Economic and Financial Review

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Office of the Chief Economist

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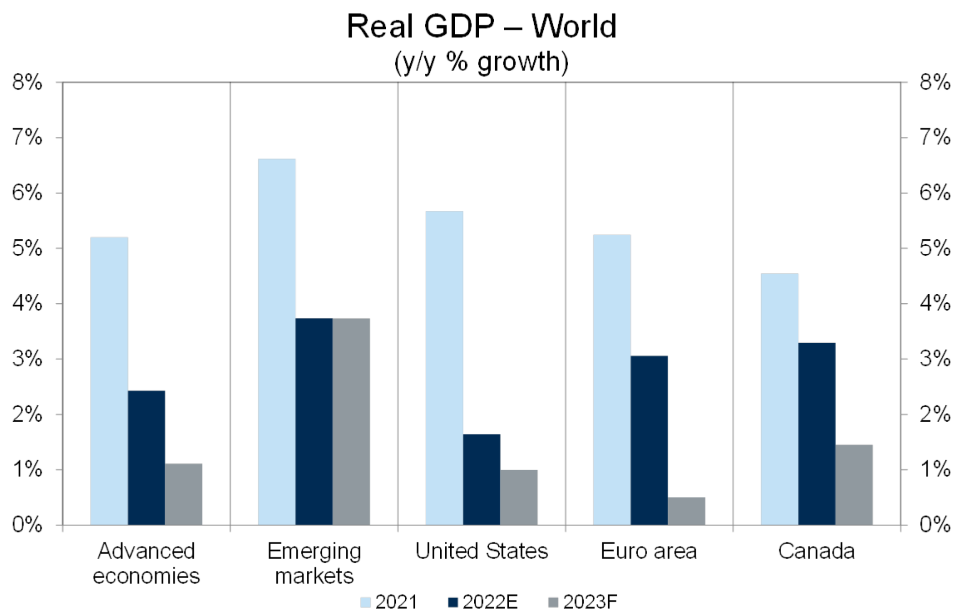
Highlights

- The global economic outlook has dimmed considerably in the last few months. Responding to high inflation, most central banks have accelerated monetary tightening through substantial policy rate hikes.
- Canada's economic growth has gradually slowed, dampened by rising interest rates, a cooling global economy and declining commodity prices.
- After an excellent start to the year, Québec's economy is increasingly showing signs of weakness, with Q2 GDP growth at only 1%, a quickly deteriorating housing market, and a labour market that has softened since the summer.
- After rebounding over the summer, stock markets resumed their downward trend, reaching new lows as investors were rattled by persistent inflation and the more aggressive stance taken by the central banks.
- On the bond markets, yields increased significantly as a result of central banks' restrictive monetary policies, which will be maintained for some time to come.

