AUTORITÉ DES MARCHÉS FINANCIERS

Economic and Financial Review

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Office of the Chief Economist

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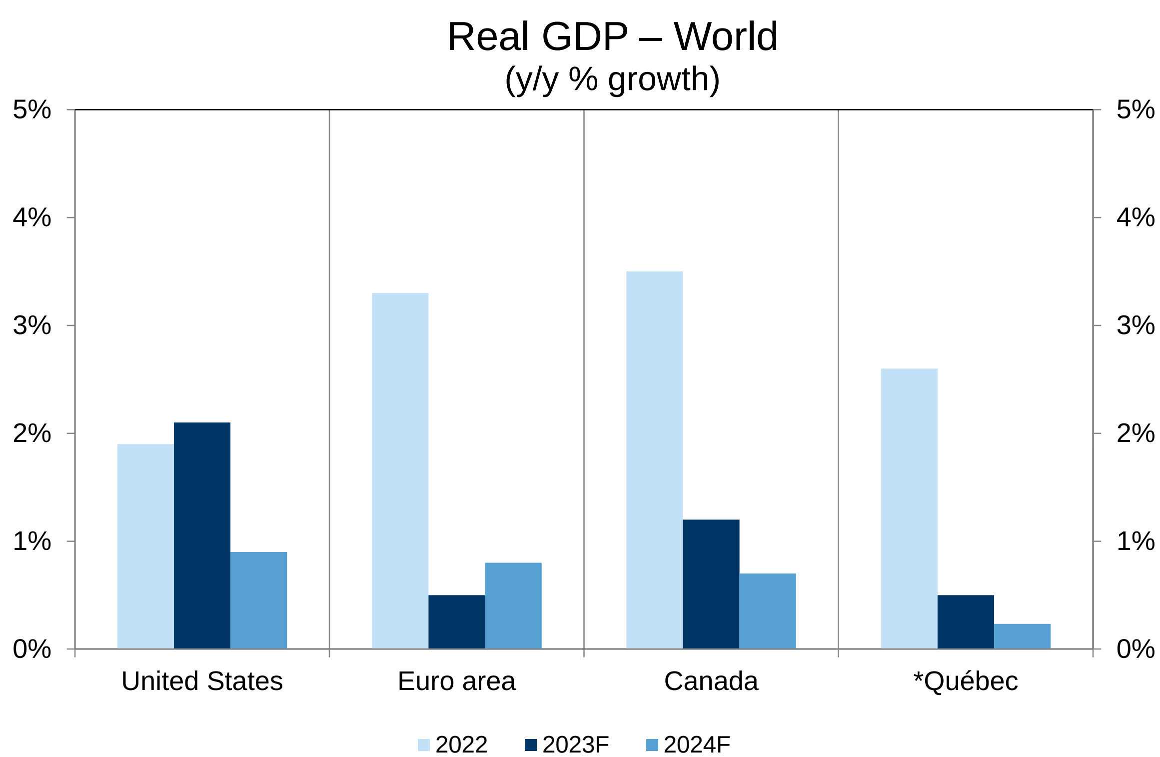
Highlights

- Global growth is showing signs of slowing as the full effect of interest rate hikes is starting to be felt more acutely. The central banks have indicated that policy rates will have to remain higher for longer to lower inflation sustainably.
- The U.S. economy continues to be particularly resilient owing mainly to household spending, while the economy in the euro area is edging closer to a recession.
- In the second quarter, the Canadian economy dipped 0.2%, contracting for the second time in the last three quarters. Household consumption pulled back sharply, while residential investment and net exports declined.
- In Québec, real GDP declined 1.9% in the second quarter, a much larger decrease than in Canada as a whole, while the labour market sputtered.
- The major stock markets were down in the third quarter, rattled by inflationary pressures, rising interest rates and the risk of a significant slowdown in the global economy.
- Bond yields rose strongly at the end of the quarter, with investors expecting central banks to keep their key policy rates relatively high for several more quarters.



