Caisse de dépôt et placement du Québec

GLOBAL ECONOMIC AND FINANCIAL CONTEXT 2012

SUMMARY

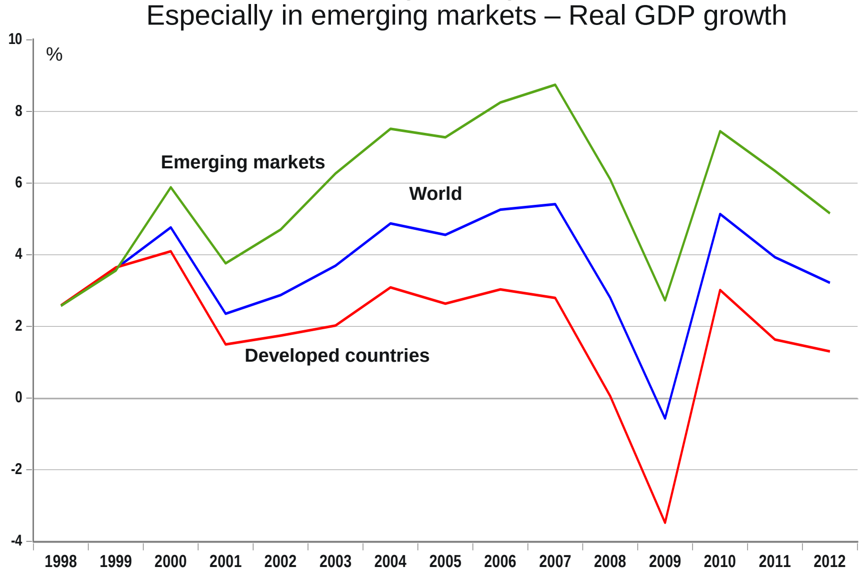
In 2012, the developed countries, especially the United States, made progress in their efforts to resolve some of the imbalances that have beset their economies in recent years. Even so, the year was generally disappointing from the economic standpoint.

After recording growth of almost 4.0% in 2011, the global economy slowed perceptibly, barely expanding by 3.0%. This situation was partially due to a slowdown in the emerging economies after two years of spectacular but unsustainable growth. It was also the outcome of weak growth in the developed economies for the second consecutive year. A moderate recovery in the United States was not enough to offset the weakness in the euro zone, which slid back into recession. Fortunately, the encouraging signs that began to appear in emerging markets in the last quarter of 2012, especially in China, bode well for 2013.

Despite the subdued economic background, financial markets ended 2012 on a positive note. As in 2011, the major stock and bond indexes faced political and economic headwinds during the year, but were supported by further strong central bank actions. Toward the end of the summer, aggressive intervention by the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) succeeded in restoring confidence in the markets.

Decelerated global growth in 2012

Especially in emerging markets – Real GDP growth



Sources: Economic Analysis and Asset Allocation Strategies, Datastream, FMI

EUROPE

Europe found itself on the financial markets' radar screen for a large portion of 2012. The year began well with the success of the ECB's Long-Term Refinancing Operations. This program, announced in December 2011, injected massive amounts of liquidity into Europe's banking system and bolstered investor confidence. But the euphoria was short-lived.