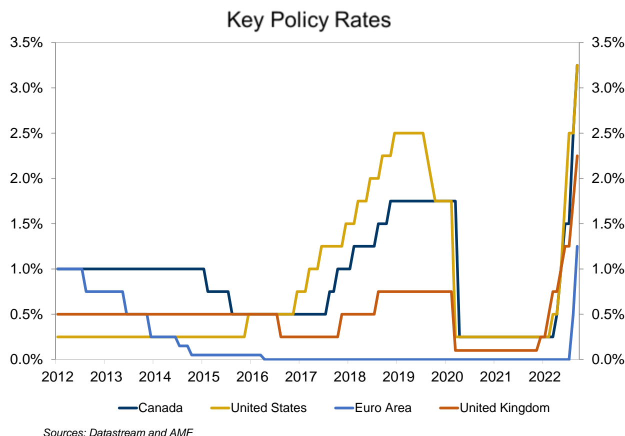


Sources: International Monetary Fund and AMF

Economy

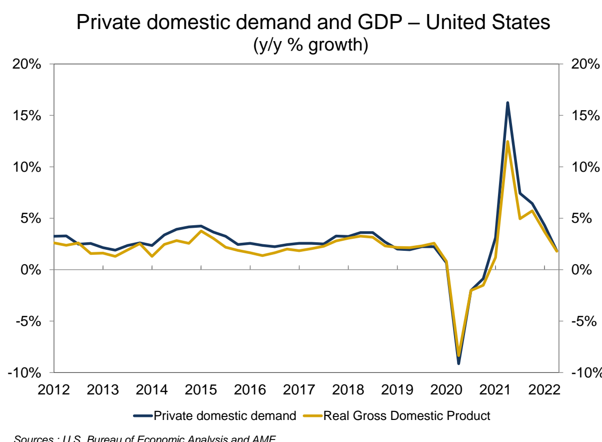
World

The global economic outlook has dimmed considerably in the last few months. Responding to high inflation, most central banks have accelerated monetary tightening through substantial policy rate hikes.



This high-wire act is meant to achieve a soft landing for the economy, but recession risks are mounting. The fight against inflation is being reflected in a widespread economic slowdown and highly volatile financial markets. OPEC's announced oil output cuts could make the situation even worse.

In the United States, GDP fell slightly during the first six months of the year, and the growth outlook appears modest for the remainder of 2022. Private domestic demand continues to slow, particularly on the consumer spending and residential investment sides, as household disposable income is eaten up by inflation and monthly mortgage payments continue to rise.



The labour market remains tight, with unemployment under 4%, a sustained pace of employment growth, and a low level of new employment insurance claims.

At 8.2% in September, inflation was down slightly from its high in June but has remained above 8% for over six months. Although the price of gasoline has come down in recent months, Americans have had to pay more for most other purchases.

In September, the Federal Reserve announced a third consecutive 75-basis-point hike in its benchmark interest rate, raising it to a range of 3%-3.25%. The Fed remains determined to bring inflation back down to the 2% target and indicated that other significant increases are to be expected in the coming months. According to the Fed's projections, its benchmark interest rate will be at 4.4% at the end of 2022. Moreover, the strong U.S. dollar, spurred by high rates, is deepening inflation in many countries and forcing their central banks to take action.

Due to its proximity to Russia and dependence on Russian natural gas, Europe is being hit harder by the war in Ukraine, a direct consequence of which is soaring inflation. Russia has already interrupted most of its gas deliveries, forcing the Europeans to find new suppliers and implement energy saving

measures as winter nears. Although natural gas inventories are 80-90% replenished, they may not be sufficient to make it through the cold months ahead, and power rationing may be necessary.

Inflation in the euro area reached a record high of 10% in September, mainly owing to the rising costs of not only energy but also food, goods and services.

In response, the European Central Bank (ECB) hiked its key interest rates in the third quarter, by 50 basis points in July and 75 basis points in September. The ECB expects inflation to remain high for some time and intends to continue raising its rates.

Unlike the Fed, however, the ECB does not plan to reduce the size of its balance sheet for the time being and will continue to reinvest the proceeds from matured securities purchased under its quantitative easing programs.

So far, the economy in the euro area has proven surprisingly resilient, with year-over-year GDP growth at 4.1% in the second quarter and unemployment down to 6.6% in August.

However, the impact of Russian gas supply cuts is already being felt, and things could get worse as winter approaches. Soaring energy prices and rate hikes could hit households and businesses hard and put the brakes on the economy.

Purchasing managers indexes, which are a sound indicator of the economic outlook, fell throughout the summer and are now pointing to a contraction in economic activity in both the manufacturing and services sectors.

In the United Kingdom, the Bank of England hiked its bank rate 50 basis points in September, simultaneously announcing that the country was already in a recession. This was a seventh consecutive hike, with inflation hovering around 10% since the summer and the British pound at historic lows and nearing parity with the U.S. dollar.

To bolster the economy, the U.K. government announced large tax cuts and a support plan for households and businesses, raising fears of a public debt spiral and undermining inflation-fighting efforts. The Bank of England had to intervene to stabilize the bond markets, and the government reversed course on some measures.

The Chinese economy, one of the most important drivers of global economic growth, continued to sputter in the third quarter.

