Caisse de dépôt et placement du Québec

Global economic and financial context
1st half 2013

ECONOMIC OUTLOOK

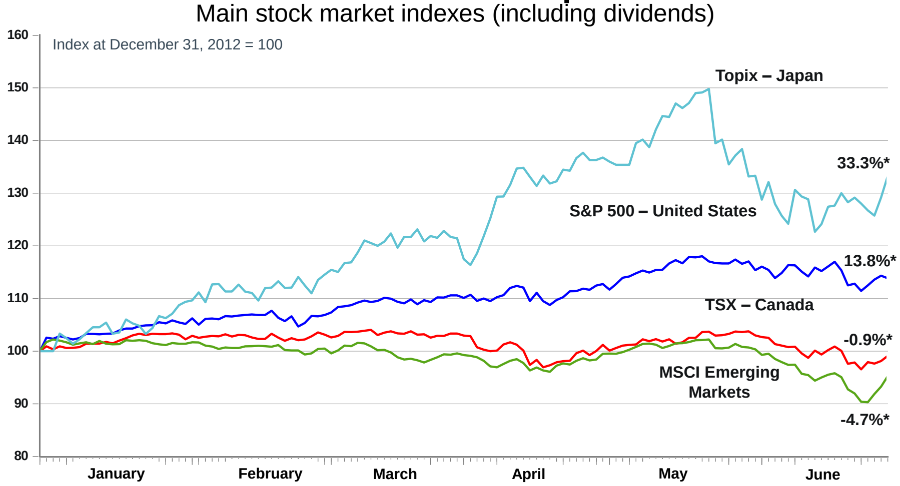
In the first half of 2013, the global economy grew at a moderate rate of about 3.0%. Some developed countries saw their economies improve significantly, notably the United States and Japan, mainly because of aggressive monetary easing. Also, the European economy showed signs of stabilizing in the second quarter of 2013. In most emerging markets, economic growth slowed as these countries encountered numerous challenges.

The performance of the equity markets diverged markedly across countries in the first six months of the year. The U.S. and Japanese stock markets recorded remarkable gains while the markets declined everywhere else. In Canada, the TSX Index lost 0.9% (including dividends), mainly because of falling commodity prices. The MSCI Emerging Markets Index slid almost 4.7%. Lastly, the Euro Stoxx 50 Index managed to end the first half down only 0.4%, sustained by the European Central Bank (ECB) President's pledge that he will do whatever it takes to preserve the eurozone.

In late May and in June, long-term U.S. government bond yields spiked after the Fed announced that it might begin tapering the pace of its asset-purchase program in the fall. The announcement also pushed up yields on the long-term debt of most other developed countries.

Remarkable stock market performance in the U.S. and Japan

Main stock market indexes (including dividends)



*Change between December 31, 2012, and June 30, 2013

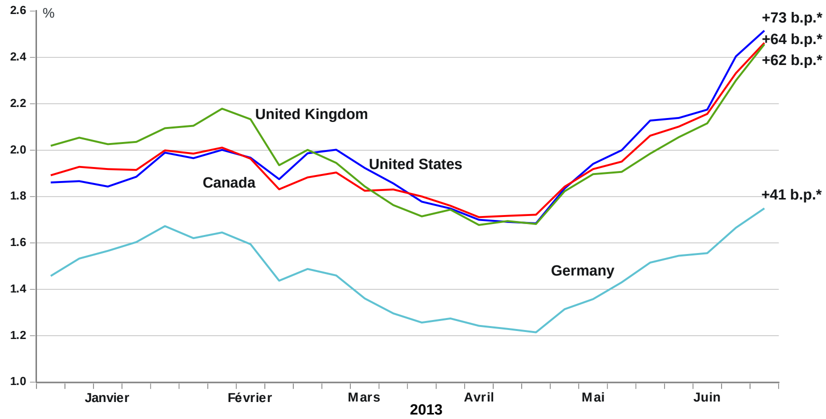
Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, Bloomberg

United States

Buoyed by the Fed's ambitious quantitative easing program, the U.S. residential real estate market entered a recovery phase. Higher housing prices, combined with a strong performance by the U.S. stock market, enabled households to continue repairing their balance sheets. Public finances also improved considerably. With the tax increases that took effect at the start of the year and the automatic spending cuts imposed by the budget sequester in March, the federal budget deficit fell from about 9.0% of GDP two years ago to roughly 4.2% over the past 12 months. Even more importantly, the U.S. economy is coping fairly well with the significant tightening of fiscal policy, owing to its dynamic private sector. Households have been able to increase their spending at a reasonable rate despite a heavier tax burden. The housing and energy sectors also contributed to the economy's growth. There are also indications that investment is beginning to recover. In this context the Fed stated at the end of May that, if the economy continued to perform as expected, it could begin scaling back its asset purchases in September, causing long-term U.S. government bond yields to spike by 75 basis points.