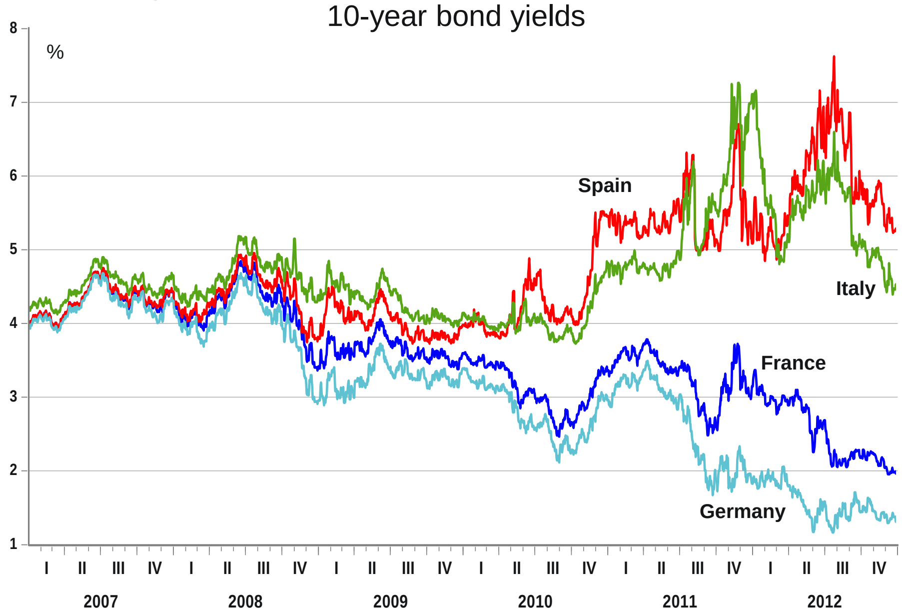
By spring, it was clear that Spain's economy and public finances had deteriorated more seriously than previously thought. And in May, political uncertainty in Greece spiked and remained elevated for most of the summer.

These events, combined with the high level of public debt and economic weakness in several peripheral countries, revived concerns about the viability of the single currency. This contributed to a significant widening of the spreads in yields on Spanish and Italian bonds vis-à-vis German bonds.

As bond yields in the peripheral countries surged, the ECB pledged to do whatever was necessary to preserve the euro zone. In September, it unveiled its Outright Monetary Transactions program for open-ended purchases of indebted countries' bonds on specified conditions. This program significantly reduced the likelihood that the euro zone would break up. It also caused European government bond spreads to narrow sharply and the world's equity markets to rally.

The positive developments in financial markets notwithstanding, the euro zone ended the year in the grip of a severe recession. The decline in the euro zone economy was largely attributable to the considerable tightening of fiscal policy in the peripheral countries and the high degree of uncertainty that prevailed from late spring until early summer. In December, the euro zone's overall unemployment rate exceeded 11.7%, its highest level since the monetary union was created. Unemployment reached more than 26.0% in Spain and close to 27.0% in Greece towards the end of the year.

Strong financial volatility in Spain and Italy in 2012
10-year bond yields



Sources: Economic Analysis and Asset Allocation Strategies, Bloomberg L.P.

UNITED STATES

In the United States, economic growth and the financial markets were affected significantly by these global developments, as well as by domestic political uncertainty and the actions of the Federal Reserve. In particular, uncertainty related to the fiscal cliff[1] weighed on the economy for most of the year, with negative effects becoming apparent as early as spring 2012.

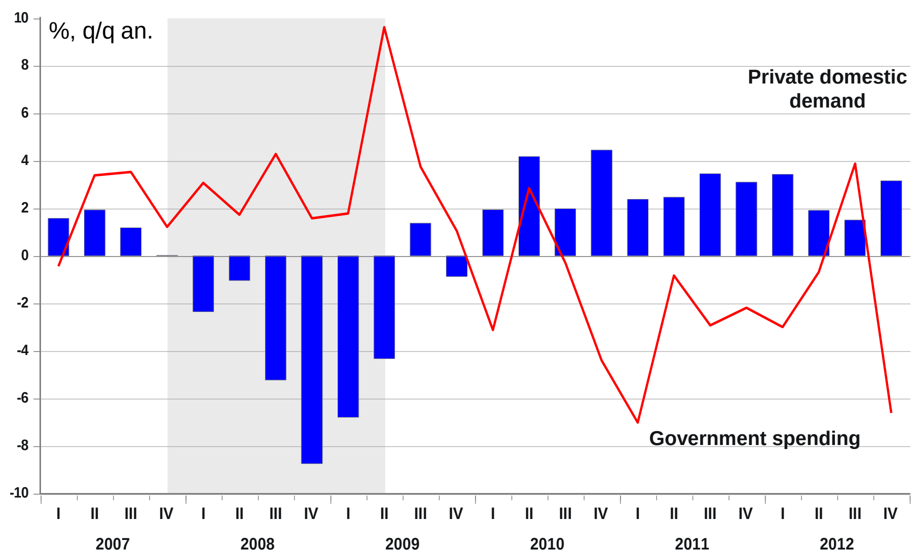
This prompted the Fed to take an even more accommodative monetary stance. Most notably, it launched two new programs of open-ended asset purchases, which were conditional on improvements in the labour market: the one for mortgage-backed securities and the other for long-term treasury bonds. The economy and the financial markets responded positively to these measures.

