AUTORITÉ DES MARCHÉS FINANCIERS

Economic and Financial Review

January 19, 2024

Office of the Chief Economist

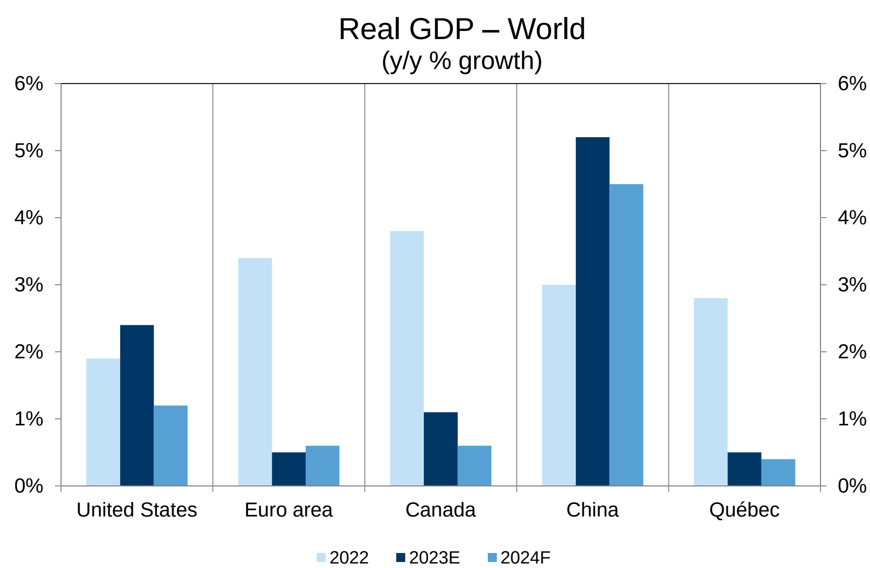
Table of contents

Mario Houle, Chief Economist
Nouhou Ballo, Financial Markets Specialist
Philippe Bergevin, Senior Economist
Jean-Paul Calero, Financial Markets Specialist
Alexandre d'Aragon, Senior Economist
Tessa Kintoumba, Economist

Legal deposit – Bibliothèque et Archives nationales du Québec, 2024
ISSN 2561-7109

Highlights

- In 2023, the fight against inflation turned a corner as the effects of key policy rate hikes were felt. Inflation gradually came down from the highs reached in 2022. At the same time, the global economy, while it slowed, proved more resilient than anticipated. Central banks are now trying to orchestrate a soft landing for the economy.
- The U.S. economy was particularly resilient throughout 2023, due in part to strong household consumption and a solid labour market. An average of more than 200,000 jobs were created every month in 2023, and the jobless rate has been under 4% for almost two years.
- While the United States exceeded expectations, the Canadian economy struggled, owing in part to anemic productivity growth and high household debt, which is making the economy more sensitive to rising interest rates.
- In Québec, the economy stalled in 2023. All components of private domestic demand slowed or lost ground. Business and residential investment fell. Only consumer spending remained relatively firm.
- After significant declines in 2022, the main stock markets resumed their upward trajectory in 2023, buoyed by the expected end of monetary tightening and the resilience of the global economy.
- Bond yields rose for most of 2023, then declined at the end of the year. This downturn in bond yields was due to a moderation of inflationary pressures and a shift in investors' monetary policy expectations.
- Several issues will need to be monitored in 2024, including inflation and monetary policy, geopolitical tensions, household and corporate debt, the residential and commercial real estate markets, financial market resilience, and disruptive technologies.



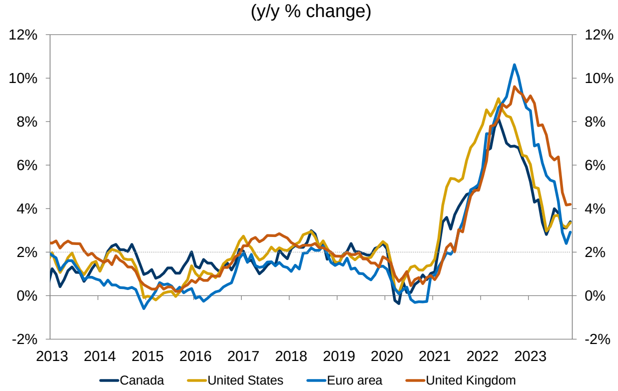
Sources: Consensus forecast, Bloomberg and AMF

