

ECONOMIC and FINANCIAL

REVIEW

Office of the Vice-President
Strategy, Risks and Performance

October 15, 2019



**AUTORITÉ
DES MARCHÉS
FINANCIERS**

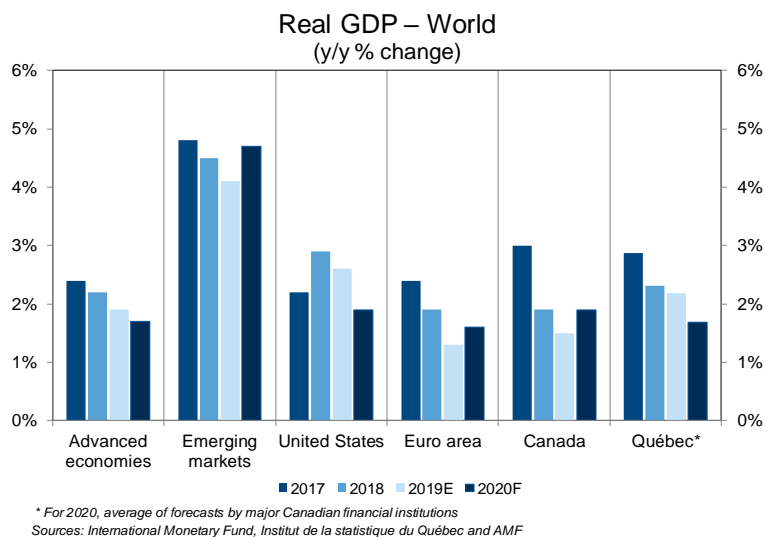
TABLE OF CONTENTS

Highlights	3
Economic context	4
World	4
United States	5
Canada.....	6
Québec.....	7
Financial markets	9
Stock markets	9
Bond markets	10

Mario Houle, Chief Economist
Philippe Bergevin, Senior Economist
Alexandre d’Aragon, Senior Economist
Catherine Morin, Economist
Léa Leduc Berryman, Economist
Alain Miot, Intern

HIGHLIGHTS

- The global economy entered a synchronized slowdown. Escalating trade tensions between the United States and China are undermining trade, disrupting supply chains and causing companies to delay their investments.
- The economic slowdown is particularly marked in Europe and Asia. In several countries, manufacturing purchasing managers indexes fell below the level of 50, slipping into contraction territory.
- To deal with the slowdown in the global economy, many central banks, including the Federal Reserve and the European Central Bank, adopted monetary policy easing measures.
- After months of tepid growth, the Canadian economy rebounded in the second quarter, posting annualized quarterly growth of 3.7% on account of strong exports in the oil and aeronautics sectors, among others.
- Bolstered by a robust housing market and relatively loose fiscal policies, the Québec economy remains strong and is emerging unscathed from the slowdown that has affected the rest of Canada over the past few quarters.
- After several ups and downs, the global stock markets inched up during the third quarter. The price swings were largely due to China-U.S. trade tensions.
- Bond yields fell in the third quarter, continuing a trend observed since the end of 2018. The global economic slowdown and the spectre of a recession shook the confidence of investors, who flocked to the safe haven of government bonds.



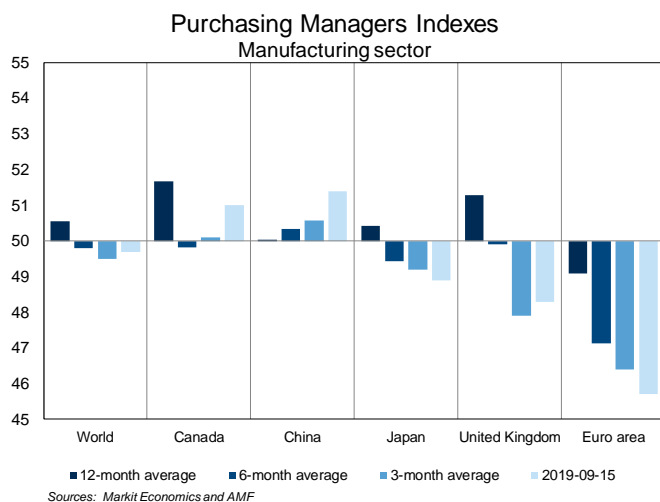
ECONOMIC CONTEXT

WORLD

The global economy entered a synchronized slowdown, and international financial institutions and organizations continued to lower their economic forecasts. Escalating trade tensions between the United States and China are increasingly undermining trade, disrupting global supply chains and causing companies to delay investments. Brexit-related worries and growing tensions in the Middle East are adding to the uncertainty. As a result, the World Trade Organization halved its forecast for growth in global trade.

The economic slowdown is particularly marked in Europe and Asia. Countries heavily exposed to global trade and commodities are being particularly hard-hit by the slowdown in China.