Faced with COVID-19 outbreaks across all areas of the country, the Chinese government is maintaining its zero-COVID policy, imposing draconian lockdown measures that are affecting entire cities and millions of people.

The country was also hit by an intense heatwave this past summer that caused major power outages, production stoppages, and a decline in manufacturing activity.

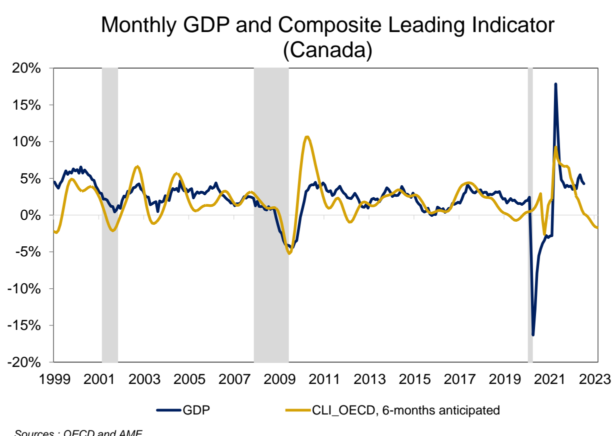
Lastly, the residential real estate sector, hobbled by high property developer debt and plummeting home sales, continued to cool. In addition, the purchasing managers' indexes are pointing to a contraction in both the manufacturing and services sectors.

Chinese officials have reduced interest rates and announced a major economic stimulus plan to counter the slowdown. It remains to be seen whether such measures will be enough given continuing low consumer confidence and weakening global demand for Chinese products. In the second quarter, the Chinese economy contracted slightly, year-over-year growth being effectively nil.

Canada

The Canadian economy is being hampered by growing headwinds created by successive policy rate hikes, tighter financial conditions, a global economic slowdown and slumping commodity prices. The slowdown in the past few months is gaining traction and will continue over the coming months and definitely into next year.

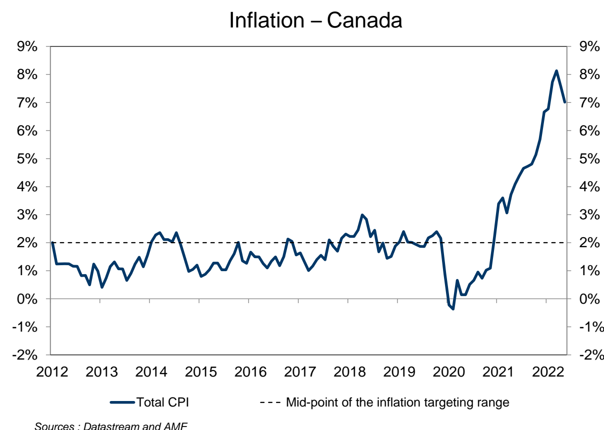
Despite this, the economy posted a solid performance in the first half of the year, averaging 3.2% GDP growth during that period. Some components of domestic demand, such as consumption and business investment, have remained very robust. Conversely, interest-sensitive sectors have already begun to buckle, the housing market being a case in point.



Rising mortgage rates have caused a significant decline in the housing market. Home sales are down significantly, sellers have lost their position of strength, and bidding wars are becoming less and less common. Home prices have started to fall, especially in major cities like Toronto and Vancouver. The uptrend in mortgage rates, which is expected to continue, will further reduce activity in the residential sector.

The labour market has lost ground in the last few months. As a result, the unemployment rate has risen from a trough of 4.9% to 5.2%, although it remains close to its historic low. Despite the slowdown, major labour shortages continue to exist in most sectors.

The Canadian inflation rate has declined slightly as of late, from a peak of 8.1% in June to 7%, owing mainly to lower gasoline prices. However, inflation has spread to a broader range of goods and services.