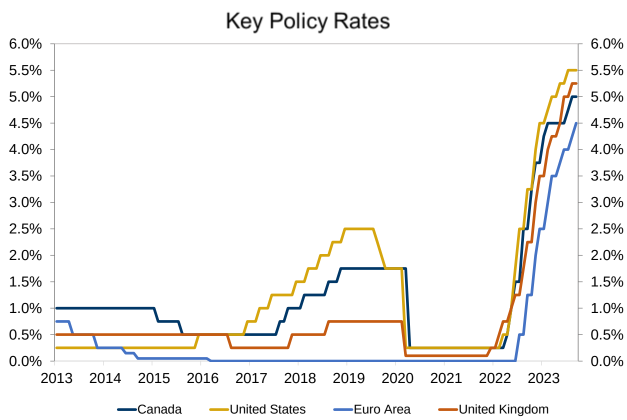
**Québec: Average of forecasts by major Canadian financial institutions*
Sources: Consensus forecast, Bloomberg and AMF

Economy

World

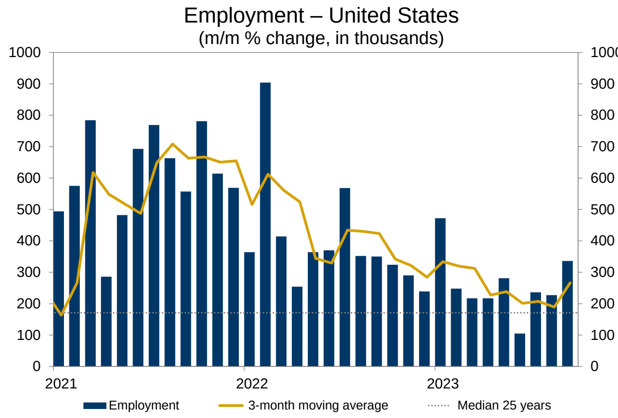
Global growth is showing signs of slowing as the full effect of higher interest rates is starting to be felt. The central banks of the advanced economies are sending clear signals that the cycle of monetary tightening is coming to an end, as inflation has dropped considerably since the highs reached in 2022.

They are also indicating that policy rates will need to remain higher for longer than initially anticipated to allow inflation to fall back to its target, which is generally set at 2%. Wage inflation continues to be high, and core inflation, which excludes the more volatile items of food and energy, is declining much more slowly. Generally, the central banks are not considering lowering policy rates before mid-2024, and any decrease that happens will be very gradual. It remains to be seen whether the banks will be able to orchestrate a soft landing for the economy, avoiding a recession. In this respect, growth rates in the United States and Europe appear to be diverging.



Sources: Refinitiv and AMF

Once again, the U.S. economy is proving to be particularly resilient owing mainly to household consumption, which continues to be robust. GDP grew by 2.1% in the second quarter, after increasing 2.2% in the first quarter. The labour market is still going strong. Job creation remained above 200,000 jobs in the second quarter, and wage inflation declined. The jobless rate has been under 4% for almost two straight years.

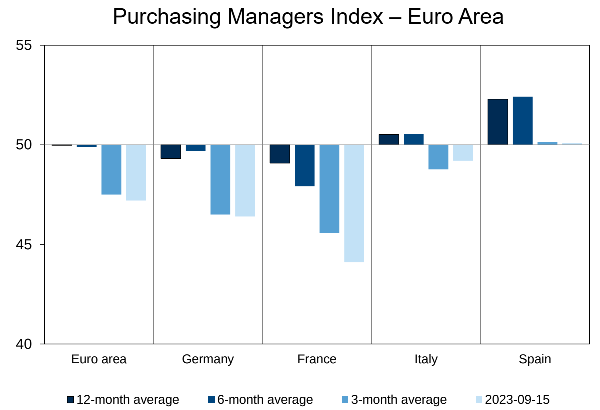


Sources: U.S. Bureau of Labor Statistics and AMF

The U.S. economy could lose momentum in the fall as it faces growing headwinds: households have spent a large portion of the savings accumulated during the pandemic; workers at major auto manufacturers are on strike; the pause on student loan payments was lifted in October; and, if Congress fails to reach an agreement, there could be a federal government shutdown in November.

The Federal Reserve hiked its key policy rate to a range of 5.25% to 5.50% in July, the highest level in 16 years, then opted for the status quo in September. Inflation, which fell to 3% in June, rebounded to 3.7% in September owing mainly to higher fuel bills. Another increase of 25 basis points between now and the end of the year has not been ruled out.

The situation is more challenging in the euro area, where growth was only 0.3% in the first quarter and 0.5% in the second quarter. The German economy, the engine of the euro area, has been idling since the Russian invasion of Ukraine. Generally, household consumption has stagnated, while exports have plummeted. The purchasing managers indexes are pointing to a contraction of economic activity in both the manufacturing and services sectors. Nonetheless, the labour market remains tight, with an unemployment rate of 6.4% in August, an historic low.