Several manufacturing purchasing managers indexes fell below 50, slipping into contraction territory. This was especially the case in the euro area, the United Kingdom and Japan.



The pressure rose a notch in the U.S.–China trade relationship. In the third quarter, both countries took turns levying new tariffs on each other's imports, then partially delayed their implementation as a gesture of good will. Trade talks between the two largest economies resumed in October. Failing an agreement,

however, the U.S. could impose customs duties on almost all Chinese imports between now and December.

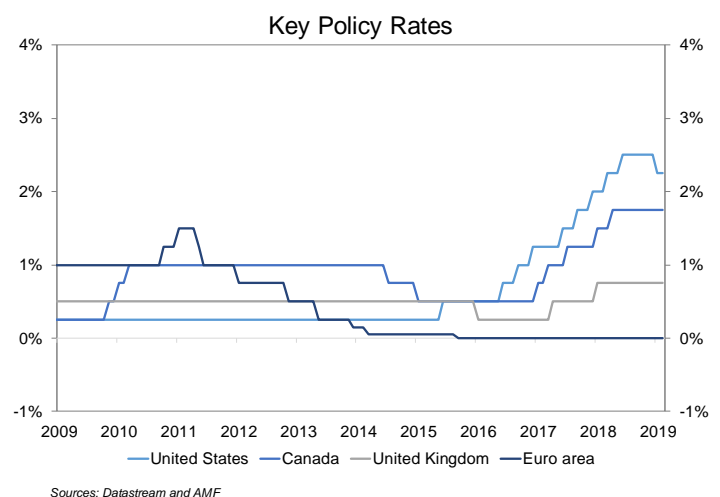
Several central banks adopted monetary policy easing measures in light of the deteriorating economic environment and a general decline in inflation.

Although the U.S. economy is proving to be resilient, the Federal Reserve lowered its key policy rate twice in a row in July and September to avoid the negative impact of the slowing global economy. Due to the inversion of the U.S. yield curve, some are predicting a recession by the end of 2020.

The Bank of Canada left its key policy rate unchanged amid the rebound in growth, robust job creation and close-to-target inflation.

In the euro area, the European Central Bank took aggressive steps to stimulate the economy and stoke inflation. It implemented several monetary easing measures, including lowering the deposit facility interest rate and restarting the asset purchase program.

These measures will remain in place for as long as necessary. With Germany on the brink of a recession, the ECB lowered its growth forecasts for the euro area and called on governments to use fiscal policy to stimulate the European economy.



In the United Kingdom, the probability of a no-deal Brexit is increasing as the October 31st deadline

looms. The new prime minister remains determined to withdraw the U.K. from the European Union on the slated date and has been uncompromising in negotiations. However, Boris Johnson suffered a series of setbacks in Parliament, which blocked the holding of early elections and legislated to force him to seek an extension to the date for withdrawal from the European Union if no agreement is reached with Brussels. In the meantime, the British economy is showing signs of fatigue.

Italy went through a political crisis after the collapse of the populist government in August, but the formation of a right-left coalition government allowed it to avoid elections in which the far-right was the frontrunner. Political uncertainty, however, continued to weigh on the euro area's third economy, which is heavily indebted and slack.

The Chinese economy continued to slow in the second quarter and posted its lowest growth rate in over 25 years. Industrial production troughed, exports began to decline owing to U.S. tariffs and domestic demand softened. The central bank reduced the banks' reserve requirement in order to encourage lending and stimulate the economy.

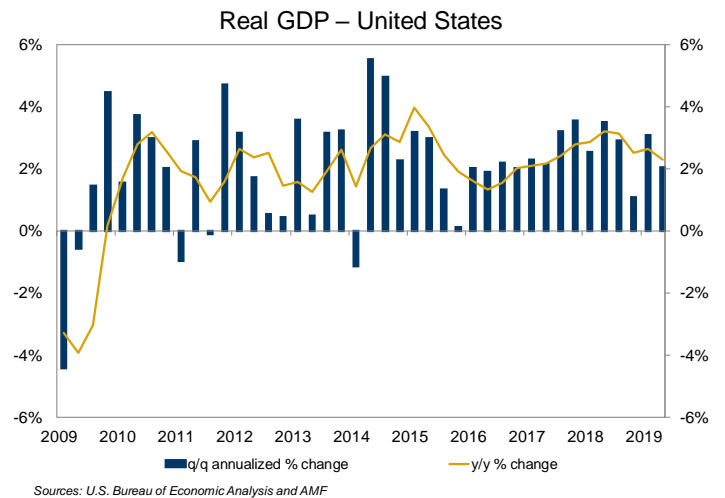


Generally, the global stock markets inched up in the third quarter, even though investors turned to safe havens, including gold and government bonds. A growing proportion of European sovereign bonds are now offering negative yields.