Economy

World

In 2023, the fight against inflation turned a corner as the effects of key policy rate hikes were increasingly felt. Inflation came down from the highs reached in 2022, so much so that central banks paused monetary policy tightening in the summer and rate cuts are now being contemplated for 2024. The global economy slowed and some countries were hit harder than others, but the recession scenarios raised at the start of the year have so far been avoided. The resilience of the global economy was evident in the face of bank failures in the United States and Europe but also amid geopolitical uncertainty linked to the wars in Ukraine and the Middle East. Central banks are now tackling the difficult task of orchestrating a soft landing for the economy.

Consumer Price Index – World
(y/y % change)



Sources: Eurostat, OECD, Statistics Canada, U.S. Bureau of Labor Statistics and AMF

The U.S. economy proved particularly resilient throughout the year in the face of inflation and high interest rates, owing in part to strong household consumption. GDP rose 4.9% in the third quarter, following increases of just over 2% in the first two quarters of the year.

An average of more than 200,000 jobs were created every month in 2023, and the jobless rate has been under 4% for almost two years.

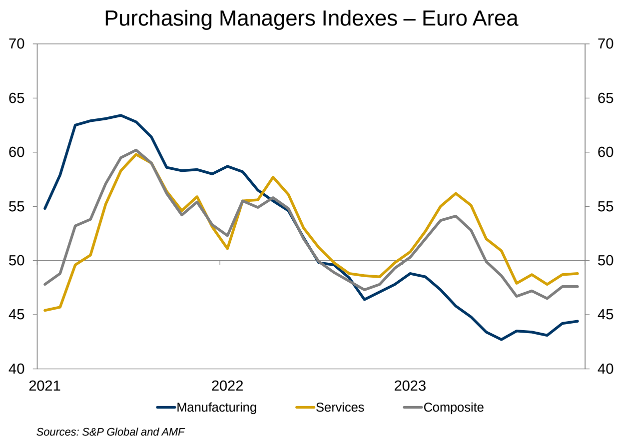
Like the economy, however, the labour market began to show signs of weakening late in the year. The pace of job creation slowed in the second half of the year, and wage growth, though relatively solid, continued to decline.

Inflation fell from 6.4% at the start of 2023 to 3.4% in December. Core inflation (which excludes the more volatile items of food and energy) ended the year at 3.9%. The ongoing deceleration in wage growth and unit labour costs suggests that this downward trend is set to continue.

The Federal Reserve raised its key policy rate four times in 2023, taking it to a range of 5.25% to 5.50%. It has maintained the status quo since July, and all indications are that the peak has already been reached. The Fed is confident that it has succeeded in bringing inflation down sufficiently, while orchestrating a soft landing for the economy. It now believes it will be in a position to cut its key policy rate a few times in 2024, with the market expecting a potential first cut in the spring.

The situation was quite different in the euro area, where the economy hovered on the brink of recession throughout the year. GDP contracted 0.5% in the third quarter, following increases of 0.4% and 0.5% in the first and second quarters. Germany, the pillar of the euro area, has been idling since the Russian invasion of Ukraine.

The outlook for 2024 is no better, with purchasing managers' indexes still pointing to economic contraction in both the manufacturing and services sectors.



Ten consecutive rate hikes by the European Central Bank appear to have beaten back inflation, which fell from a high of 10.6% in October 2022 to 2.9% last December. The ECB has not raised rates since September and will accelerate the end of its pandemic-related quantitative easing program. The Bank is still not talking about a rate cut, as it continues to be concerned about labour market tightness. The unemployment rate was 6.4% in November, close to its historic low, despite the slowing economy.

