Economic and Financial Review

January 19, 2023

Office of the Chief Economist

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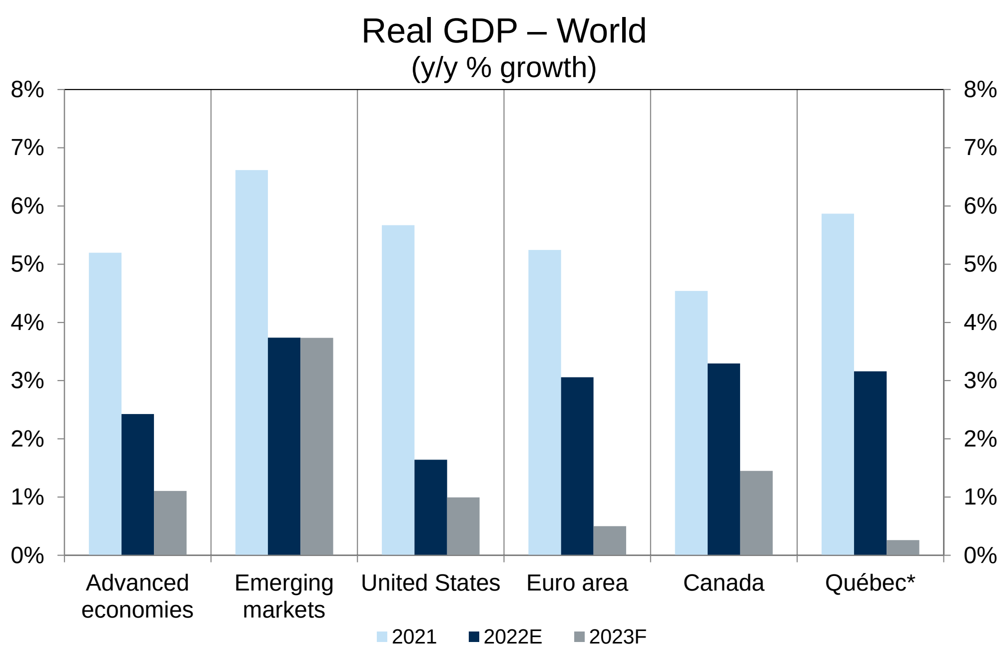
Highlights

- The global economy was marked by high inflation in 2022, a situation that was compounded by Russia's invasion of Ukraine. In response, most central banks announced a string of substantial key policy rate increases.
- Throughout the year, the central banks and other international financial organizations revised their economic forecasts downward, pointing to a widespread slowdown, and even mild recessions, in 2023.
- The Canadian economy posted solid growth in the first three quarters of 2022, which should help lift GDP over 3% for the year. However, signs of a slowdown are growing.
- Rising interest rates and the global economic slowdown caught up with the Québec economy, which had come out of the starting blocks with a bang in 2022. GDP declined in the third quarter of 2022, and a major slowdown is anticipated in 2023.
- Stock and bond indices declined sharply in 2022 as interest rates rose substantially and monetary tightening continued, significantly clouding the economic outlook.
- Several issues will need to be monitored in 2023, including inflation and monetary tightening, geopolitical tensions, the housing market, household debt, financial market volatility and cryptoassets.



** Average of forecasts by major Canadian financials institutions*
Sources: International Monetary Fund and AMF

Economy

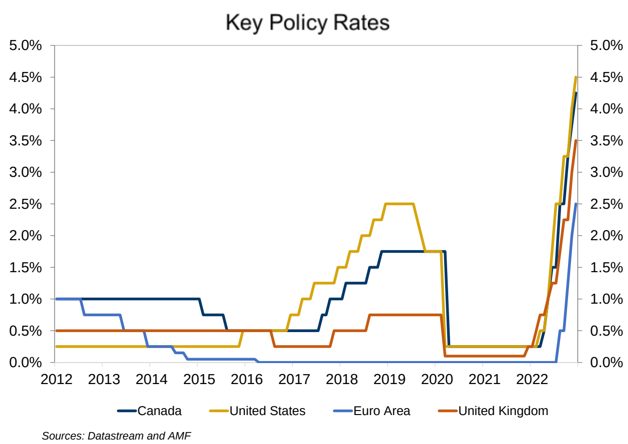
World

After decades of relative price stability, the global economy was marked by high inflation in 2022. At the start of the year, after two years of pandemic, the strong recovery in global demand had already started pushing prices up.