Oil prices briefly spiked after the attacks on Saudi oil facilities in September. However, the situation quickly returned to normal after Saudi Arabia took measures to resume production. Middle East tensions remain high, with Iran suspected of orchestrating the attacks.

UNITED STATES

The U.S. economy entered its 11th consecutive year of growth this past summer, making this the longest period of expansion since the end of WWII.



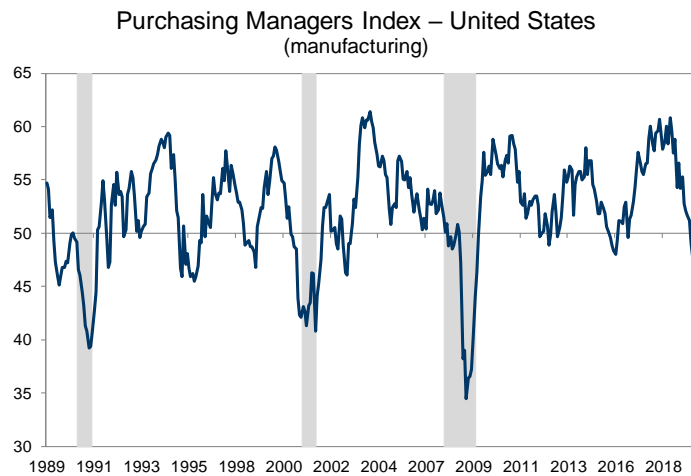
The least that can be said is that the U.S. economy is operating close to the limits of its capacity and doing so without causing significant inflation pressures as in the past. The jobless rate has fallen steadily from its peak of 10% in 2009 and has been under 4% for over a year now, its lowest level in 50 years.

Despite this long expansionary period, the U.S. economy does not appear to be running out of steam, but it is showing some signs of fatigue: manufacturing activity and capital goods orders are contracting and growth in hours worked is slowing. Business leaders have shown restraint amid the uncertainty caused by trade tensions and therefore in investment spending.

In August, the U.S. manufacturing sector contracted for the first time in three years, a sign that trade tensions and slowing global growth are weighing on the U.S. economy.

At least that is what the Institute for Supply Management (ISM) manufacturing index, one of the

most closely watched purchasing managers' indexes in the U.S., is indicating. The ISM index fell below 50 in the third quarter, signalling a contraction in manufacturing.



Sources: Institute for Supply Management and AMF

The U.S. manufacturing industry is therefore following the same road as other major economies that have already seen a weakening in manufacturing activity in recent months.

Although contagion from the weakness observed in the manufacturing sector has been limited so far, the fact remains that the U.S. economy appears, by and large, to be slightly more fragile.

The turmoil created by the trade dispute with China and the tariffs levied on imports from U.S. trading partners are also weakening the U.S. economy. The tariffs, which now extend to consumer goods, are eroding consumer purchasing power. As a result, actual consumer spending could slow over the coming months.

The job market has slowed in recent months, with the pace of job creation in the third quarter falling to 157,000 per month, compared with 189,000 a year earlier. Nevertheless, this pace was enough to lower the jobless rate to 3.5%—a new cyclical low.

In this context, the Federal Reserve lowered its key policy rate twice over the summer, by a total of 50 basis points, to a target range of 1.75% to 2.00%. As reasons for this midcycle adjustment, the Fed cited slowing global growth, trade policy uncertainty and

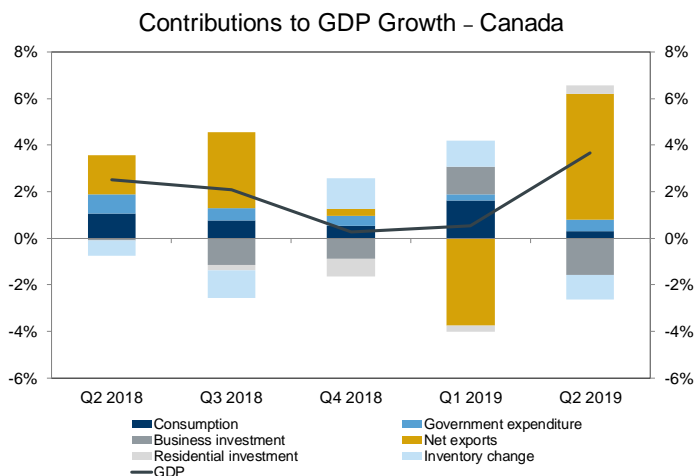
mutated inflation. It could continue to make adjustments between now and the end of the year.

Despite the slowdown in the global economy, the U.S. economy is proving to be resilient. Continuing trade tensions, rising tariffs and their negative impact on global growth will end up weighing on the U.S. economy in the coming months, unless Washington and Beijing resolve their differences and reach a trade agreement. In the wake of declining bond yields, financial conditions have eased considerably and will help bolster the economy.