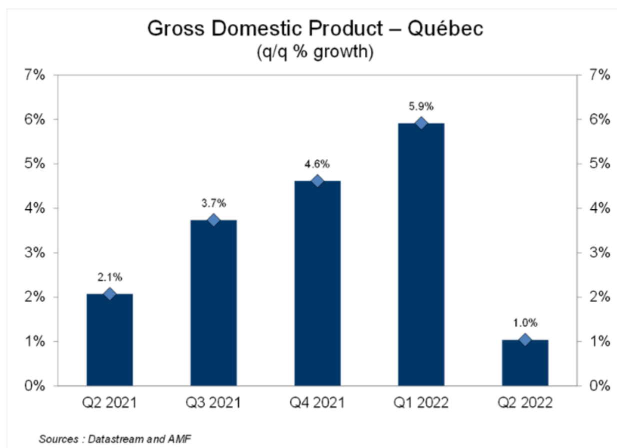


An easing of inflation pressures will not be possible until the economy experiences slower growth for a period of time. Suboptimal growth will dampen demand for goods and services and rebalance supply and demand.

Like other major central banks, the Bank of Canada has pursued an aggressive rate hike policy. Since March of this year, it has raised its policy interest rate 300 basis points, including large increases of 100 and 75 basis points in July and September, respectively—the fastest monetary tightening since the 1980s.

Moreover, the Bank of Canada has indicated that further policy rate increases are going to be needed to ease inflation pressures and bring inflation back down to near its target of 2%.

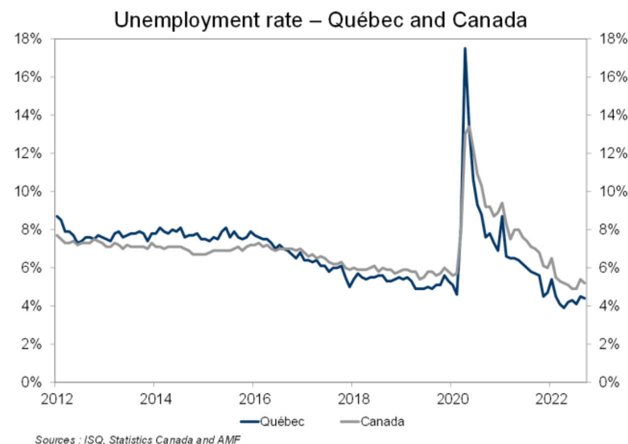
After an excellent start to the year, Québec's economy is increasingly showing signs of weakness, with Q2 GDP growth at only 1%, a quickly deteriorating housing market, and a labour market that has softened since the summer.



Rapidly rising interest rates and high inflation are applying a brake to household spending, while the global economic slowdown will eventually dampen exports. Lower GDP growth is therefore expected over the next few quarters.

The residential real estate market is feeling the effects of rising interest rates, although the correction is less severe than elsewhere in Canada. Nonetheless, the cooling of the real estate market will have direct and indirect consequences for Québec's overall economy and will contribute to slow economic momentum.

The labour market has sputtered for the past few months, and the trend is clearly lacklustre. The economy as a whole is nonetheless in a labour shortage situation, with a significant number of job vacancies, which is contributing to rapid growth in wages in 2022.

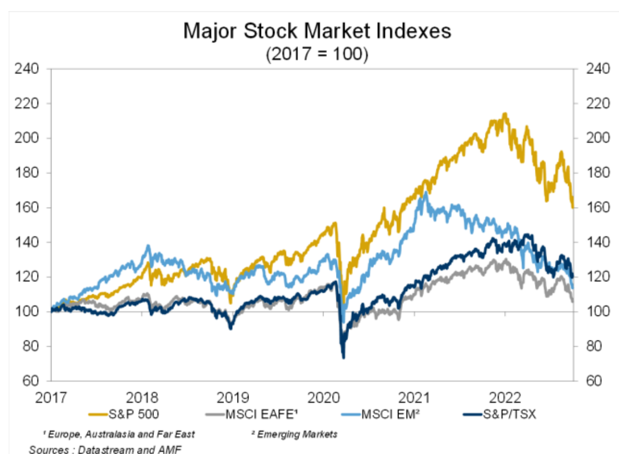


The likelihood of a recession in the United States and Canada has risen a notch owing to the almost unprecedented speed with which monetary tightening has been carried out. Québec's economy is slowing and, exposed to foreign markets, is not insulated from the turbulence rattling the global economy. As interest rates rise, consumer spending will slow and the correction in the housing market will continue. Given this situation, the outlook for 2023 has deteriorated substantially.

