# Economic and Financial Environment

**As at September 30, 2021**

**Group Savings and Retirement**

## Despite the fourth wave and inflation, markets are staying the course

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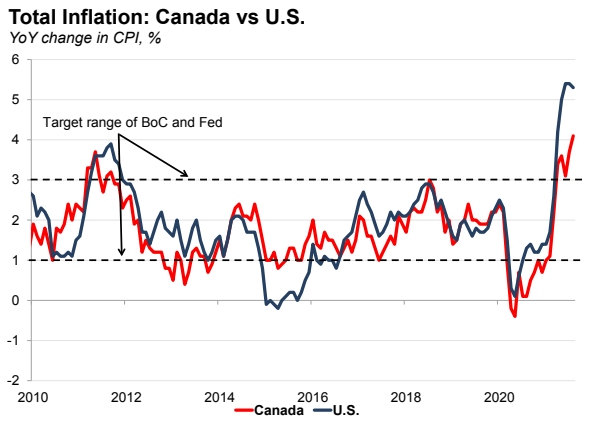
Together, the fourth wave and inflation were the dominant economic issues of the third quarter.

The Delta COVID-19 variant spread like wildfire across the planet, and regions where sanitary measures, such as the mandatory use of face-coverings indoors, were set aside prematurely, are still struggling with their worst resurgent outbreak yet. The evidence suggests that vaccination significantly reduces the risk of serious complications and mortality, but also that health measures are still required to prevent hospitals from being overwhelmed and, as a result, having to shut down certain sectors of the economy once again.

The inflationary surge that has been observed since the summer is also making headlines. In Canada, total inflation currently exceeds 4% on an annual basis, compared with 5% south of the border (with the difference mainly due to the way in which used car price increases are accounted for), as can be seen in Graph 1. We believe that the worst of the inflationary push is probably behind us, and that the funnel effects observed in several markets will gradually fade in the quarters ahead. Next, we expect wage growth to become progressively more entrenched over the next few years and average inflation to exceed the central banks' 2% target over the course of the decade ahead.

Graph 1




### China: in the process of rebalancing its economy

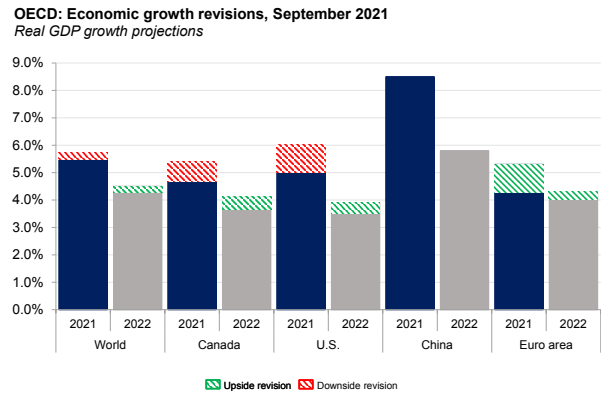
China is currently engaged in a controlled adjustment of its economy. On the one hand, the Chinese government is implementing a broad plan to regulate certain booming industries, such as technology and video games, with the stated aim of fostering an inclusive enrichment of Chinese society. On the other hand, with the Evergrande Real Estate Group as the figurehead, certain sectors that have accumulated too much debt, such as residential property development, are being restructured.

Data from China point to a resilient economy that will likely post a real GDP growth rate of over 8% in 2021 – but it is an economy that is losing momentum. The credit cycle, a key driver of the world's second-largest economy, is currently showing almost no growth, but is likely to pick up the pace in the coming quarters. The OECD predicts that China will grow by 5.8% in 2022, a rate similar to that observed before the pandemic.

### Europe: an upward revision for the Old World

Highlights of the OECD's most recent revision of growth expectations included a sharp increase for Europe. Currently, Europe is in fact experiencing a significant upswing in its economic activity, prompting the OECD to raise its expectations for real GDP growth from 4.3% to 5.3% in 2021 (in line with Canada) and from 4.4% to 4.6% in 2022, ahead of Canada and the United States (see Graph 2). Similarly to Canada, Europe's decision to impose tight measures in the face of COVID's resurgence meant that the continent's economic momentum was weaker than elsewhere in the first half of the year, but the Old World should now reap the benefits of these efforts. The labour market is also in a position that favours strong recovery in the years ahead, with a low unemployment rate and a participation rate that did not suffer too much during the pandemic.

Graph 2




The only concern at the end of the third quarter would be the sharp rise in energy prices, which will act as a tax on households and businesses. To a large extent, this emerging "energy crisis" reflects European governments' assertive efforts to reduce emissions from polluting – and less socially acceptable – energy sources. As a result, Europe has become increasingly dependent on natural gas imported from Russia, and the interplay of supply and demand has pushed prices up by a factor of more than four in recent months.

### United States: forthcoming tightening of monetary policy

Over the course of the quarter, the loss of U.S. consumer confidence was very much in the news. The fourth COVID wave, as well as the recent surge in inflation, seem to be the main culprits for this unfortunate development. Many among the unemployed prefer to stay at home for fear of being infected or simply because they have accrued enough savings in the past 18 months and can afford to wait for more attractive job offers. As a result, opinions about employment prospects in the next few years or the adequacy of accrued savings for retirement have deteriorated considerably – and suddenly.