CANADA

After two quarters of tepid growth owing, in particular, to challenges in the energy sector, the Canadian economy rebounded in the second quarter and posted annualized quarterly growth of 3.7%.

This growth came almost entirely from the rebound in exports, pushed upward by the recovery in the Alberta oil sector and by aircraft shipments, two particularly volatile sectors.



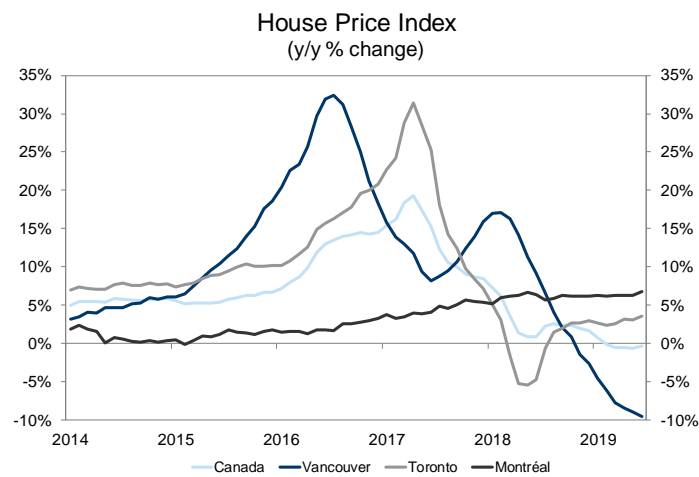
Sources: Statistics Canada and AMF

Domestic demand, however, declined for a third time in a year, dragged down over the past few quarters by slowing consumption and the contraction in private and residential investment.

Business investment fell sharply and hopes for an improvement remain limited given the continuing uncertainty over trade tensions.

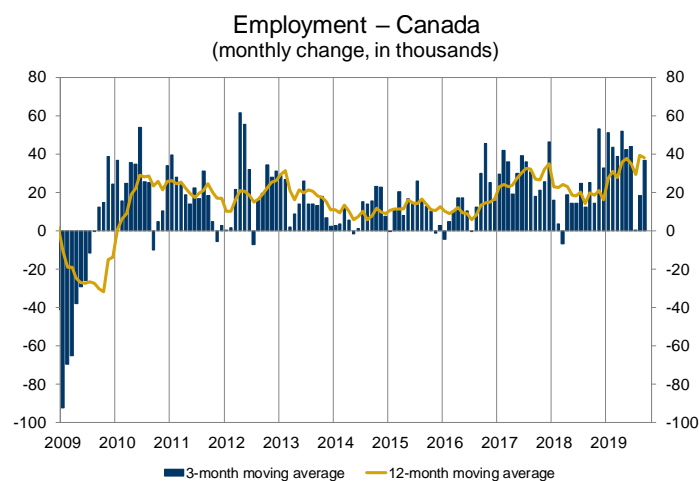
Meanwhile, residential investment posted its first increase since 2017. As confirmed by the latest data, the real estate market is stabilizing after several months of adjusting to federal and provincial macroprudential measures and past increases in interest rates.

In the Greater Toronto Area, prices started to rise again and sales increased. In Greater Vancouver, however, prices continued to slide, but sales started to climb.



Sources: The Canadian Real Estate Association and AMF

The labour market remains fairly vibrant. Wage growth, which, despite a tight labour market characterized by labour shortages in a number of industrial sectors, was moderate until the end of 2018, has accelerated since then.



Sources: Statistics Canada and AMF

Despite the robust labour market and strengthening wage growth, consumption has grown modestly over the past few quarters. High household debt, which reached an all-time peak in the second quarter, could be a factor contributing to this discrepancy. Likewise, the slowdown in the real estate market since 2017 may have created a negative wealth effect and affected related spending on durable goods.

In short, the rebound in the Canadian economy in the second quarter could prove to be temporary and growth should slow in the coming quarters. The ongoing trade disputes, the global economic slowdown and their repercussions on business investment are limiting the prospects for growth.