Financial markets

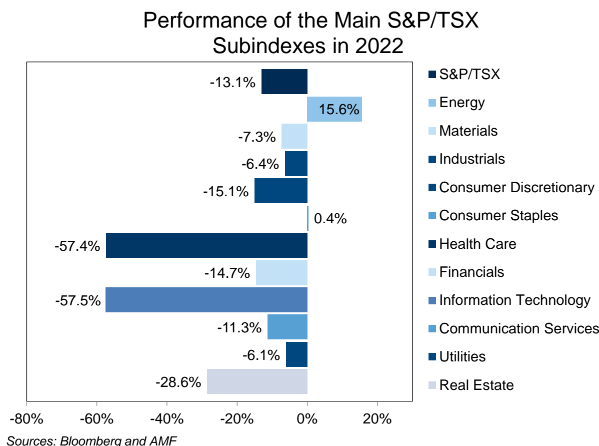
High inflation, monetary tightening and recession risks continued to be the dominant themes in the financial markets during the third quarter. After rebounding over the summer, stock markets resumed their downward trend, reaching new lows as investors were rattled by persistent inflation and the more aggressive stance taken by the central banks.

The major central banks appear to be increasingly convinced of the need to curb inflation with strong rate hikes, even if it could result in a significant economic slowdown or even a recession. In this context, the MSCI All Country World Index has fallen by close to 23% since the beginning of the year and bond yields have reached highs not seen in over a decade.



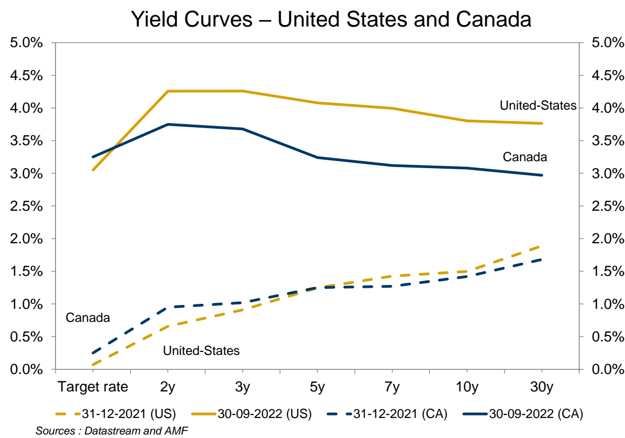
In the United States, the S&P 500 hit a new low at the end of the quarter, down 25% from the beginning of the year. Technology stocks, which are especially vulnerable to rising interest rates as a result of their relatively high valuations, continued to post sharp declines. Overall, the earnings of S&P 500 companies posted a slight increase, due mainly to the energy sector, but a significant slowdown in the economy could further dampen their growth.

U.S. 10-year yields reached 4% near the end of the quarter, a first since 2010, and then declined slightly. The interventions of the Fed officials dispelled any doubts about their willingness to further tighten monetary policy and bring its policy rate to a restrictive level and keep it there for some time.



In Canada, the S&P/TSX fared slightly better, with a decline of 13% from the beginning of the year, owing mainly to its heavier weighting in the energy sector. However, oil prices have decreased significantly from the highs reached in the wake of the conflict in Ukraine, although they remain largely up from last year. The stocks of Québec-based companies listed on the TSX posted a similar decline.

Bond yields in Canada also rose sharply, albeit slightly less so than in the United States. Canadian 10-year yields ended the quarter at 3.2%, well below U.S. 10-year yields. The Canadian economy is especially sensitive to rising interest rates owing, in part, to the relatively high level of household debt.