Russia's invasion of Ukraine and the ensuing sanctions added to the mix, causing uncertainty in the global energy supply and food supply. In many countries, inflation reached heights not seen in 40 years.

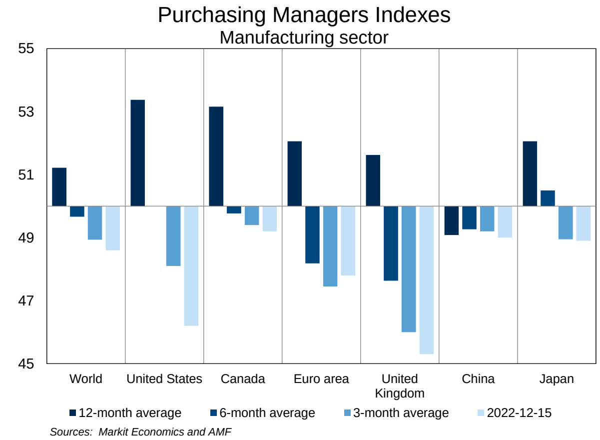
In response, most central banks announced a string of substantial key policy rate increases. By the end of the year, their actions seemed to bear fruit, with inflation levelling off in many countries, albeit while still at very high levels.

Several central banks have started to reduce the size of their rate hikes, from 75 to 50 basis points. However, the central banks are clearly indicating that tightening will have to continue in 2023 in order to bring inflation down, generally to a target rate of two percent.



Throughout the year, the central banks and other international financial organizations repeatedly revised their economic forecasts downward, pointing to a widespread slowdown, and even mild recessions, in 2023.

The slowdown in the global economy is increasingly becoming the main focus of concern, as evident in the purchasing managers indexes, most of which have been under 50, in contraction territory, for several months now.



In the United States, the economy remains resilient in adversity. After two quarters of slight contraction, U.S. GDP rose 3.2% in the third quarter of 2022. During the year, household spending remained the main economic driver, mostly owing to savings accumulated during the pandemic and labour market resilience.

The balance of trade also improved as energy exports increased to meet Europe's needs. However, household spending and business investment started to sag at year-end, pointing to a slowdown in the U.S. economy.

The labour market remains strong, even tight, with a jobless rate remaining near its historic low, at less than 4%, sustained job creation and still-low levels of new unemployment insurance claims. However, salary increases are continuing to fuel inflation.

After peaking at 9.1% in June, inflation fell back to 6.5% in December, owing in large part to lower energy prices and the easing of supply chain bottlenecks.

With some lag, the tightening of the Federal Reserve's monetary policy has also started to have an impact. The Fed hiked its rates from almost 0% in March to a target range of 4.25 to 4.50% in December, including four consecutive 75-basis-point increases.

Europe ultimately fared better than might have been expected at the start of the invasion of Ukraine given the continent's heavy dependence on Russian oil and natural gas. The Europeans have found new suppliers and implemented energy saving measures to limit the impact of Russian supply cuts. Helped by a mild autumn and replenished gas inventories, Europe is expected to get through the winter without the need for rationing.

Governments also provided generous support to households in the face of rising energy and food prices. Like elsewhere, however, the euro area economy slowed, posting GDP growth of 1.3% in the third quarter. The unemployment rate, down since the beginning of the year, was 6.5% in November.

Inflation in the euro area declined to 9.2% in December after peaking at 10.6% in October. This decline is largely attributable to lower energy prices.