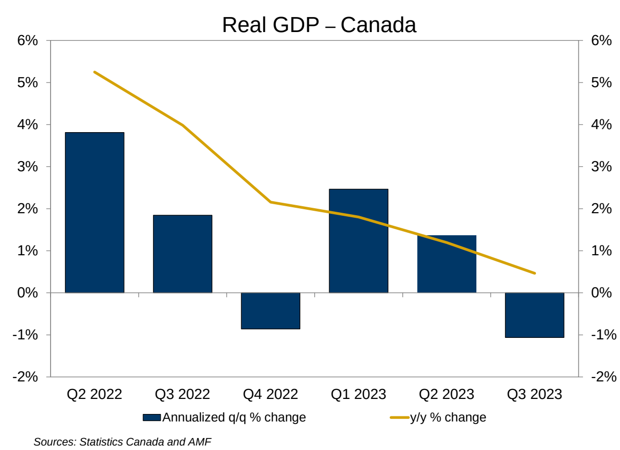
For its part, China is still struggling to gain traction a year after the lifting of the zero-COVID policy that paralyzed its economy during the pandemic. The anticipated rebound failed to materialize, despite the authorities' support measures. Instead, economic indicators revealed a muted recovery throughout the year. GDP grew 5.2% in 2023, barely above the modest 5% target set by the government. Such growth may prove more difficult to achieve in 2024.

While the whole world is fighting inflation, China is instead battling the threat of deflation owing, in no small part, to weak demand for its products both at home and abroad. Exports are falling and manufacturing activity is contracting. The country must also contend with the indebtedness of local governments and state-owned companies, the collapse of the real estate sector, where bankruptcies are on the rise, a shrinking working-age population, and strained trade relations with the West. Moody's rating agency has placed the world's second-largest economy under watch, lowering its outlook on Chinese debt from stable to negative.

Canada

Whereas the U.S. exceeded expectations last year, the Canadian economy struggled. This appears set to remain the case for most of 2024. There are two main reasons why Canada will continue to lag behind the U.S.: anemic productivity growth and much higher household debt, which is making the economy more sensitive to rising interest rates.

Although the Canadian economy avoided a recession, growth remained very modest. GDP contracted in the third quarter, pulled down by business investment and net exports. Over the past year, economic growth has been steadily slowing.



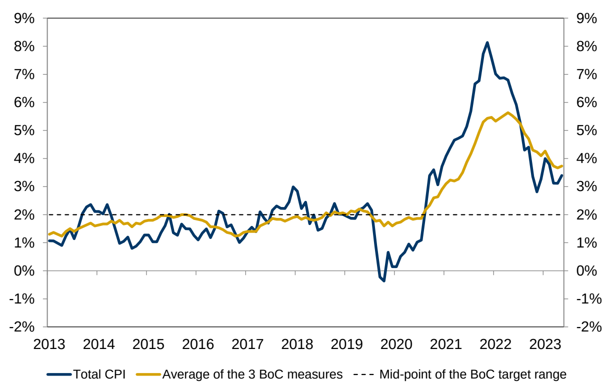
Private investment has ground to a halt, residential construction is declining and consumer spending has slowed considerably. As a result, the Canadian economy is expected to experience a few quarters of weak or negative growth, before showing some improvement in the second half of the year.

Labour market tightness is easing. Employment growth is slowing, job vacancies are falling, and the unemployment rate is rising, increasing gradually from 5% at the start of 2023 to 5.8% by the end of the year. Despite a loosening of labour market tightness, wage growth remains sustained and above inflation, at between 4% and 5%.

The deteriorating job market, increasing unemployment and rising borrowing costs will have even more bite in the coming months and will further depress consumer spending. In addition, high household debt and the recent years' interest rate hikes will increase household debt service.

Inflation is down considerably from its peak in the summer of 2022. However, it will be more difficult to bring inflation down from its current rate of 3.4% in December to the Bank of Canada's 2% target.

Inflation – Canada



Sources: Statistics Canada and AMF

The key policy rate is now at 5%. The Bank of Canada has kept its rate unchanged at this level since last July and remains ready to tighten monetary policy further if conditions warrant.

Like the U.S. Federal Reserve, the Bank of Canada is likely to keep its key policy rate close to its current level for some time to come. The authorities will then gradually ease monetary policy.

In 2023, 10-year Government of Canada bond yields reached levels not seen since 2010. Structural forces will keep interest rates higher than they have been for the past decade. This new higher interest rate environment could force Canadian consumers to undergo a painful deleveraging process and businesses to reduce their financial leverage.