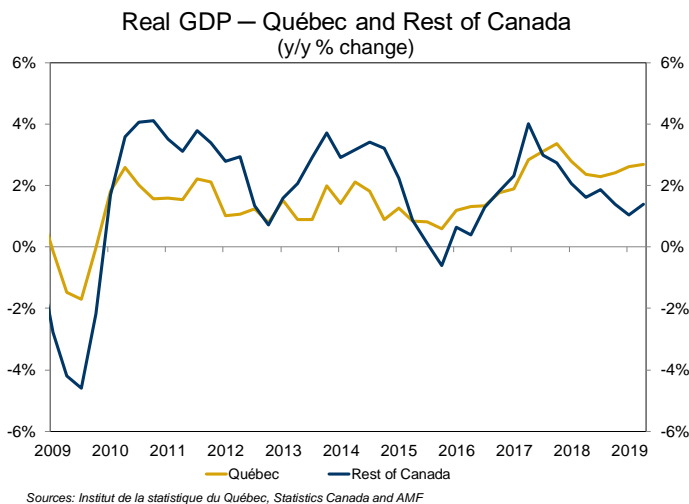
Whereas the U.S. Federal Reserve has cut its key policy rate twice since the start of the summer, the Bank of Canada has decided to maintain the status quo. The current level of Canada's key policy rate remains below the estimated neutral rate, which is the rate at which monetary policy neither inhibits nor stimulates economic growth.

Nevertheless, a reduction in the key policy rate by the Bank of Canada before the end of the year cannot be ruled out, especially if trade disputes escalate further and lead to an even deeper slowdown of the global and, therefore, Canadian economy.

QUÉBEC

Bolstered by a robust housing market and relatively loose fiscal policies, the Québec economy remains strong and is emerging unscathed from the slowdown that affected the rest of Canada in late 2018 and early 2019. However, the manufacturing industry is facing certain challenges resulting from trade tensions and the slowing global economy.

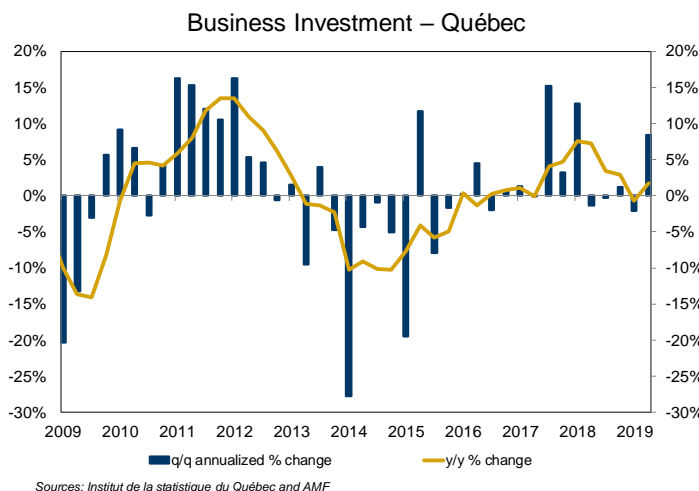
GDP growth in the second quarter was 2.9%, buoyed by household consumption, government expenditure, residential construction and a recovery in business investment.



Consumption slowed quarter-over-quarter, but posted reasonable year-over-year growth. Supported by solid employment gains and lower borrowing costs, household spending is expected to keep its momentum into the near future.

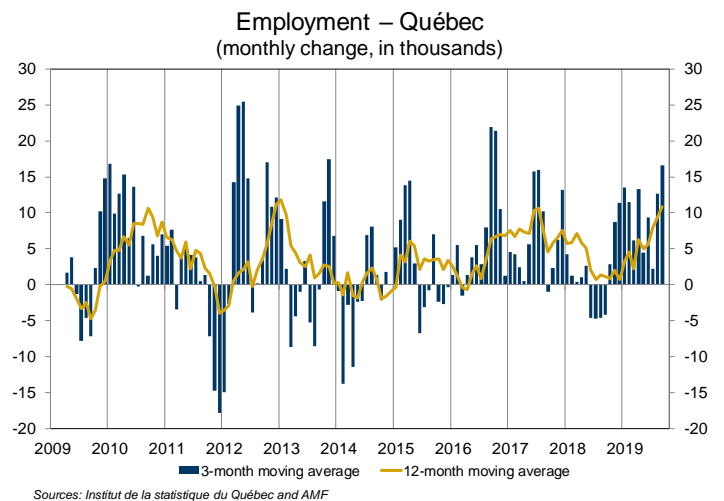
The real estate market and residential construction are also benefiting from the strong labour market and the easing of financial conditions. Home sales increased at a sustained pace, while the housing supply tightened, spurring a rise in housing starts. These conditions are putting upward pressure on property prices, which have increased an average of nearly 7% in the resale market since the start of the year.

Following a long period of stagnation, business investment rebounded. However, this does not necessarily mean a sustainable recovery is taking hold: the slowing global economy, trade tensions and resulting uncertainty are not amenable to this.



In foreign trade, exports stagnated in the second quarter after a sharp decline in the previous quarter. By contrast, there was an improvement in interprovincial trade. Ultimately, Québec’s total exports of goods and services remained at a standstill.

The labour market has fared well since the start of the year. Job creation has picked up over the past few months, with close to 96,400 jobs over the first nine months of the year. The labour shortage is deepening, as evidenced by the record number of job vacancies (over 140,000). The unemployment rate stood at 4.8% in September, after falling to an all-time low of 4.7% the previous month.