Sources: S&P Global and AMF

In September, the European Central Bank went ahead with a tenth consecutive hike, raising its key policy rate to 4.5%, a 16-year high. The Bank believes that maintaining this level should allow inflation to fall back to its 2% target. Inflation, which has been on a steady downtrend since it peaked one year ago, decreased to 4.3% in September.

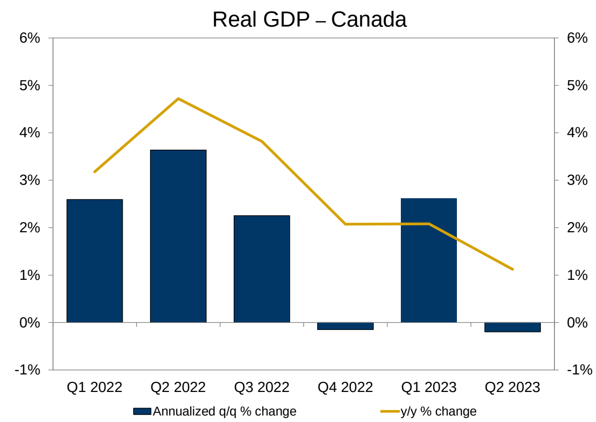
In China, the economy appears to be stabilizing after slowing significantly in the second quarter. GDP growth dropped to 3.2% in the second quarter, after rebounding at the start of the year following the lifting of COVID-related restrictions. The government has implemented a number of measures to stimulate the economy, with what appears to be positive results. Industrial output and retail sales gathered steam over the summer and manufacturing appears to be picking up.

China must, however, deal with a debt crisis in the real estate sector and softening global demand for its products, not to mention structural problems such as growing state intervention and an aging population. Time will tell if the world's second largest economy will reach the growth objective of 5% set by the government for 2023.

Canada

The Canadian economy contracted in the second quarter, shrinking at an annualized rate of 0.2%. This is the second time that the economy has contracted in the last three quarters and a sign that monetary tightening is beginning to have an effect on the components of demand.

In particular, GDP was pulled down by residential investment and net exports. Also, consumer spending continues to cool. All components of domestic demand, except for government spending, have slowed or lost ground in the past year.



Sources: Statistics Canada and AMF

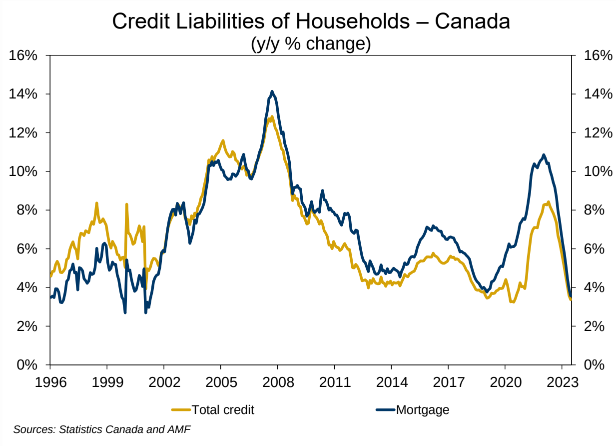
Inflation in Canada is down considerably from its June 2022 peak but has been climbing again since June. Prices are still increasing across the board, and the average of the three measures of core inflation used by the Bank of Canada recently rose to 4.3%.

The Bank of Canada left its key policy rate unchanged in September. This decision came on the heels of two successive increases in its key policy rate in June and July. The target for the overnight rate is now at 5.0%, the highest level since 2001.

Canadian monetary authorities continue to be concerned, however, by the lack of progress on the inflation front and are prepared to increase rates again, if necessary.

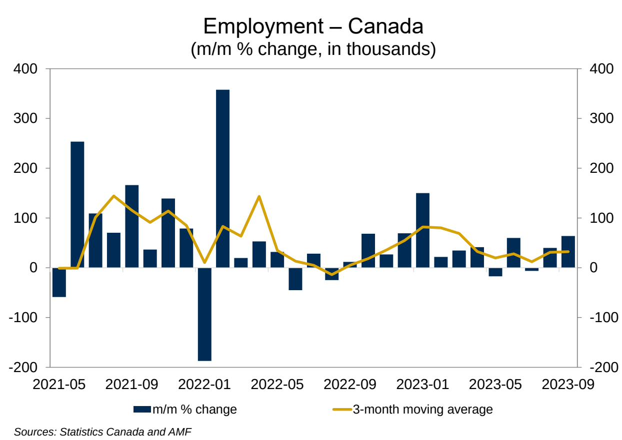
Meanwhile, borrowing conditions have been tightened further in Canada owing to rising longer-term interest rates, mortgage rates and borrowing costs for businesses.