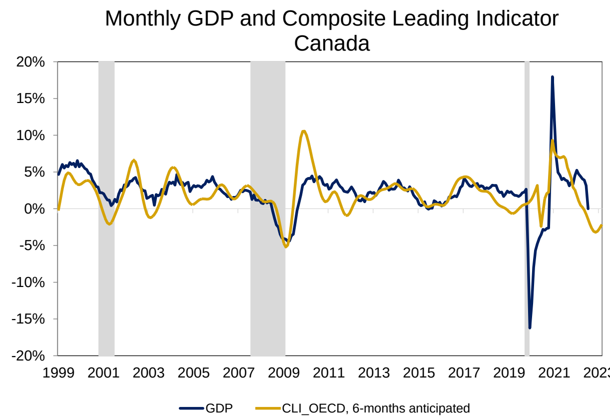
The European Central Bank only started to tighten its monetary policy in the summer, raising its rates by 250 basis points over a six-month period. In December, the ECB announced that there would be at least two further 50-basis-point hikes in Q1 2023. Starting in March, it will also begin to reduce the amount of assets purchased under its quantitative easing programs.

Falling far short of its usual growth levels, China recorded GDP growth of only 3% in 2022, a marked slowdown that was largely due to the government's stubborn zero-COVID policy. Systematic testing and forced quarantines brought entire cities and the lives of millions of people to a standstill. The situation was compounded by difficulties in the overindebted residential real estate sector.

Late in the year, public protests in China softened the government's resolve. However, because of the ensuing easing of the zero-COVID policy, China is now experiencing its first real wave of infections, which could slow its economy even further. Therefore, it could be a few months before the country regains its momentum. China's rebound will have a direct impact on the global economic recovery, although the country's energy and raw material needs might also fuel inflation.

Canada

The Canadian economy weathered the headwinds it faced. Strong growth in the first three quarters of 2022 will ensure a rise in GDP of over 3% for the year as a whole. However, the signs of a slowdown are growing.



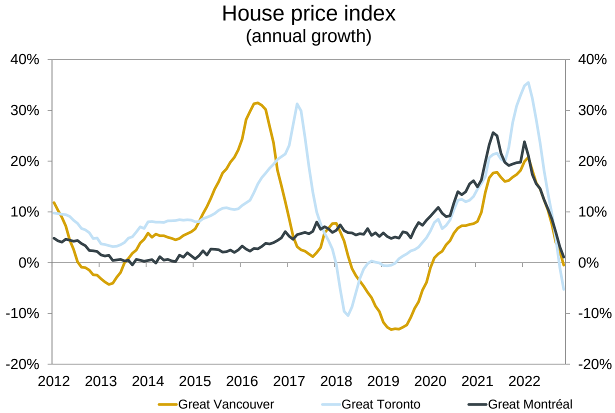
Sources : OECD and AMF

In retrospect, the lifting of public health restrictions led to a jump in consumer spending over the summer, despite higher prices and a sharply lower pace of job creation. The rebound, however, was short-lived. Interest-rate-sensitive spending, including consumer spending on durables and home renovations, is already on the decline.

Confronted with soaring consumer prices, the Bank of Canada launched an aggressive campaign in March to tighten its monetary policy. In total, the Bank raised its policy rate 400 basis points, increasing it to 4.25% in December. This was the fastest rise ever in the policy rate, which is now at its highest level since 2008.

Although the inflation rate started to buckle in the fall, it is still far above the Bank of Canada's target range of 1% to 3%. Inflation posted a year-over-year increase of 6.3% in December, after peaking at over 8% in the summer. The three measures of core inflation rose an average of 5.6%.

Rising interest rates and tightening financial conditions shook the residential real estate market and caused home sales across Canada to tumble significantly. The major metropolitan areas of Toronto and Vancouver, which experienced the largest price gains in recent years, recorded the largest year-over-year price decreases. As prices and sales fell, so did housing starts.



Sources: Canadian Real Estate Association and AMF

A relatively strong Canadian economy, high inflation and runaway commodity prices boosted corporate profit margins in 2022. The anticipated economic slowdown, wage inflation and tightening borrowing costs will squeeze margins and cause a slowdown in investment spending in 2023 as the confidence of business leaders drops.

The labour market strengthened in the final months of 2022. The pace was sufficiently sustained to keep the economy at full employment and reduce the unemployment rate to 5.0% in December.