Québec

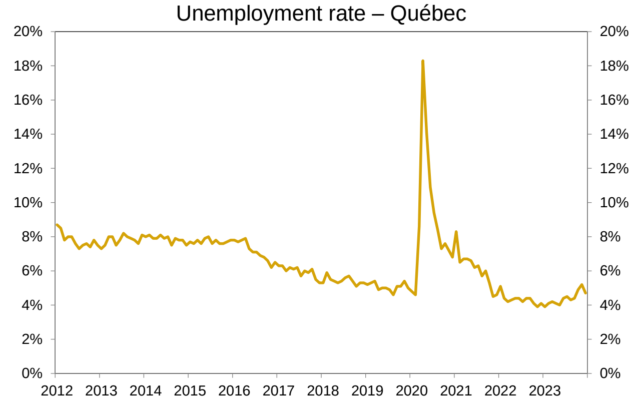
Québec's economy stalled in 2023. At best, real GDP is expected to have increased only marginally in 2023—a slowdown that stands in stark contrast to 2021 and 2022, when the economy bounced back from the pandemic with a boom.

The economic growth outlook for 2024 is no better, with the Québec economy continuing to be undermined by persistent inflation that is higher than elsewhere in Canada, rising borrowing costs and increasing unemployment.

All components of private domestic demand slowed or lost ground in 2023. Business investment took a nosedive, as did residential investment. Despite a marked slowdown, consumer spending remained relatively firm.

The labour market had a subdued performance. The pace of job creation was significantly slower than in 2022. Still, 65,000 jobs were created in 2023, though the pace slowed during the year. The unemployment rate rose 0.8 points, from 3.9% at the start of 2023 to 4.7% at the end of the year. The labour market is likely to continue to be negatively impacted by the economic slowdown, and the unemployment rate is expected to rise further before levelling out.

Unemployment rate – Québec



Sources: Statistics Canada and AMF

Residential real estate warmed up in 2023, with sales stabilizing. Due to a combination of rising mortgage rates and rebounding prices, the Québec housing market is less affordable today than at any other time in its history.

Tighter financial conditions, rising interest rates and deteriorating economic conditions make the situation ripe for a further downturn in the real estate market over the coming months.

Difficult economic conditions, slowing demand and emerging excess capacity will act as a brake on hiring and business investment in 2024. However, the slowdown in investment spending should prove relatively moderate. The current economic slowdown is fairly subdued and is releasing little in the way of excess capacity. At the same time, a large number of current and pending infrastructure and construction projects are tempering the decline in investment.

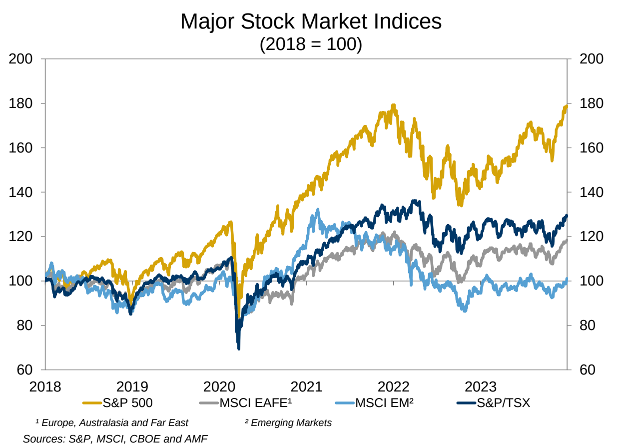
The Québec economy is at a standstill, and the slowdown in the labour market has already led to a rise in the unemployment rate. The real estate market and residential investment are vulnerable to changes in economic conditions. The next few months are likely to be difficult, with tighter borrowing conditions dampening demand.

All in all, the Québec economy will go through a tough period in the first half of the year, which will be followed by a modest recovery.