Another sign that monetary tightening is having an effect: the growth of mortgage credit has slowed significantly concurrently with the cooling of the residential real estate sector. Mortgage credit growth is at its lowest point since the early 2000s.



Labour has fluctuated sharply since the start of the year. The exceptional rebound last September (+63,800 jobs) is in contrast with the slowdown observed this year.

This rebound is expected to be a one-time event, with the labour market eventually being affected by the general economic slowdown. The unemployment rate is stable at 5.5%, slightly above the recent low of 5%.



The slow increase in inflation anticipated for the coming months will keep pressure on interest rates. It is unlikely that there will be any easing of the monetary policy over the short or medium term in Canada.

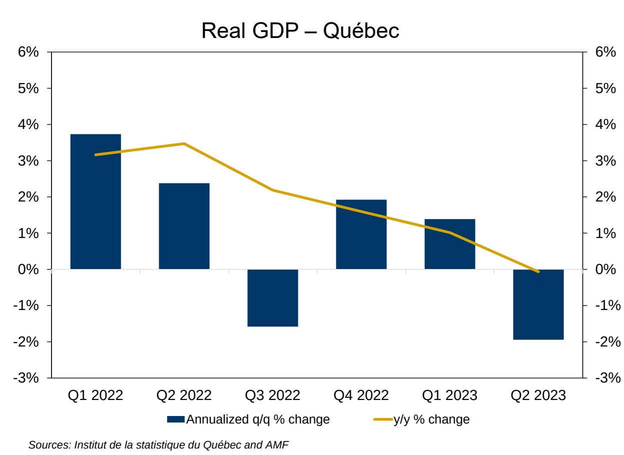
Despite the current economic slowdown, monetary policy will continue to be restrictive for some time to come. The heavier debt load of Canadian households compared to their U.S. neighbours is raising fears that rising interest rates will impact Canada more significantly than the United States and may even result in a long period of suboptimal growth in the Canadian economy over the next few years, which will be characterized by a deleveraging cycle.

Québec

In Québec, real GDP fell at an annualized 1.9% in the second quarter, a much steeper drop than for the Canadian economy. It was the second quarterly decline in economic activity in a year.

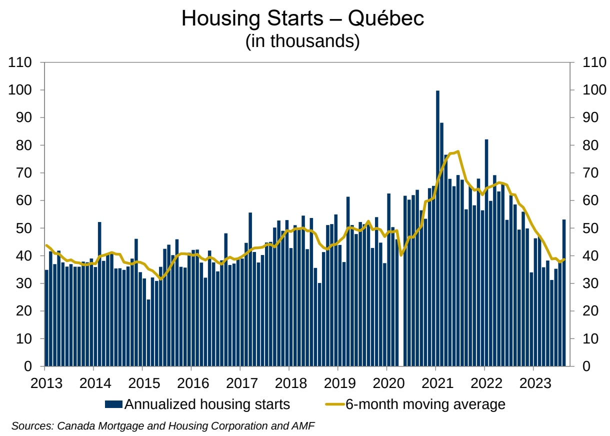
Household consumption expenditure fell 2%, delivering a hard blow to GDP growth. Rising consumer prices and higher debt servicing costs are taking an ever-bigger bite out of disposable income, while the labour market has stagnated since the start of the year. All these factors, combined with the declining savings rate, have dampened consumption.

Non-residential investment continues to slide following a more favourable quarter at the start of the year. Residential investment, hobbled by high financing costs, posted a fifth consecutive decline.



Despite robust growth in employment in September that added nearly 39,000 new jobs, the unemployment rate climbed a tenth of a percentage point to 4.4%, the lowest in Canada. Concurrently, the labour shortage is easing slightly, but remains substantial, with a job vacancy rate estimated at 5%.

In Québec, construction of residential dwellings continues to cool. Housing starts decreased by 23,600 between January and August, down 36.7% from the same period last year. The six-month moving average is showing a similar downward trend. Home sales recorded a smaller decrease.