Given the anticipated economic slowdown, the unemployment rate is expected to increase in 2023. With GDP growth anticipated at below 1%, the pace of job creation will be slower than the rate of labour force growth. If the Canadian economy were to enter a recession, the unemployment rate would rise even higher.

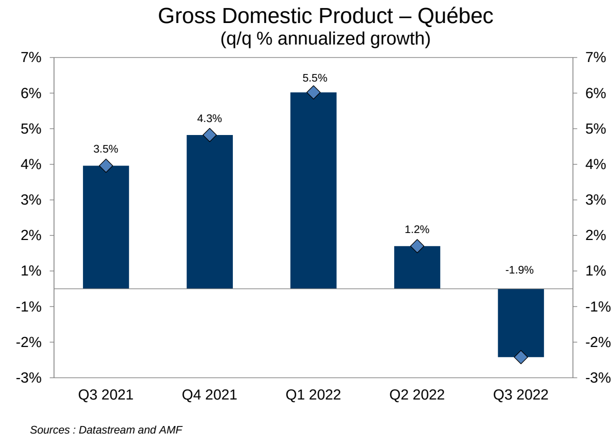
The Canadian economy nonetheless ended 2022 with solid growth above 3%. As a result, it remained in a situation of excess demand, which means it will have to cool even further if inflation is to get even close to the Bank of Canada's inflation target. With declining energy prices, monetary tightening and a cooling economy, the inflation rate will decline gradually over the coming year.

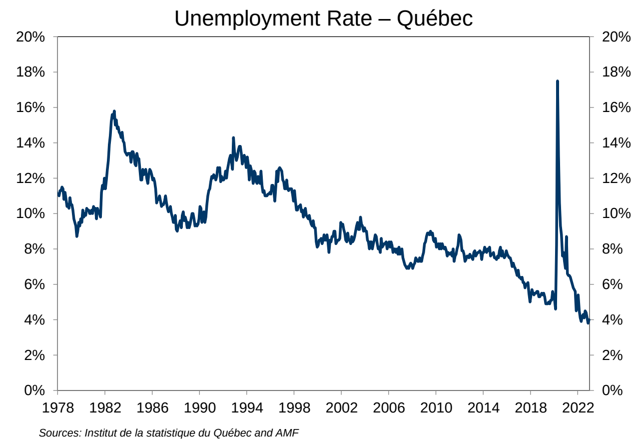
The economic outlook, however, is shrouded in an extraordinary degree of uncertainty. The fate of the Canadian economy will depend in large part on how well the U.S. economy fares, how the geopolitical situation evolves, and how much cooling there will be in the residential real estate sector.

The household debt ratio has reached record highs in recent years. If households were to commit in large numbers to reducing their debt levels, the economic recovery could prove to be slower and more difficult afterwards. However, the consensus scenario is that there will be a brief period of suboptimal growth in 2023, followed by a gradual recovery.

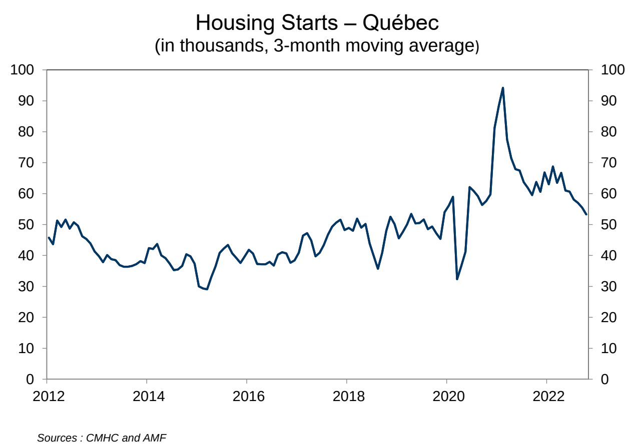
Québec

Rising interest rates and the global economic slowdown caught up with the Québec economy, which had come out of the starting blocks with a bang in 2022. Lost purchasing power due to inflation, higher borrowing costs and heightened global uncertainty took a toll on the province's economic performance. GDP declined in the third quarter, and growth is expected to slow significantly in 2023.