Financial markets

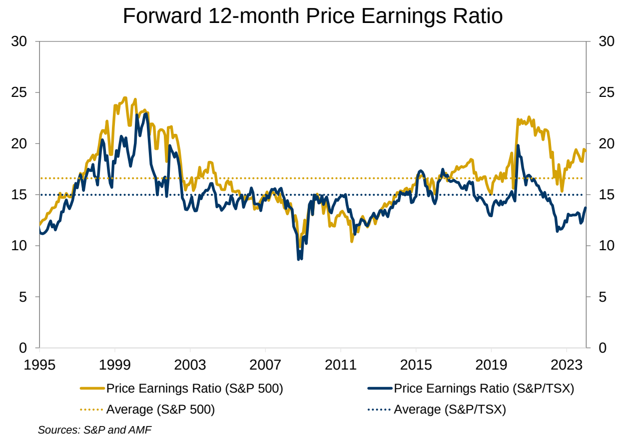
After significant declines in 2022, the major stock indexes rebounded in 2023, buoyed by the expected end to monetary tightening and a resilient global economy. The MSCI All Country World Index, which tracks global equity markets, finished the year up 19.5%, compared with a decline of 17.5% in 2022.

Stock markets in the advanced economies performed especially well in 2023, with an increase of 21.8%, according to the MSCI World Index. Emerging market indexes posted more modest gains of around 7%. Stock markets in China, where the economy is sputtering, recorded significant declines.

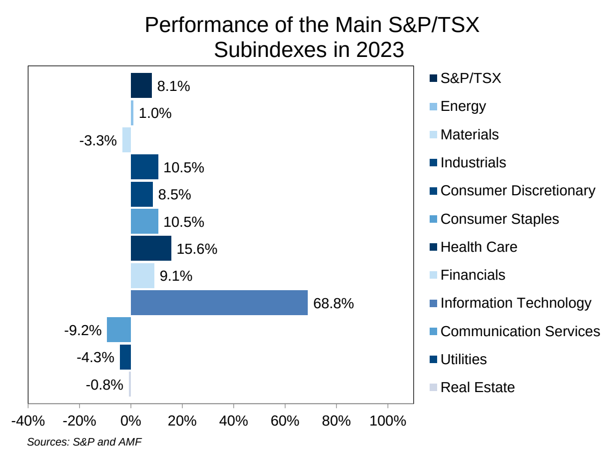


U.S. stock markets led the way in 2023, with the S&P 500 rising 24.2% primarily on the strength of technology stocks. Information Technology, which accounts for approximately 29% of the U.S. index's capitalization, returned an impressive 56.4% in 2023, a jump fuelled by investors' appetite for companies that might benefit from major advances in artificial intelligence.

Flat earnings growth meant the rise in the U.S. stock markets mostly came from higher valuation levels. The S&P 500 is currently trading at around 19 times forward earnings, far above its historical average.



In Canada, the S&P/TSX posted a more modest 8.1% return in 2023. Although the TSX's Information Technology sector also performed very well, it accounts for only about 9% of the index. Financials, which makes up approximately 31% of the TSX's capitalization, returned 9.1% for the year. The business environment for the banking sector has been made more difficult by an uncertain economic environment, low demand for credit, and rate hikes.

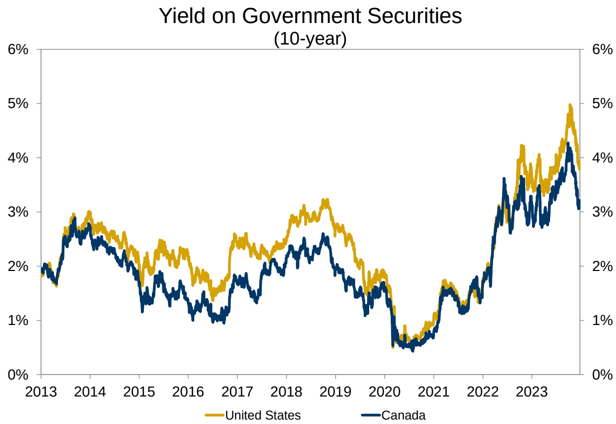


The TSX's Energy sector inched up 1%, mirroring the price of oil, which ended 2023 essentially at the same level as at the start of the year. In the end, the valuation of the S&P/TSX was at moderate levels, below its historical average.

Québec-based companies, on the whole, outperformed the S&P/TSX, with the

Morningstar National Bank Québec Index posting a 13.5% return in 2023.