The economy grew at an overall rate of 2.2% and non-farm business-sector activity was up 3.0% in 2012. Even more important, households continued to repair their balance sheets, reducing their debt-to-assets ratio from a peak of close to 35.0% in 2009 to about 26.0% at the end of 2012.

As well, the housing sector entered a sustainable recovery. Housing starts increased significantly and house prices began to rise. This improvement is welcome because the real estate sector has a positive impact on household balance sheets and is a significant driver of growth. Finally, the federal government made progress, albeit modest, in improving its fiscal position. Government spending fell by 1.7% and the federal budget deficit went from 8.7% in 2011 to 7.3% in 2012.

Private domestic demand takes over in the United States

Growth of private domestic demand and government spending



Sources: Economic Analysis and Asset Allocation Strategies, Global Insight

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[1] The budget cliff refers to a series of income tax increases and government spending cuts that were to take effect automatically on January 1, 2013.

EMERGING MARKETS

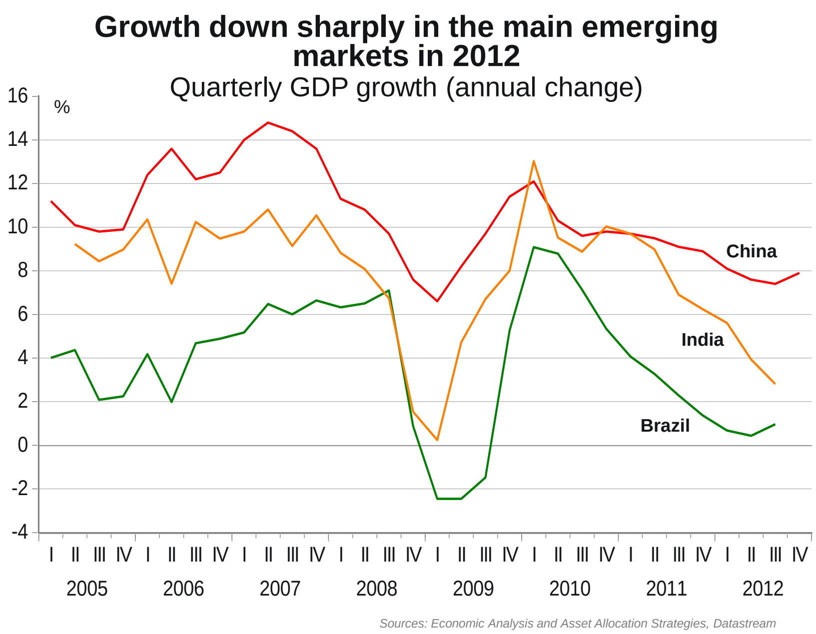
Growth generally slowed in the emerging market economies in 2012, mainly because of internal factors, such as supply constraints and financial imbalances, but also amid weak domestic demand in the developed economies.

China's growth slowed significantly as a result of monetary tightening implemented 12 to 18 months earlier and a substantial decrease in the government's capital spending, which returned to a more sustainable level after the strong stimulus provided in 2009. Weaker external demand also contributed to the economic slowdown.

India's growth also flagged in 2012 amid the impact of previous interest rate increases, slow approval of new projects and timid structural reforms.