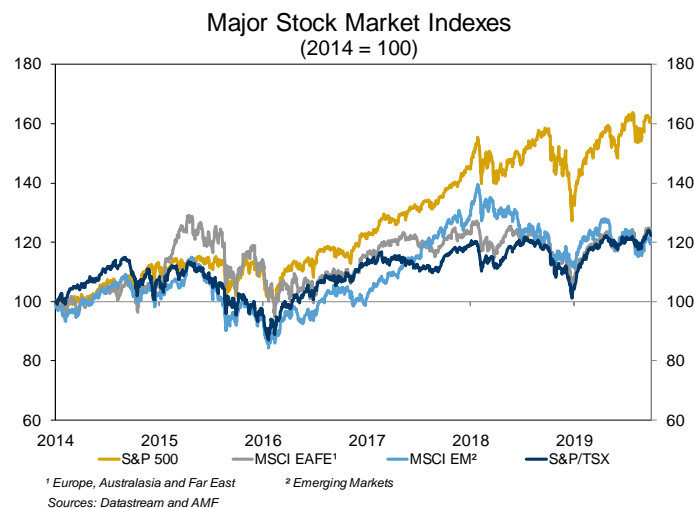
Overall, Québec’s economic performance has been enviable. Notwithstanding the ups and downs in production and demand from one quarter to the next, the economy as a whole, including domestic demand, has strengthened since the start of the year. In addition to consumer spending, which has long been its mainstay, the Québec economy was also able to rely on private investment, residential construction and government expenditure in the second quarter.

Québec could once again end the year with higher GDP growth than the Canadian economy as a whole. However, the economy will slow in the coming quarters owing to the global slowdown, trade tensions and the limits placed on potential GDP by the aging of the population and the slower rate of growth of the labour force.

FINANCIAL MARKETS

STOCK MARKETS

Although the stock markets experienced many ups and downs in the past few months owing to fears related to the global economic slowdown and trade tensions, they nonetheless posted slightly positive returns over the third quarter as a whole. The central banks calmed those fears by further easing their monetary policies, while the widespread decline in interest rates is making the markets more appealing.



The MSCI All Country World Index ultimately posted a gain of 0.6% over the quarter and has returned an impressive 15.2% since the start of the year.

Despite the highly uncertain economic picture, stock market valuations continue to be relatively high, particularly in the U.S. P/E ratios have risen slightly since the start of the year and remain relatively high from a historical perspective.

Stock Market Valuations

	Forward P/E ratio		P/E ratio		Dividend yield		Price to book	
	Actual	10 year average	Actual	10 year average	Actual	10 year average	Actual	10 year average
World	15.1	13.9	17.8	17.5	2.5	2.6	2.2	2.0
United States	17.1	15.2	20.0	18.2	1.9	2.0	3.4	2.7
Canada	14.1	14.4	15.8	18.2	3.2	2.8	1.8	1.9
EAFE*	13.7	13.2	16.6	19.0	3.5	3.3	1.6	1.6
Emerging	11.9	11.2	13.3	13.6	3.0	2.6	1.5	1.6

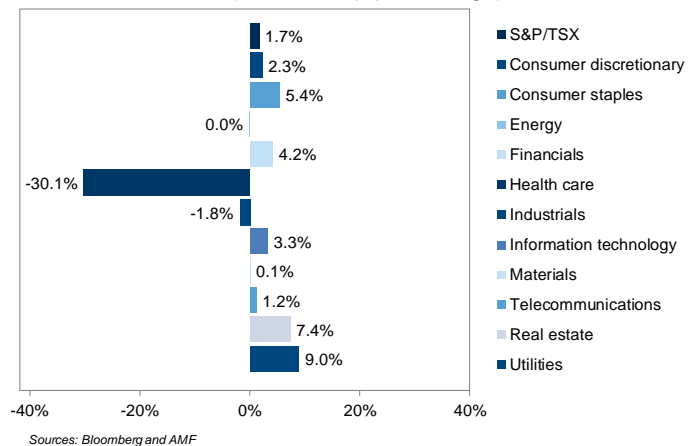
* Europe, Australasia and Far East
Sources: Bloomberg and AMF

As mentioned, all other things being equal, the decrease in interest rates is making the stock markets more appealing by increasing the present value of future corporate profits, despite a mixed earnings outlook.

In the U.S., the S&P 500 also posted a slightly positive gain, returning 1.2%. Investors seem to have taken worsening economic conditions and pressures on profits in stride. According to I/B/E/S data, corporate earnings are expected to decline about 2% in the third quarter, a first decrease since 2016.