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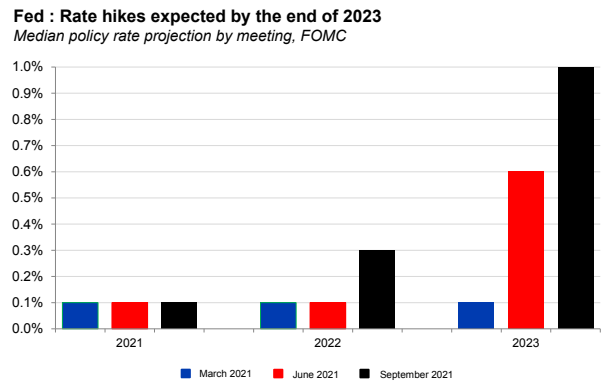
In turn, inflation is beginning to extinguish a portion of household demand, putting plans to purchase durable goods, such as furniture, cars, and even homes, on hold.

Consequently, the U.S. labour market finds itself in an unfamiliar position, with low unemployment, low participation rates, and a record number of unfilled job postings. What is the next logical step? A surge in wages, which will likely keep inflation above the target set by the Federal Reserve.

Accordingly, the Federal Reserve announced at the end of the quarter that, if conditions remain favourable, it expects to ease off the accelerator in the fourth quarter and reduce its quantitative easing program gradually until its end-point, possibly in summer 2022. The first policy rate hikes should follow, probably in 2023 (see Graph 3).

Graph 3




## Canada: the labour market in great shape

Canada's economy remains in a strong position, and we expect a fairly stable performance from it over the next few quarters due to the strength of the country's labour market. Let us recall that by August 31, the Canadian economy had recovered 95% of the jobs lost during the 2020 recession (that figure reached 99% in Québec) compared to about 75% south of the border. The participation rate and employment rate have also returned to pre-COVID-19 levels, an achievement that few countries outside Europe can claim.

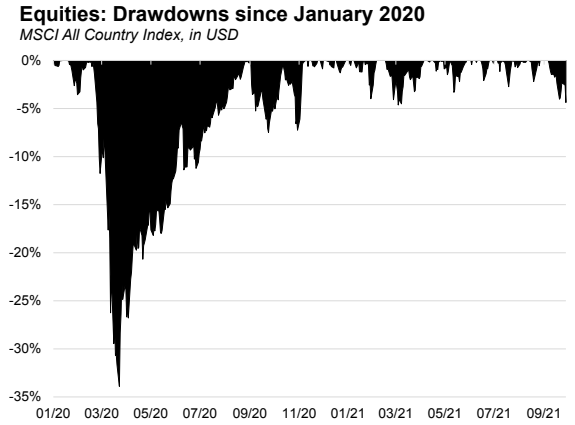
With regard to GDP growth, the negative revisions to second-quarter data undoubtedly came as a surprise and resulted in a contraction in GDP as compared with the first quarter. There are many reasons of a one-off nature for this occurrence, including stricter lockdown measures in Canada than in the U.S. and a slowdown in international trade due to shortages affecting several key products. Despite all this, we firmly believe that the long-term outlook for Canada is quite favourable.

In the third quarter we also had a federal election, which resulted in an almost unchanged level of representation in Parliament and another minority mandate for the Liberal Party. The main issues for the government are likely to be the budget deficit (a return to equilibrium is, in all likelihood, not on the cards for the next five to ten years) and, of course, health. The lessons from the 1930s are quite clear: during a global crisis, it is better for governments to do too much than to attempt to balance their budget too quickly.

## Markets: volatility seems to have vanished!

Stock markets are surprisingly calm in 2021. As mentioned in the last quarter, the second year of a bull market is generally characterized by low, positive returns, and, above all, a return to volatility. However, markets have been behaving quite differently this time around: since October 2020, the MSCI All Country World Stock Index has not undergone a correction of 5% or more (see Graph 4)!

Graph 4




Despite the steady march to new highs, stock markets still experienced stealth corrections. For instance, the average stock in the U.S. S&P 500 Index recently fell by more than 10%, indicating that a handful of major-company stocks are popular with investors and responsible for the gains in leading stock indices. Will stock markets become increasingly volatile by the end of the year or do they still offer an attractive entry point for buyers? It is hard to say, but we recommend that investors proceed with caution.

Global interest rate levels remain under pressure, despite some upward movement at the end of the quarter. Prospects for a gradual end to quantitative easing by the U.S. Federal Reserve and potential policy rate hikes in the next 12 to 24 months are helping to revive the upward movement in global interest rates we saw in the first quarter of this year, but we still expect general rate levels to remain depressed from now to the end of the year.

## Strategy: exercise caution

We are already in the middle of the second year of this new market cycle (which started on March 23, 2020). Since then, the S&P 500 Index has doubled (the swiftest 100% leap in its history, we might add). Meanwhile, interest rates remain at historically low levels.