The residential real estate market came down to earth as interest rates rose. Home sales have so far fallen 26%, prices have retreated from their peak (-5.4% in Montréal and -2.5% in Québec City), and housing starts have pulled back significantly.



Job creation in 2022 was more moderate than in the previous year, with a net increase of 78,600 jobs, or only half as many as in 2021. That was still enough to maintain the downward trend in the unemployment rate, which reached a new historic low of 3.8% in November and ended the year at 4.0%. The economic slowdown will ultimately affect labour market performance and is expected to be reflected in rising unemployment.

Currently, Québec has nearly 250,000 job vacancies, for a vacancy rate of 6.1%, which means that there are more job vacancies than unemployed workers actively looking for work.

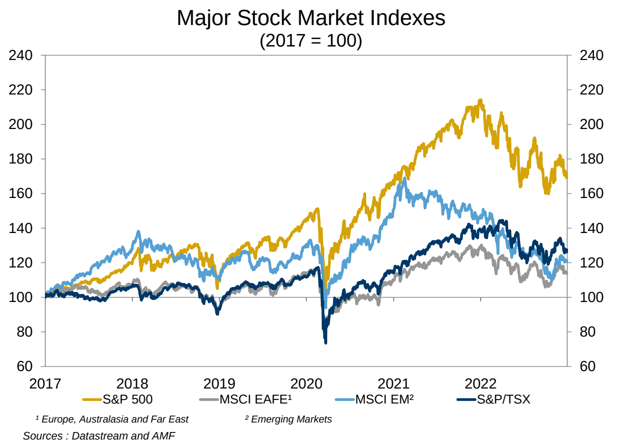
The labour shortage may curb the impact of the economic slowdown on the labour market. Of course, this is just an assumption, as such a situation has never been seen before. The number of job vacancies may also decline over the next year, not because they will have been filled, but because the jobs will have been eliminated.

Faced with a marked slowdown in employment and higher borrowing costs, Québec households may curb their consumer spending. The confidence of business leaders has also been shaken, which may be reflected in a deceleration in investment spending and the postponement of some expansion and modernization projects until the return of a more favourable environment.

The economic slowdown, however, is expected to be short-lived, and conditions could improve as early as the second half of 2023, unless inflation continues to act as a spoiler.

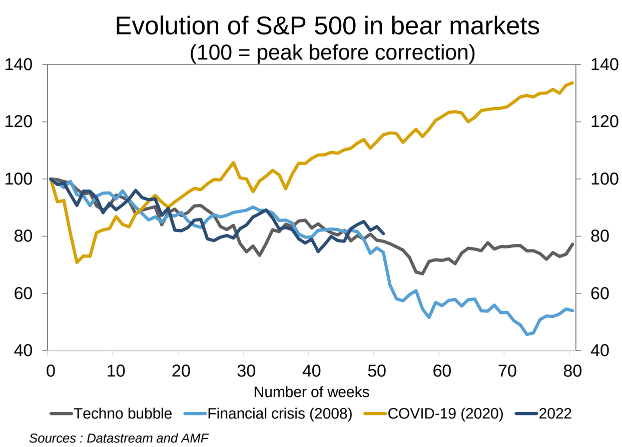
Financial markets

The year 2022 was a trying one for investors. Stock and bond indexes declined sharply as interest rates rose substantially and monetary tightening continued, significantly clouding the economic outlook.



The MSCI All Country World Index, which tracks global equity markets, was down approximately 17% on the year. The S&P 500, the flagship U.S. index, fell 19%.

This is quite a different situation from the March 2020 bear market, which was characterized by a rapid, substantial rebound in equity indices.



This time, the S&P 500's performance since its most recent peak is similar to other recent bear markets, with declines and rebounds occurring over a longer period.

The S&P 500's drop in 2022 is due in part to the poor performance of Communication Services and Information Technology. Declines in tech stocks were especially steep.

After benefiting from low interest rates, high valuations and the appetite for technology amid the pandemic, the major tech stocks suffered significant losses as interest rates rose, consumer behaviours changed and the economic environment deteriorated.