The S&P/TSX also ended the year in positive territory, with a 1.7% return. The utilities and real estate subindexes stood out with returns of 9% and 7.4%, respectively. These sectors are particularly sensitive to movements in interest rates as their dividend yields are typically higher. As a result, when rates fall, these sectors become relatively more appealing to investors. By contrast, the health subindex fell sharply by 30.1%, reflecting the poor performance posted by cannabis companies.

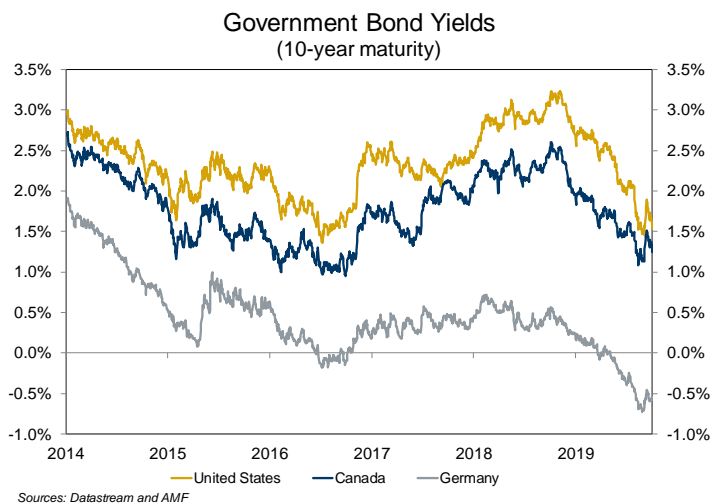
Performance of the Main S&P/TSX Subindexes
(Q3 2019, q/q % change)



Lastly, TSX-listed companies headquartered in Québec slightly underperformed S&P/TSX-listed companies as a whole in the third quarter. As in the case of the overall S&P/TSX, the Québec-based utilities and real estate sectors performed well, as did financials.

BOND MARKETS

Bond yields fell in the third quarter, continuing a trend observed since the end of 2018. The global economic slowdown, trade tensions and the spectre of a recession weighed heavily on the confidence of investors, who flocked to safe havens such as government bonds. The major central banks further eased their already accommodative monetary policies, thereby increasing the downward pressure on bond yields.

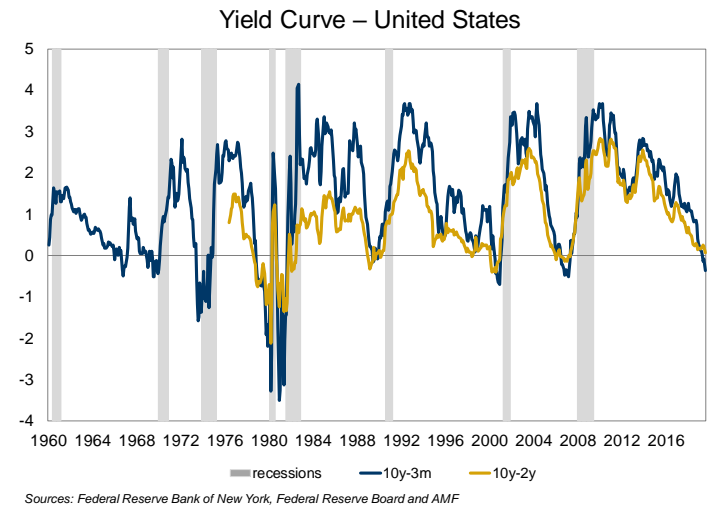


The yields on 10-year U.S. Treasury notes ended the quarter at 1.7%, down roughly 100 basis points since the start of the year. Despite generally acceptable economic conditions in the U.S., the Federal Reserve proceeded with two rate cuts in recent months in response to the global economic slowdown and muted inflation pressures. Notwithstanding these two cuts, the Fed's target rate, which is now within a range of 1.75% to 2%, remains above those of other major central banks.

The markets are pricing in even further cuts to the Fed's key policy rate. In fact, the futures market has priced in a slightly greater than 70% probability of a cut between now and the end of the year.

The spread between 10-year and 3-month yields has been negative for several months, heightening fears of a recession. According to the New York Fed model, the probability of a recession over a one-year horizon is now at 38% in the U.S. The spread between 10-year

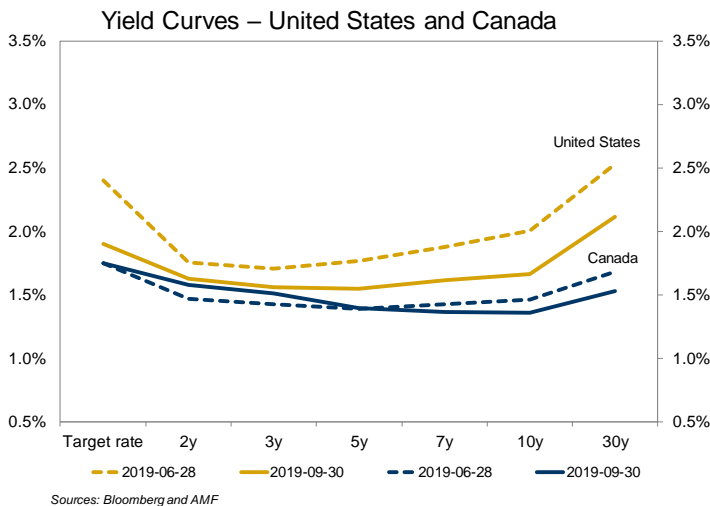
and 2-year yields ended the quarter in positive territory but nonetheless continued to narrow.