The Canadian dollar declined sharply against the U.S. dollar, although it generally performed well against other major currencies. The Canadian dollar ended the quarter under 73 U.S. cents, compared with close to 80 U.S. cents at the beginning of the year. The U.S. dollar is up approximately 17% against all major currencies this year, according to the U.S. Dollar Index. The rise in the U.S. dollar reflects the Fed's relatively aggressive stance, high bond yields, and concerns about the health of the global economy.

Elsewhere in the world, the major stock market indices were also down sharply from the beginning of the year. The rise in inflation and interest rates was widespread, including in Europe. In the euro area, inflation is hovering around 10%, while German 10-year yields, which were in negative territory at the beginning of the year, rose to 2.1% at the end of the quarter. Emerging markets are also being hit hard and must contend with the rising U.S. dollar.

In the United Kingdom, the government's announced fiscal measures and large, unfunded tax cuts sent shock waves through the financial markets. The British pound plummeted and bond yields jumped, forcing the Bank of England to announce the large-scale purchase of British sovereign bonds to preserve financial stability and the government to backtrack.

Over the coming months, the economic and financial environment will likely continue to bring considerable uncertainty for investors. Inflation, monetary tightening and, more broadly, the risk of a significant slowdown in the global economy continue to influence developments in the financial markets.

Market Performance

Stock Markets

		Level	% change							Last 12 months	
		2022-09-30	1 month	3 months	6 months	9 months	1 year	3 years[2]	5 years[2]	Min.	Max.
MSCI All Country World Index		679	-8.6	-5.3	-18.7	-22.9	-17.7	3.5	3.9	679	886
MSCI EAFE[1]		1,137	-6.6	-4.3	-12.7	-16.5	-13.5	0.0	0.2	1,135	1,383
MSCI Emerging Markets		54,180	-9.6	-9.1	-17.3	-22.7	-23.7	-1.3	-1.3	54,161	73,478
S&P 500		3,586	-9.3	-5.3	-20.9	-24.8	-16.8	6.4	7.3	3,586	4,797
S&P/TSX		18,444	-4.6	-2.2	-15.7	-13.1	-8.1	3.5	3.4	18,308	22,087
Morningstar National Bank Québec Index		337	-3.4	1.6	-13.8	-12.9	-15.3	3.0	4.5	323	411

Bond Markets

		Level								Last 12 months	
		2022-09-30	-1 month	-3 months	-6 months	-9 months	-1 year	-3 years	-5 years	Min.	Max.
Québec	10-year	3.9	3.9	4.0	3.1	2.0	2.1	2.0	2.8	1.9	4.4
Ontario	10-year	3.9	3.9	4.0	3.1	2.1	2.1	2.0	2.7	2.0	4.4
Canada	10-year	3.2	3.1	3.2	2.4	1.4	1.5	1.4	2.1	1.3	3.6
United States	10-year	3.8	3.2	3.0	2.3	1.5	1.5	1.7	2.3	1.3	3.9
United Kingdom	10-year	4.1	2.8	2.2	1.6	1.0	1.0	0.5	1.4	0.7	4.5
Germany	10-year	2.1	1.5	1.3	0.5	-0.2	-0.2	-0.6	0.5	-0.4	2.2
	AA Corp. (10-year)	4.5	4.4	4.5	3.6	2.4	2.4	2.4	3.3	2.3	5.0
Canada	BBB Corp. (10-year)	5.5	5.2	5.3	4.3	3.0	3.0	3.1	4.0	3.0	5.7
	BBB - 10-year Gov. spread	2.3	2.1	2.1	1.9	1.6	1.5	1.8	1.9	1.5	2.3
	AA Corp. (10-year)	4.9	4.2	4.1	3.2	2.1	2.0	2.4	3.1	2.0	5.1
United States	BBB Corp. (10-year)	6.0	5.2	5.1	3.9	2.7	2.6	3.1	3.7	2.5	6.2
	BBB - 10-year Gov. spread	2.2	2.0	2.1	1.6	1.2	1.1	1.5	1.4	1.1	2.3

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

Sources: Datastream, Bloomberg and AMF

NOTE

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