For example, the technology-heavy NASDAQ suffered one of the worst declines among the major indices, falling 33% compared to the beginning of the year.

In Canada, the S&P/TSX fared relatively well, posting a more limited decrease of 9%, its best performance against the S&P 500 since 2005. Since 2011, the S&P/TSX has delivered a higher annual return than the S&P 500 only once before, in 2016.

In 2022, soaring raw materials prices benefited Energy and Materials, which account for about 30% of the S&P/TSX's capitalization, compared to 8% for the S&P 500.

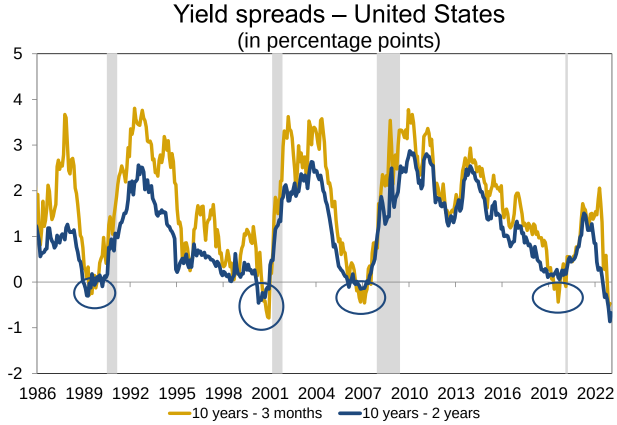
TSX-listed Québec companies stood out. The Morningstar National Bank Québec Index was down only 7% on the year, owing, in part, to the strong performance of Materials and Consumer Staples.

Bond rates rose in 2022. U.S. government 10-year yields climbed from approximately 1.5% at the beginning of the year to 3.9% when the year ended, while the Fed increased its target range for rates from 0.00%–0.25% to 4.25–4.50%.

In recent months, long-term yields have fluctuated sharply, weighed down by fears of an economic slowdown or even a recession.

During 2022, the yield curve inverted, meaning that short-term interest rates became higher than long-term interest rates. Historically, an inverted yield curve often signals a recession one to two years ahead.

The spread between 10-year and 3-month U.S. government bond yields recently reached levels below those observed just prior to the last four U.S. recessions.



Sources : Datastream and AMF

In Canada, bond yields followed the same upward trend, but Canadian 10-year yields ended the year at 3.3%, below U.S. yields. The Bank of Canada's policy interest rate reached 4.25% at year end, the same level as the bottom of the Fed's target rate range.

The Canadian economy is particularly sensitive to increases in interest rates owing to, among other things, relatively high levels of household debt and the structure of its mortgage market.

In 2023, investors' attention will be firmly focused on changes in inflation and monetary policy and recession risks. If inflation persists in 2023, central banks' policy rates will need to remain higher for longer, which could lead to a significant recession and further declines in equity markets.

The year 2022 was a tumultuous one, to say the least, for cryptoassets and the entire infrastructure that supports cryptoasset custody and exchanges.

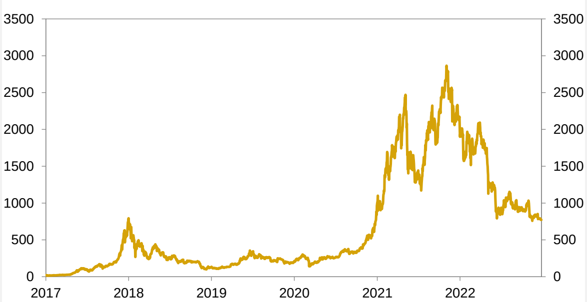
The total value of all cryptocurrencies peaked at nearly US$3 trillion at the end of 2021, before they collapsed, losing more than two thirds of their value in 2022.

Bitcoin was trading at more than US$65,000 at its peak before entering a downward spiral, which more or less coincided with the start of monetary tightening by the central banks.

A number of factors also compounded this significant decline, including the strengthening of the regulatory framework, the ban on crypto mining in China and Russia, the collapse of several exchange platforms, and the loss of investor confidence.

By the end of 2022, the cryptoasset market was worth only about US$790 billion, while the value of bitcoin had fallen to US$6,500, down 75% from its peak.