On bond markets, yields rose for most of 2023, only to pull back from their peak during the final months of the year. In the United States, U.S. 10-year yields ended 2023 at 3.9%, essentially the same level as at the beginning of the year but well below the level of 5% reached in October.



Sources: LSEG and AMF

This downturn in bond yields late in the year reflected a moderation of inflationary pressures and a shift in investors' monetary policy expectations. According to the futures market, the Fed has ended monetary tightening and may reduce its key policy rate in 2024.

Canada experienced a similar situation, with bond yields showing strong growth in 2023 before coming back down during the final months of the year. Canadian 10-year bond yields finished 2023 at 3.1%, a decrease of roughly 20 basis points for the year. As in the United States, investors are expecting there to be several cuts in the key policy rate in 2024.

The impact of interest rate hikes and the spectre of a more pronounced economic slowdown will continue to weigh on financial market developments in 2024. Although the central banks are trying to orchestrate a soft landing for the economy, the possibility of a more pronounced slowdown, or even a recession, cannot be discounted. Under such a scenario, financial markets can be expected to be more volatile.

Market Performance

Stock Markets		Level	% change				Last 12 months	
		2023-12-29	1 month	3 months	6 months	1 year	Min.	Max.
MSCI All Country World Index		869	3.95	9.04	5.86	19.51	727	870
MSCI EAFE[1]		1,393	2.78	4.64	2.66	13.01	1,232	1,393
MSCI Emerging Markets		61,542	2.95	5.17	2.84	7.07	56,185	62,769
S&P 500		4,770	4.42	11.24	7.18	24.23	3,808	4,783
S&P/TSX		20,958	3.57	7.25	3.98	8.12	18,737	21,016
Morningstar National Bank Québec Index		410	3.87	5.74	1.42	13.46	361	410

Bond Markets		Level					Last 12 months	
		2023-12-29	-1 month	-3 months	-6 months	-1 year	Min.	Max.
Québec	10-year	3.72	4.22	4.76	3.97	4.03	3.44	4.98
Canada	10-year	3.11	3.55	4.02	3.27	3.30	2.72	4.24
United States	10-year	3.88	4.33	4.57	3.84	3.88	3.31	4.99
Canada	BBB - 10-year Gov. spread	1.69	1.79	1.93	2.09	2.08	1.69	2.19
United States	BBB - 10-year Gov. spread	1.34	1.48	1.67	1.69	1.85	1.34	1.98

[1]Europe, Australasia and Far East

Sources: Bloomberg and AMF

Issues to be monitored in 2024

Geopolitical tensions

Geopolitical risks will continue to occupy the spotlight in 2024, with two conflicts for which no end appears to be in sight (Ukraine, Middle East) and elections in several global hotspots (Taiwan, Russia, India and the United States), not to mention the attacks on commercial ships in the Red Sea. Tensions between the United States and China, with their many points of contention (Taiwan, trade relations, military presence in the Asia-Pacific region) will remain high. In the United States, polarization between Democrats and Republicans is undermining good government. A second Donald Trump presidency would cause tensions with the U.S.'s traditional allies and result in major changes in foreign policy, particularly in U.S. support for Ukraine, the fight against climate change, and multilateral organizations.

Residential real estate

The residential real estate market warmed up in 2023, with sales stabilizing and prices rebounding even as mortgage rates rose. However, despite the housing shortage, housing starts continued to decline. Increasing mortgage rates and tightening borrowing conditions are placing additional constraints on households faced with renewing their mortgages at higher rates and are hindering access to the market for new homebuyers. The residential real estate market remains vulnerable to the vagaries of economic conditions and interest rates.

Commercial real estate

Office building vacancy rates have continued to trend upwards in major Canadian cities as hybrid work arrangements have become the norm in many sectors. Some real estate developers are experiencing difficulties owing to higher financing and construction costs. Although the Canadian financial system has relatively limited exposure to commercial real estate, conditions in the office building market could exert downward pressure on prices.

