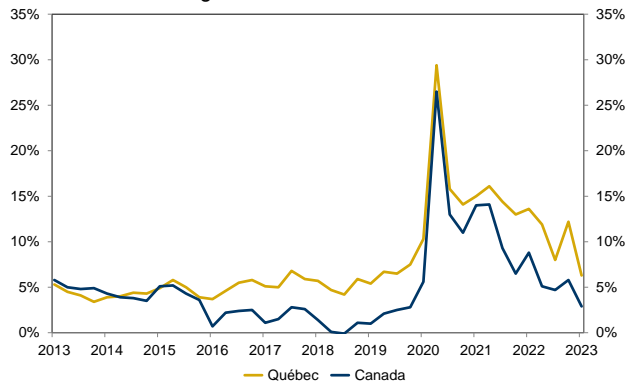
Contribution to GDP Growth – Québec



Sources: Institut de la statistique du Québec and AMF

Bolstered by the high savings levels of Quebeckers, household spending rose 6% in the first quarter and was a key factor in GDP growth. Household spending was primarily concentrated in the services sector, with more subdued activity in the goods sector. The savings rate, however, fell from 12.2% to 6.3%.

Savings rate – Québec and Canada



Sources : Institut de la statistique du Québec, Statistics Canada and AMF

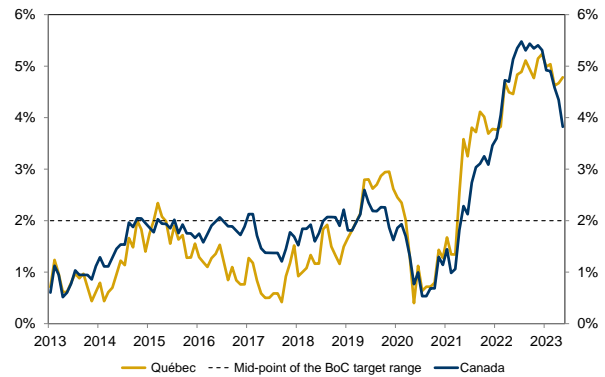
Business investment grew 3%, despite lower investment in machinery and equipment. In contrast, residential investment continues to decline. Net exports shaved 1.3 percentage points off GDP growth owing to a cooling global economy.

There has been a slight slowdown in the labour market in recent months, with job creation over the previous three months posting a net gain of 3,700 jobs in June. Except for April's figures, the cumulative pace of job creation has been gradually decreasing since February. The unemployment rate now stands at 4.4%.

Without erasing the signs of strong demand, the lower job vacancy rate (4.9%) indicates a moderate easing of labour market tightness. This tightness continues to be more severe in Québec than in the rest of Canada, where the job vacancy rate is 4.4%. Wage growth slowed to 4.2% year over year.

Québec can also claim the dubious distinction of being the province with the highest rate of core inflation (i.e., not including energy and food prices). Core inflation reached 4.8% in May, higher than in April.

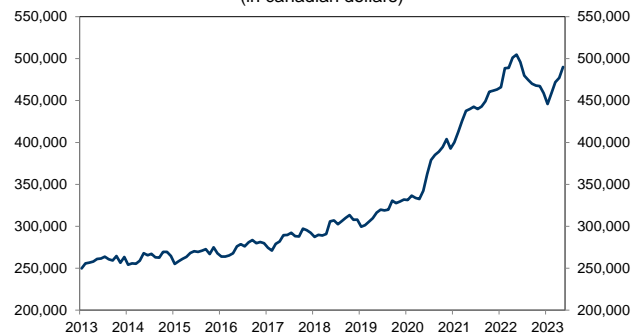
Core Inflation Rate – Québec and Canada



Sources : Statistics Canada and AMF

Residential real estate market activity seems to be stabilizing. After a price correction a year ago, prices resumed their upward trajectory in February. The average housing price is now only 3% below the previous peak. Sales have also picked up again but remain approximately 33% below the peak reached in 2021. Given the overall environment, this recovery is unlikely to be genuinely sustainable.

Weighted Average Housing Price – Québec (in Canadian dollars)



Sources : Centris and AMF

Québec owes its resilience to strong consumer spending, which has counteracted the other, weaker components of demand. However, the rapid pace at which households have been spending their savings for this to happen is not sustainable.