U.S. leads global interest rates higher

Weekly average of 10-year interest rates since early 2013

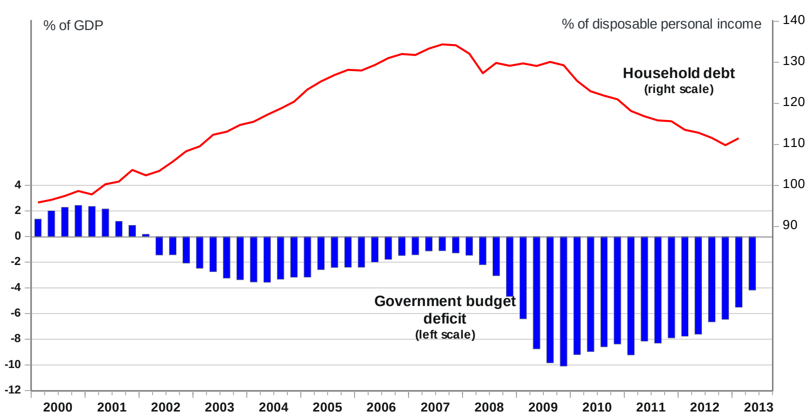


*Increase in basis points between December 31, 2012, and June 30, 2013

Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, Bloomberg

U.S. makes progress in controlling its debt load

Household debt and government budget deficit



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, IHS Global Insight

Japan

Japan's economic growth accelerated strongly in the first quarter as a result of fiscal and monetary stimulus. Moreover, the monetary stimulus was increased with the change in regime announced by the Bank of Japan's new Governor. Reliable economic indicators, such as the Tankan survey, suggest that growth will remain strong for the rest of the year. The authorities' more proactive approach enabled the Japanese stock market to record an excellent first half, with the Topix Index rising by more than 30.0%.

Europe

The situation remains difficult in Europe. After a record six consecutive quarters of decline, real GDP in the eurozone exhibited signs of stabilizing in the second quarter of 2013, with Germany and France both growing. In the majority of the peripheral countries, the recession continued in Q2, but at a slower pace. The level of economic activity in these countries is substantially below the peak attained prior to the financial crisis.

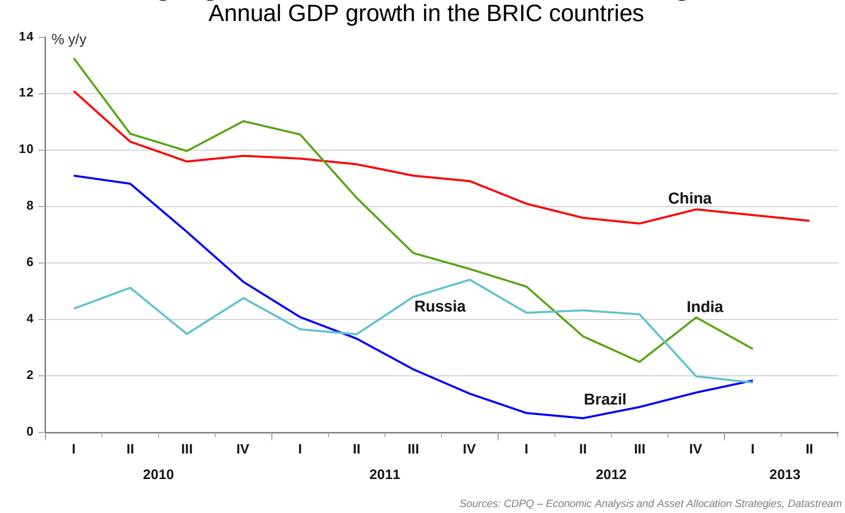
Although the ECB has maintained an accommodative monetary policy for some time and has even eased further in recent weeks, credit growth remains negative in the most heavily indebted countries. In the so-called peripheral countries, including Italy and Spain, the private sector must borrow at far higher interest rates and on much stricter conditions than in Germany and France. In short, the transmission mechanism of monetary policy is not working properly. Moreover, even though some countries have been given more time to reach their budget targets, austerity measures continue. In brief, Europe is far from establishing the conditions for a strong and sustained recovery.