Household debt

Slowing credit growth led to a slight decrease in Canadian household debt in 2023. Despite this, the debt burden on households remained very high, at over 180% of disposable income. The last two years' interest rate hikes caused interest charges to jump nearly 80%, and in turn increased debt service. Household debt is a key vulnerability for the Canadian economy because it makes it more sensitive to interest rate fluctuations. Since interest rates are expected to remain high for a while longer, there is a significant risk that the Canadian economy may enter a long deleveraging phase. The risk is lower in Québec, however, where debt levels are not as high.

Corporate debt

Corporate profit margins are under pressure owing, in part, to rising borrowing costs, input prices and wages. Unfavourable economic conditions mean future sales indicators such as backlogs are down.

The number of corporate insolvencies continued to grow in Canada and Québec over the year, up 38% and 40%, respectively. Although many companies have built up a financial cushion, they will be forced to refinance at higher rates in the coming quarters.

Stock market valuation and resilience

Stock markets have posted significant gains since the start of the year, supported by the strong performance of technology stocks. However, uncertainty remains high amid tight monetary conditions and recession risks. U.S. stock market valuation levels are relatively high, and deteriorating economic conditions could cause the markets to tumble. Despite rapidly rising rates, financial markets have remained resilient with, among other things, adequate liquidity levels. Should economic conditions deteriorate, imbalances may occur from time to time between the supply of and demand for liquidity.

Labour shortage

The Québec labour shortage appears to have slowly eased over the past year. The number of job vacancies declined, as did the job vacancy rate, which now stands at 4.3%. With the number of retirements expected to reach a high between 2025 and 2030, a glaring labour shortage in several key economic sectors and several regions of Québec is maintaining pressure on wages, limiting the production of goods and delivery of services, and forcing some businesses to forgo expansion plans. The financial sector is no exception and is also experiencing a shortage. This situation is exerting constant pressure on employers to find innovative ways to overcome the persistent labour shortfall.

Climate change

The year 2023 once again showed how quickly physical risks from climate change are increasing. Canada had its worst forest fires in history in 2023, with 18 million hectares burned and the equivalent of 1.9 billion tonnes of GHGs emitted, demonstrating the dangerous self-reinforcing effects of climate change. In addition to the forest fires, an ice storm (April), high winds (July) and floods (July, August, October) caused $3.1 billion in insured damage in Canada. The insurability of many climate change-related risks could become a global issue in the near future. Various regulations related to the development of carbon taxation and/or carbon market tools, enhanced disclosure of climate change financial risks, and incentives to advance the transition to a more sustainable economy are expected at the international level in 2024.

Sustainable finance

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 economy or one fostering better working conditions. However, the investment criteria for this new asset class are not yet clearly regulated or standardized. Nevertheless, various international regulatory initiatives are underway to better define and improve the framework for these new products. A number of initiatives are expected in 2024.

Artificial intelligence

The growing fusion of artificial intelligence (AI) with other emerging technologies such as augmented reality, blockchain and quantum computing could be a major trend in 2024. Increased monitoring is required to prevent any drift, especially in terms of disinformation and cyber threats. Stricter regulations are being developed, particularly in the areas of AI ethics and algorithm transparency.

Digital assets and decentralized finance

With the growing adoption of cryptoassets such as Bitcoin and Ethereum, digital assets are becoming increasingly important. Cryptoasset market volatility and regulatory disparities persist, influencing developments in the sector. Other issues need to be monitored, including operational risks, leverage and the growing involvement of major financial institutions, which is increasing interconnections between the traditional financial system and the digital asset sector.

While decentralized finance (DeFi) may continue to develop, providing alternatives to traditional financial services, it may also pose security and regulatory challenges. Security shortcomings and the lack of transparency could result in significant financial losses.

Cybersecurity

The coming years will be marked by major changes in the nature of cyber threats, owing to advances in artificial intelligence. Information security officers will need to review their strategies in order to protect their organizations' assets and data through such things as the use of generative artificial intelligence (GenAI). Sophisticated attacks on critical infrastructures, including in the financial sector, could lead to widespread disruptions, spurring the world's major powers to strengthen their cyber resilience and legal frameworks and promote international cooperation. In this context, the establishment of a "Geneva Convention" on cybersecurity could emerge as a way to deter nation state attacks and hold the persons responsible for such attacks accountable.

NOTE