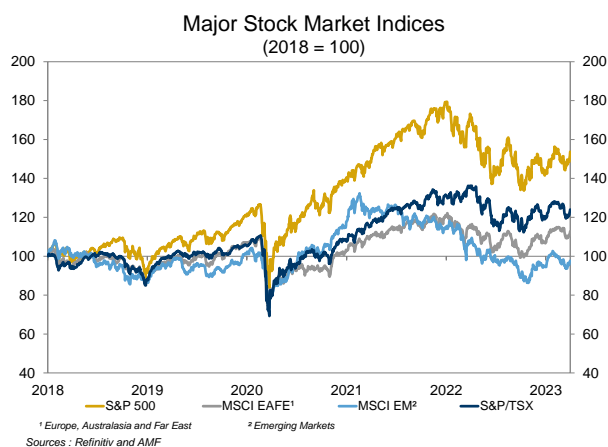
The Québec economy is not insulated from the global economic slowdown and tighter borrowing conditions. All signals indicate that Québec will experience an economic downturn in the coming months.



## Financial markets

Stock markets were generally up in the second quarter, buoyed by the solid performance of technology stocks. Investors successfully navigated a difficult environment that included banking sector stress and uncertainty surrounding the raising of the U.S. debt ceiling.

On the bond markets, yields resumed their upward trajectory in the face of a resilient global economy, persistent inflation and the increased likelihood of further monetary tightening. However, further tightening of monetary conditions and relatively high recession risks will mean the next few quarters will be fraught with risk for the financial markets.

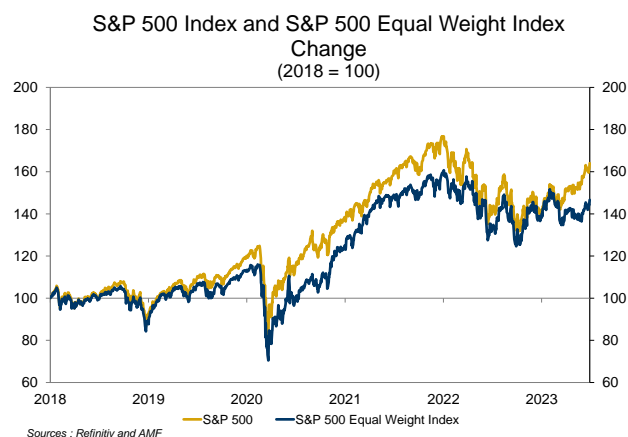


In the United States, the solid performance of technology stocks allowed the S&P 500 to post a gain of 8.3% in the second quarter. In recent weeks, the flagship index has risen more than 20% from its most recent trough in October 2022, entering a bull market, as per the most widely used definition of the term.

The NASDAQ recorded an impressive gain of 12.8% for these same reasons. The strong performance of technology stocks was partly due to investor appetite for artificial intelligence, advances in which appear to be accelerating.

The extent to which some major tech stocks have outperformed the rest of the market can be illustrated by comparing changes in the overall S&P 500 Index against changes in the S&P 500 Equal Weight Index. The companies on the S&P 500 Equal Weight index are the same as those on the S&P 500 Index but are given equal weight rather than being weighted by market capitalization.

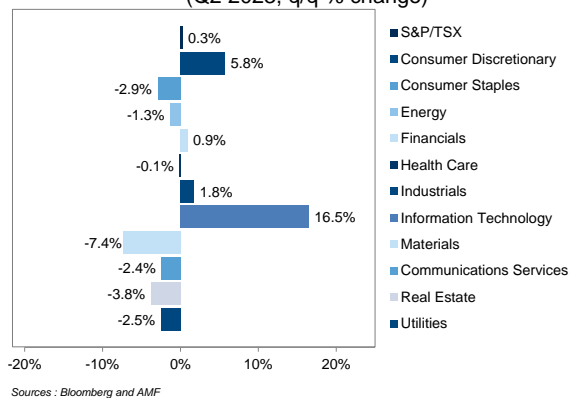
The S&P 500 Equal Weight Index has returned only 6% since the start of the year, compared with 16% for the S&P 500. Valuation levels in the Information Technology sector are relatively high when compared against the overall market.



Canada's S&P/TSX did not fare as well, returning essentially zero in the second quarter. Technology stocks posted a very solid performance on the S&P/TSX Index, also; however, because the sector is weighted less heavily in the Toronto index than in the S&P 500 (8% versus 28%), they made a smaller contribution to changes in the overall index.

Financials, the largest sector of the S&P/TSX with a weighting of around 30%, posted a slight increase of 0.9%. This weak growth is due in part to the earnings of Canadian banks, which have suffered from the less favorable economic climate.