For the time being, the real estate sector is gradually trending towards a buyer's market, but catch-up is now happening much more slowly. Nonetheless, the market is still tight, which is buoying prices despite the rise in mortgage rates.

Like everywhere across the country, Québec is facing stubborn inflation. Québec continues to rank number one among the provinces with the highest inflation rates. Core inflation rose to 4.3% in August, a jump of 0.6 percentage points.

The decline in real GDP in the second quarter seems to indicate that Québec is beginning to exhaust the strengths that made its economy relatively resilient in previous quarters.

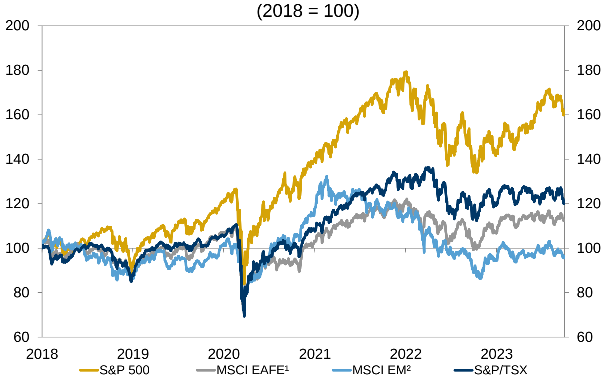
The size of economic contraction in the second quarter was surprising. Rising borrowing costs and high inflation are eating away at household purchasing power and weakening demand.

Québec is facing a more difficult economic outlook for 2024. The effects of Canadian monetary tightening, which have been felt for some time now, will be even more noticeable in the coming months. Furthermore, the slowdown in the global economy could result in weakening demand for products from Québec.

Financial markets

Inflationary pressures, rising interest rates and the likelihood of a significant slowdown in the global economy continued to weigh on financial market developments. After making strong gains in the first half of the year, the major stock market indices slipped in the third quarter, while interest rates reached highs not seen in more than a decade. Persistent inflation and the more restrictive stance of central banks have forced investors to revise their interest rate expectations for the coming quarters upward.

Major Stock Market Indices
(2018 = 100)



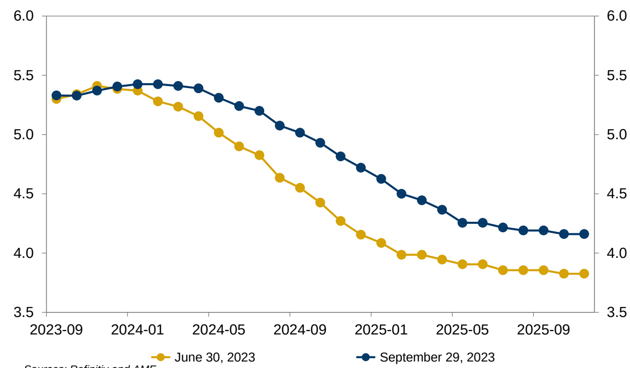
¹ Europe, Australasia and Far East ² Emerging Markets
Sources: Refinitiv and AMF

In the United States, the S&P 500 fell 3.4% in the third quarter, although it has risen 12% since the start of the year. Investor confidence was shaken by the surge in U.S. interest rates at the end of the quarter. The Big Tech stocks, which had lifted the entire U.S. stock market in the first half of the year, have been on a downtrend for the past few months amid rising rates.

U.S. 10-year yields hit 4.6% at the end of the quarter, the highest level since 2007. Corporate bond yields also rose significantly, but spreads with government bond yields are relatively low in historical terms.

This across-the-board increase in bond rates reflects the persistence of inflationary pressures and investors' monetary policy expectations. According to the futures market, investors expect the Fed to keep its key policy rate in restrictive territory for several more quarters and no easing to occur before the second half of 2024.

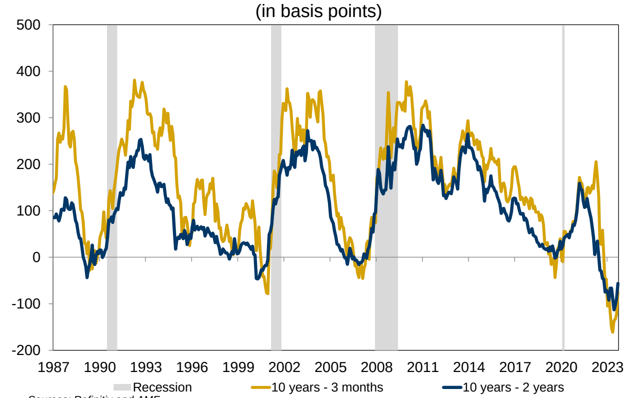
Market Expectations for Fed Funds Rate
(implicit expectations on forward market)



Sources: Refinitiv and AMF

With rapidly rising long-term yields, the yield curve has straightened slightly but remains deeply inverted. As a reminder, an inversion of the yield curve is typically associated with a recession over a one-year horizon on average. The U.S. economy has proven to be quite resilient so far but could slow down in the coming quarters owing to the delayed effect of higher interest rates.