Changes in cryptoasset capitalization
(in billions of US dollars)



Sources : Bloomberg and AMF

The cryptoasset debacle led to the collapse of several exchange platforms and the systematic freezing or loss of investors' assets. It also exposed liquidity and transparency issues concerning reserves as well as interconnections with affiliated entities.

Collapsing platforms and fraudulent activity have resulted in billions of dollars in losses for investors.

Cryptoassets are increasingly inter-connected with the traditional financial market but not yet enough to threaten financial stability.

While some consider them a portfolio diversification asset, they are still risky and highly volatile.

As part of its financial awareness and education efforts, the AMF recently published an issues paper on the risks and benefits of digital financial services:

Insights into the risks and benefits of digital financial services for consumers

Market Performance

		Level				% change				Last 12 months	
Stock Markets											
		2022-12-31	**1 month**	**3 months**	**6 months**	**9 months**	**1 year**	**3 years[2]**	**5 years[2]**	**Min.**	**Max.**
MSCI All Country World Index		727	-4.9	7.0	1.3	-13.0	-17.5	3.4	4.3	678	886
MSCI EAFE[1]		1,232	-3.1	8.4	3.8	-5.3	-9.5	1.2	1.1	1,135	1,383
MSCI Emerging Markets		57,479	-2.2	6.1	-3.6	-12.3	-17.9	-2.2	-1.1	52,493	71,889
S&P 500		3,840	-5.9	7.1	1.4	-15.3	-19.4	5.9	7.5	3,577	4,797
S&P/TSX		19,385	-5.2	5.1	2.8	-11.4	-8.7	4.3	3.6	18,206	22,087
Morningstar National Bank Québec Index		361	-3.1	7.1	8.8	-7.7	-6.8	3.6	4.6	323	392
Bond Markets											
		Level								**Last 12 months**	
		2022-12-31	**-1 month**	**-3 months**	**-6 months**	**-9 months**	**-1 year**	**-3 years**	**-5 years**	**Min.**	**Max.**
Québec	10-year	4.0	3.7	3.9	4.0	3.1	2.0	2.3	2.6	2.0	4.5
Ontario	10-year	4.1	3.7	3.9	4.0	3.1	2.1	2.3	2.6	2.1	4.5
Canada	10-year	3.3	2.9	3.2	3.2	2.4	1.4	1.7	2.0	1.4	3.7
United States	10-year	3.9	3.6	3.8	3.0	2.3	1.5	1.9	2.4	1.5	4.2
United Kingdom	10-year	3.7	3.2	4.1	2.2	1.6	1.0	0.8	1.2	1.0	4.5
Germany	10-year	2.6	1.9	2.1	1.3	0.5	-0.2	-0.2	0.4	-0.2	2.6
	AA Corp. (10-year)	4.6	4.3	4.5	4.5	3.6	2.4	2.6	3.1	2.4	5.1
Canada	BBB Corp. (10-year)	5.4	5.1	5.5	5.3	4.3	3.0	3.3	3.8	3.0	6.0
	BBB - 10-year Gov. spread	2.1	2.1	2.3	2.1	1.9	1.6	1.6	1.7	1.6	2.4
	AA Corp. (10-year)	4.7	4.5	4.9	4.1	3.2	2.1	2.5	3.1	2.1	5.3
United States	BBB Corp. (10-year)	5.7	5.6	6.0	5.1	3.9	2.7	3.2	3.7	2.7	6.5
	BBB - 10-year Gov. spread	1.9	2.0	2.2	2.1	1.6	1.2	1.3	1.3	1.2	2.3