Performance of the Main S&P/TSX Subindexes (Q2 2023, q/q % change)



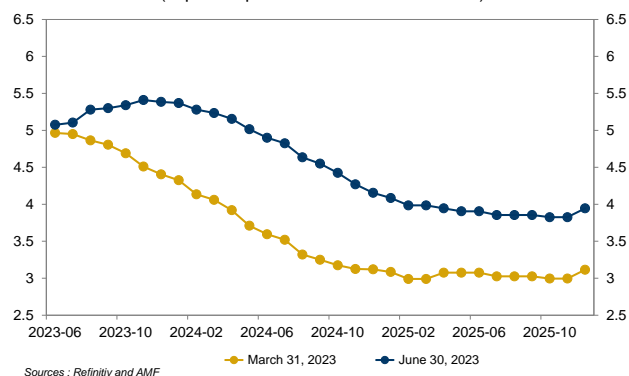
The S&P/TSX Energy sector declined slightly. Owing to weak global demand, the price of oil has fallen in recent months, despite oil output cuts by OPEC and its partners.

Lastly, Québec-based companies generally performed in line with the S&P/TSX index. The Morningstar National Bank Québec Index posted slight growth of 1.4% over the quarter, weighed down by a drop in Consumer Staples.

On bond markets, yields rose in the last quarter, approaching their most recent peak reached in 2022. U.S. government 10-year yields stood at 3.8% at the end of the quarter, up roughly 40 basis points, while Canadian 10-year yields ended the quarter at 3.3%. Canadian 5-year yields were around 3.7% at the end of the quarter, their highest level since 2008.

The rise in rates was mainly due to persistent inflation and stronger-than-expected economic growth, which prompted central banks to adopt a more hawkish tone and further tighten monetary policy. As a result, investors have adjusted their expectations and now expect key policy rates to stay higher for longer, notably in the United States.

Market Expectations for Fed Funds Rate (implicit expectations on forward market)



Over the coming quarters, developments in inflation and monetary policy will remain a central theme in the financial markets. The current cycle of monetary tightening is likely to continue for some time and weigh on global economic growth and financial asset valuations.

## Market Performance

Stock Markets											
	Level	% change								Last 12 months	
		2023-06-30	1 month	3 months	6 months	9 months	1 year	3 years <sup>2</sup>	5 years <sup>2</sup>	Min.	Max.
MSCI All Country World Index		821	5.28	5.95	12.89	20.79	14.36	32.97	40.02	678	821
MSCI EAFE <sup>1</sup>		1,356	3.45	3.19	10.08	19.33	14.22	29.18	19.82	1,135	1,368
MSCI Emerging Markets		59,844	2.88	0.72	4.11	10.45	0.37	4.11	2.27	52,493	62,451
S&P 500		4,450	6.47	8.30	15.91	24.12	17.57	43.55	63.72	3,577	4,450
S&P/TSX		20,155	2.98	0.28	3.97	9.28	6.86	29.91	23.82	18,206	20,767
Morningstar National Bank Québec Index		404	4.15	1.36	11.87	19.77	21.71	52.09	38.02	332	405

Bond Markets											
	Level	% change								Last 12 months	
		2023-06-30	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	3.97	3.90	3.65	4.03	3.94	3.95	1.32	2.79	3.35	4.47
Ontario	10-year	3.97	3.91	3.65	4.06	3.95	3.99	1.32	2.81	3.37	4.49
Canada	10-year	3.27	3.19	2.90	3.30	3.17	3.22	0.53	2.17	2.61	3.67
United States	10-year	3.84	3.65	3.47	3.88	3.83	3.02	0.66	2.86	2.58	4.24
United Kingdom	10-year	4.38	4.18	3.49	3.66	4.08	2.23	0.17	1.28	1.81	4.50
Germany	10-year	2.39	2.28	2.29	2.57	2.11	1.33	-0.46	0.30	0.78	2.75
Canada	AA Corp. (10-year)	4.51	4.45	4.19	4.57	4.54	4.55	1.65	3.13	3.91	5.07
	BBB Corp. (10-year)	5.35	5.25	5.04	5.37	5.46	5.33	2.58	3.81	4.72	6.01
	BBB - 10-year Gov. spread	2.09	2.06	2.15	2.08	2.29	2.11	2.05	1.64	1.89	2.40
United States	AA Corp. (10-year)	4.60	4.48	4.27	4.72	4.93	4.07	1.60	3.74	3.52	5.33
	BBB Corp. (10-year)	5.53	5.53	5.29	5.73	6.04	5.14	2.38	4.50	4.66	6.47
	BBB - 10-year Gov. spread	1.69	1.88	1.82	1.85	2.21	2.12	1.72	1.64	1.62	2.28

<sup>1</sup>Europe, Australasia and Far East    <sup>2</sup>Annualized returns  
Sources: Datastream, Bloomberg and AMF

#### NOTE

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