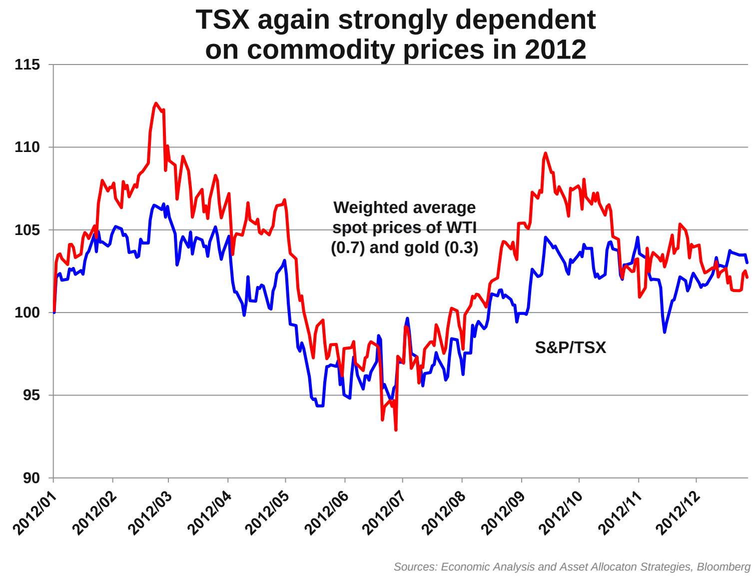
In Brazil, previous monetary tightening to counteract inflationary pressures resulted in a further decrease in growth, which reached only 1.0% in 2012. Brazilian policymakers adopted a series of monetary and fiscal measures to stimulate the economy but to little avail as it became increasingly clear that growth was curtailed by weaknesses in the supply side of the economy.

That being said, a broad range of production and demand indicators suggests that growth accelerated in the emerging economies in the latter part of 2012 in response to stimulative policies. Governments in emerging markets have limited remaining monetary and fiscal leeway, however. Policymakers must introduce structural reforms to ensure their economies are innovative and flexible and offer strong growth potential.



CANADA AND QUÉBEC

The difficult global economic environment contributed significantly to the slowing of the Canadian economy in 2012. Partially as a result of the increasing trade deficit in the first three quarters of the year, Canada's real GDP expanded by 1.9%[2] versus 2.6% in 2011. Growth of final domestic demand was solid in 2010 and 2011 but adversely affected by tighter fiscal policy, lower non-residential private investment and the onset of an adjustment period in the residential real estate sector in the second half of the year.



In this context, the Bank of Canada held its key policy rate at 1.0% all year despite its concerns about high levels of household debt. Moreover, the slowdown in emerging markets, combined with increased energy output in the United States, caused prices to drop for many Canadian natural resource producers. As a result, the Toronto Stock Exchange underperformed the other major stock markets in 2012.

Québec's economy expanded at a rate slightly below 1.0% last year.[3] The manufacturing sector and exports were constrained by the global slowdown in 2012 and the strong Canadian dollar. Household spending also fell significantly during the first half of the year, due particularly to a drop in consumer confidence. Moreover, after strongly supporting economic activity in recent years, government investment in infrastructure continued at a more moderate pace. The year's encouraging developments included a generally favourable labour market and a positive contribution by non-residential private investment.

CONCLUSION

Although disappointing in some respects, 2012 ended on a rather positive note. The tail risk in the euro zone appears to have been reduced considerably. The United States made substantial progress in addressing its fundamental problems and many emerging economies are showing signs of returning to strong growth. In this context, 2013 is looking like a year of transition toward a more robust global economy with a stronger rate of growth. But, to ensure such an outcome, strong policy implementation will be needed in many countries, especially the euro zone.

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[2] This figure is an estimate because Canada's fourth-quarter national accounts have still not been published.
[3] Only the economic account data for Québec's first and second quarters have been published to date by the Institut de la statistique du Québec.