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

Sources: Datastream, Bloomberg and AMF

Issues to be monitored in 2023

- Aggressive monetary tightening has significantly increased the risk that there will be a global recession in 2023. In response, inflation has begun to drop, but it is still offering resistance and may take a while to move closer to the inflation targets set by the central bank. In the meantime, there are increasing signs that the economy is slowing. If there is a recession, it is expected to be mild and short-lived.
- Geopolitical tensions will continue to occupy the spotlight in 2023. The deepening war in Ukraine will test the West's resolve and continue to weigh on the global economy, including energy supplies. In addition, the implementation of an Indo-Pacific strategy aimed at isolating China is likely to raise tensions, particularly as it involves a more assertive Western military presence in the South China Sea and around Taiwan. Any slip could have major repercussions for the global economy and markets.
- The COVID-19 pandemic appears to be under control in most countries. However, after going it alone with its zero-COVID policy, China is only now facing a first wave of infections. The Chinese economic slowdown is therefore expected to continue in the coming months. China's weight in the global economy, particularly in the manufacturing industry and supply chains, means that how it manages this public health crisis will have repercussions beyond the country's borders.
- Home sales have been declining for more than a year and housing prices have recently started to trend downward. Rising interest rates are tightening conditions on new mortgages and increasing debt servicing. Already weakened by the tightening of credit conditions, the housing market is also vulnerable to the risk of a recession.
- Household debt reached a new high in 2022 in Canada, at close to 183% of disposable income. The most indebted households will be more vulnerable to a less favourable economic environment and rising debt servicing. The risk of default will be increased by possible rising unemployment.
- The low interest rates and favourable economic environment of the past few years have incentivized Canadian businesses to make greater use of debt, which consequently reached record levels. In 2022, these levels decreased but were still high by historical standards. With the global economic slowdown and rapidly rising interest rates, many companies may find it difficult to obtain financing or meet their payment obligations.
- The stock markets are expected to continue to be volatile over the next year, given the high level of uncertainty surrounding interest rates and the economy. The substantial declines in 2022 mean that equity market valuations have decreased significantly. However, if inflation proves again to be persistent, monetary policies will need to be more restrictive for a longer time and will impact the direction of the markets in addition to generating volatility.
- The labour shortage has become even more acute in the past year. Job vacancies are up in most sectors of the economy, there being fewer unemployed workers than job vacancies. The labour shortage is maintaining pressure on wages, limiting the production of goods and the provision of services, and forcing a number of businesses to forgo expansion plans.
- The year 2022 once again showed how quickly the physical risks from climate change are increasing. High winds affected Ontario and Québec during the summer, while Hurricane Fiona caused heavy financial losses in the Maritime provinces in the fall, particularly in Nova Scotia and Prince Edward Island. These two events rank as, respectively, the sixth and seventh largest insured losses in Canada. The costs of the winter storm in late 2022 have not yet been tallied but could also be significant. According to the Intergovernmental Panel on Climate Change, physical risks are expected to increase going forward.

- Various regulations related to the development of carbon taxation tools, enhanced disclosure of financial risks related to climate change, and incentives to advance the transition to a more sustainable economy are expected at the international level in 2023. In this context, the development of sustainable finance will continue.
- Consumers have access to a growing range of financial products often labelled as “green,” “ESG” (combining environmental, social and governance criteria) or “sustainable,” enabling them to invest in the transition to a more environmentally friendly, lower-carbon global economy. However, the investment criteria for this new asset class are not yet clearly standardized or regulated. Nevertheless, various international regulatory initiatives are ongoing to better define and improve the framework for these new products. Certain initiatives, some after delays or transition periods, will be coming into force in the near future.
- The pandemic has spurred enthusiasm for self-directed online brokerage, sometimes leading to speculation on certain stocks or risky asset classes. The speculative waves have sometimes been stoked by social media, influencers or promotional practices. The new economic environment that has emerged since the end of 2022, which is marked by a decreasing savings rate, rising interest rates and increased market volatility, seems to have dampened interest in self-directed brokerage, which nonetheless remains higher than pre-pandemic levels and will therefore continue to be monitored.
- In addition to the cryptocurrency debacle, the cryptoasset industry has been hit by several scandals and exchange platform collapses. Extreme volatility and growing interconnections with the traditional financial system are prompting increased oversight.
- With the active deployment and rapid growth of digital financial products and services, cybersecurity continues to be a major risk for the entire digital industry. Cyber attacks have long been profit-oriented, but they are increasingly being used for destabilizing purposes, which can lead to disastrous consequences for the financial system.

NOTE