An inverted curve has correctly signalled the last seven U.S. recessions, with varying lead times of just over a year on average. Although past inversions often reflected severe tightening by the Fed, the current inversion has more to do with falling long-term yields, reflecting the ultra-low long-term yields in Europe and Japan and other structural factors. All other things being equal, the Fed's change of course is reducing recession risks. These risks would also be mitigated by the resolution of trade disputes.

Bond yields also fell sharply in Europe—particularly in Germany, where the entire yield curve is in negative territory, including yields on 30-year bonds. Suffice it to say that this situation is highly unusual from a historical perspective and seems to defy all logic.

Europe is facing a significant economic slowdown and an inflation rate that has remained at well below 2%. In this context, the European Central Bank further lowered its deposit facility rate and announced it was restarting its asset purchase program. A number of observers are starting to question the effectiveness of such additional measures given already very low interest rates, especially as they exert significant pressures on lenders' net interest margins. Everything seems to indicate that rates in Europe will continue to remain at very low levels for several years to come.



In light of this, the Bank of Canada decided to maintain the status quo, keeping its key policy rate unchanged at 1.75%. The futures market is pricing in just a 25% probability of a rate cut between now and the end of the year, but the Bank may have to take action if global economic conditions worsen further.

In Canada, long-term bond yields have generally followed the same downward trend. Yields on Government of Canada 10-year bonds ended the quarter at 1.4%, compared with 2% at the beginning of the year. Although the Canadian economy got off to a slow start, it has since rebounded and inflation measures are near 2%, the mid-point of the Bank of Canada’s target range.

Market Performance

		Stock Markets									
		Level	% change							Last 12 months	
		2019-09-30	1 month	3 months	6 months	9 months	1 year	3 years ²	5 years ²	Min.	Max.
MSCI All Country World Index		613	2.0	0.6	3.2	15.2	0.4	8.3	5.9	510	622
MSCI EAFE ¹		1,135	3.2	1.1	2.7	12.6	-1.5	5.3	3.1	990	1,153
MSCI Emerging Markets		56,357	1.3	-3.0	-3.6	5.5	-2.7	5.1	3.0	52,056	60,394
S&P 500		2,977	1.7	1.2	5.0	18.7	2.2	11.1	8.6	2,351	3,026
S&P/TSX		16,659	1.3	1.7	3.5	16.3	3.6	4.2	2.2	13,780	16,900
Morningstar National Bank Québec Index		309	1.3	1.2	4.2	18.4	7.0	8.2	9.0	252	312
		Bond Markets									
		Level	% change							Last 12 months	
		2019-09-30	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	2.0	1.8	2.1	2.3	2.8	3.0	1.9	3.1	1.8	3.2
Ontario	10-year	2.0	1.9	2.1	2.4	2.8	3.0	1.9	3.1	1.8	3.2
Canada	10-year	1.4	1.2	1.5	1.6	2.0	2.4	1.0	2.1	1.1	2.6
United States	10-year	1.7	1.5	2.0	2.4	2.7	3.1	1.6	2.5	1.5	3.2
United Kingdom	10-year	0.5	0.5	0.8	1.0	1.3	1.6	0.7	2.4	0.4	1.7
Germany	10-year	-0.6	-0.7	-0.3	-0.1	0.2	0.5	-0.1	0.9	-0.7	0.6
Canada	AA Corp. (10-year)	2.4	2.2	2.4	2.7	3.2	3.3	2.3	3.1	2.1	3.5
	BBB Corp. (10-year)	3.1	2.9	3.1	3.4	4.0	4.0	3.2	3.8	2.9	4.2
	BBB - 10-year Gov. spread	1.8	1.8	1.6	1.8	2.1	1.6	2.3	1.7	1.5	2.1
United States	AA Corp. (10-year)	2.4	2.2	2.7	3.1	3.7	3.8	2.5	3.2	2.2	4.0
	BBB Corp. (10-year)	3.1	3.0	3.5	4.0	4.6	4.5	3.2	4.0	2.9	4.8
	BBB - 10-year Gov. spread	1.5	1.5	1.5	1.6	1.9	1.5	1.7	1.5	1.4	1.9

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

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