Yield Spreads – United States
(in basis points)



Sources: Refinitiv and AMF

In Canada, the S&P/TSX fared slightly better than its U.S. counterpart, decreasing 3.0% in the third quarter. The Toronto index was boosted by the steep rise in oil prices amid oil output cuts by Saudi Arabia and Russia. Several sectors have posted significant declines, including Information Technology, which dropped 8%. Overall, TSX-listed companies based in Québec slightly underperformed the S&P/TSX.

On the bond markets, Canadian 10-year yields tracked the U.S. trend to end the quarter at 4.0%, up 76 basis points. As in the case with the Fed, investors expect the Bank of Canada to keep its key policy rate relatively high for a few more quarters.

In the months ahead, investors will have to continue to cope with an uncertain economic environment. A soft landing for the global economy is far from certain. Significant deterioration of the economy would undermine investor confidence and further reduce corporate earnings, which are already sagging under the effect of higher input costs, salaries, borrowing costs and softening demand.

Market Performance

Stock Markets											
		Level	**% change**							**Last 12 months**	
		2023-09-30	**1 month**	**3 months**	**6 months**	**9 months**	**1 year**	**3 years[2]**	**5 years[2]**	**Min.**	**Max.**
MSCI All Country World Index		797	-3.64	-2.91	2.87	9.60	17.28	6.63	5.47	678	846
MSCI EAFE[1]		1,331	-1.36	-1.89	1.23	8.00	17.07	7.99	2.93	1,137	1,378
MSCI Emerging Markets		58,515	-1.99	-2.22	-1.52	1.80	8.00	-1.90	0.20	52,493	62,769
S&P 500		4,288	-4.87	-3.65	4.35	11.68	19.59	8.44	8.03	3,577	4,589
S&P/TSX		19,541	-3.70	-3.05	-2.78	0.81	5.95	6.62	3.98	18,206	20,767
Morningstar National Bank Québec Index		387	-4.07	-4.08	-2.78	7.30	14.88	10.70	6.05	334	409
Bond Markets											
		Level								**Last 12 months**	
		2023-09-30	**-1 month**	**-3 months**	**-6 months**	**-9 months**	**-1 year**	**-3 years**	**-5 years**	**Min.**	**Max.**
Québec	10-year	4.76	4.27	3.97	3.65	4.03	3.94	1.27	3.03	3.44	4.82
Ontario	10-year	4.76	4.27	3.97	3.65	4.06	3.95	1.27	3.05	3.46	4.84
Canada	10-year	4.02	3.56	3.27	2.90	3.30	3.17	0.56	2.43	2.72	4.09
United States	10-year	4.57	4.11	3.84	3.47	3.88	3.83	0.69	3.06	3.31	4.61
United Kingdom	10-year	4.44	4.36	4.38	3.49	3.66	4.08	0.23	1.57	3.00	4.74
Germany	10-year	2.84	2.46	2.39	2.29	2.57	2.11	-0.52	0.47	1.78	2.93
Canada	AA Corp. (10-year)	5.37	4.90	4.51	4.19	4.57	4.54	1.66	3.35	3.98	5.42
	BBB Corp. (10-year)	5.96	5.55	5.35	5.04	5.37	5.46	2.42	4.03	4.72	6.03
	BBB - 10-year Gov. spread	1.93	1.99	2.09	2.15	2.08	2.29	1.86	1.61	1.89	2.40
United States	AA Corp. (10-year)	5.32	4.84	4.60	4.27	4.72	4.93	1.51	3.77	4.11	5.34
	BBB Corp. (10-year)	6.24	5.76	5.53	5.29	5.73	6.04	2.19	4.52	5.03	6.47
	BBB - 10-year Gov. spread	1.67	1.65	1.69	1.82	1.85	2.21	1.50	1.46	1.60	2.28

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

Sources: Datastream, Bloomberg and AMF

NOTE