A quick glance at current stock market valuations will likely give many investors the impression that the stock market has become speculative, leading them to consider that a defensive position is required. Conversely, others will see the positive monthly returns of their portfolios accrue and seek to take risks beyond their level of tolerance.

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We believe that current conditions favour a rather neutral position within a balanced portfolio. Specifically, we have implemented neutral positioning in both equities and bonds in our diversified funds, with slight overweighting in Canadian equities offset by underweighting in U.S. equities, which have become relatively more expensive.

Our optimism for Canadian assets also extends to the Loonie, which we see rising into the 85 to 90-cent range over the course of the year ahead.

# Economic and Financial Environment (continued)

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## Chart 1
## Returns of the Canadian Bond Market as at September 30, 2021

| Index | Returns (%) | |
|---|---|---|
| | 3 months | YTD |
| FTSE Canada Universe Bond Index | (0.5) | (4.0) |
| FTSE Canada Short Term Bond Index | 0.1 | (0.4) |
| FTSE Canada Mid Term Bond Index | 0.0 | (3.0) |
| FTSE Canada Long Term Bond Index | (1.6) | (8.9) |
| FTSE Canada Federal | (0.4) | (3.4) |
| FTSE Canada Provincial | (0.8) | (5.5) |
| FTSE Canada Municipal | (0.5) | (4.5) |
| FTSE Canada Corporate | (0.1) | (2.4) |

## Chart 2
## Market Returns as at September 30, 2021

| Index | Returns (%) | |
|---|---|---|
| | 3 months | YTD |
| FTSE Canada 91 Day T-Bill Index | 0.1 | 0.1 |
| FTSE Canada Universe Bond Index | (0.5) | (4.0) |
| S&P/TSX Composite Index | 0.2 | 17.5 |
| S&P 500 (Can. $) | 2.9 | 15.3 |
| MSCI - EAFE (Can. $) | 1.8 | 7.7 |
| MSCI - World (Can. $) | 2.3 | 12.4 |
| Exchange Rate (Can. $ / US $) | 2.3 | (0.6) |

## Chart 3
## Market Returns as at September 30, 2021

| Index | Returns (%) | |
|---|---|---|
| | 3 months | YTD |
| **S&P/TSX Sector Allocation** | | |
| Energy | 2.8 | 41.0 |
| Materials | (5.6) | (6.0) |
| Industrials | 4.0 | 11.0 |
| Consumer Discretionary | (6.5) | 9.9 |
| Consumer Staples | 4.6 | 13.5 |
| Health Care | (19.4) | (1.7) |
| Financials | 1.1 | 24.8 |
| Information Technology | (1.3) | 20.1 |
| Communication Services | 0.7 | 19.0 |
| Utilities | 1.0 | 6.0 |
| Real Estate | 3.3 | 25.8 |
| S&P/TSX Composite Index | 0.2 | 17.5 |

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## Chart 4
## Economic and financial scenarios

### Economic scenario

| | | | | | | | Change since June 30, 2021 | |
|---|---|---|---|---|---|---|---|---|
| | | 2019 | 2020 | 2021 | 2022 | 2023 | 2021 | 2022 |
| **U.S.** | Real GDP | 2.3% | -3.4% | 5.9% | 4.1% | 2.4% | -0.7% | -1.7% |
| | Inflation rate | 1.8% | 1.2% | 4.3% | 3.0% | 2.3% | +0.1% | -0.5% |
| | Unemployment rate | 3.7% | 8.1% | 5.5% | 4.3% | 3.8% | -- | +0.1% |
| **Canada** | Real GDP | 1.9% | -5.3% | 5.1% | 4.0% | 2.4% | -1.3% | -1.1% |
| | Inflation rate | 1.9% | 0.7% | 3.0% | 2.4% | 2.1% | -0.8% | -0.7% |
| | Unemployment rate | 5.7% | 9.6% | 7.6% | 6.2% | 5.8% | +0.1% | +0.1% |

### Financial scenario*

| | | | Targets | | | Change since June 30, 2021 | |
|---|---|---|---|---|---|---|---|
| | | Actual | Dec. 21 | June 22 | Dec. 22 | Dec. 21 | June 22 |
| **Interest rate** | Canada 10-year rates | 1.51% | 1.95% | 2.50% | 2.80% | -0.20% | -- |
| | U.S. 10-year rates | 1.49% | 1.90% | 2.60% | 3.00% | -0.35% | -- |
| **Exchange rate** | $US/$CA | 0.79 | 0.82 | 0.85 | 0.86 | -0.02 | -- |
| | $US/EUR | 1.16 | 1.20 | 1.24 | 1.25 | -0.02 | -- |
| | Oil price (WTI), $US | 75 | 80 | 83 | 85 | +8 | +13 |
| | S&P 500 | 4,308 | 4,400 | 4,550 | 4,675 | -- | -- |
| | S&P/TSX | 20,070 | 21,375 | 22,230 | 23,085 | -- | -- |

* end of period