Emerging markets

After accelerating at the end of 2012, economic growth in emerging markets slowed again. The growth rate now stands at about 5.0%, or roughly the average pace of the past year. This subdued growth rate is due partly to weak external demand, especially from Europe, which is reflected in lower exports. It is also the result of various internal factors.

Emerging markets: moderate economic growth

Annual GDP growth in the BRIC countries



In the case of China, more moderate growth is also attributable to the new leaders' intention to take the necessary steps to reorient the economy. They stated that they were prepared to accept slower growth (the target being 7.5% for 2013) to give themselves time to put in place a model based more on consumption and less on fixed investment. To foster the transition, they also plan to impose stricter oversight on the banking sector and to liberalize interest rates.

Weaker economic activity in China had an impact on growth in the other emerging markets. In recent years, emerging market economies have significantly increased their trade linkages. The slowdown in Chinese goods production and fixed investment has especially affected commodity producers such as Brazil. The performance of Brazil – like that of other countries – also suffered because of significant rigidity in key markets and an infrastructure deficit.

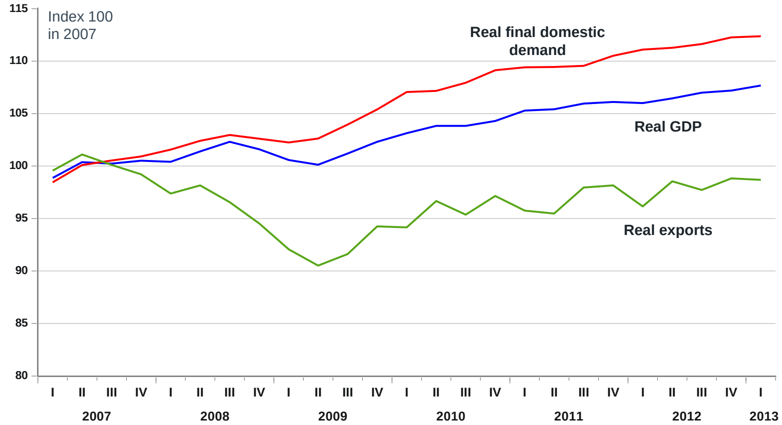
Québec and Canada

Over the past few quarters, Québec and Canada entered a period of modest growth characterized, amongst other things, by the need to focus their economies more on exports and less on domestic demand. Importantly, the latest external-trade developments are positive: improvements in the U.S. private sector, combined with the slight depreciation of the Canadian dollar, have increased demand for products manufactured in Québec and Canada, which is favorable for exports.

The TSX Index lost a little ground in the first half, primarily because of low prices for commodities, especially gold. Long-term interest rates were up almost 65 basis points in the wake of higher rates in the United States.

Two economies to be reoriented from domestic demand to exports

Québec



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, Institut de la statistique du Québec

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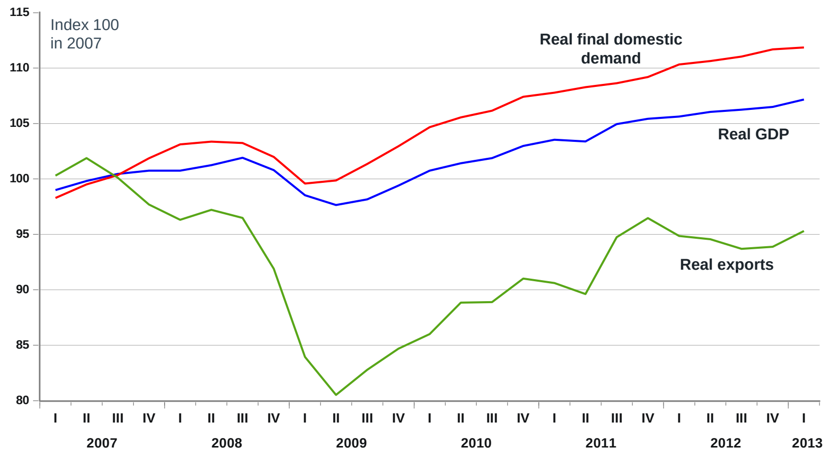
Canada



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, Global Insight, Statistics Canada

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Conclusion

Global economic growth continues to be modest but many countries have made substantial progress in addressing the problems that have beset their economies in recent years. The United States is gaining control over its debt, Japan has finally introduced a credible monetary policy to end its deflationary spiral, some European countries have put in place appropriate structural reforms and China has begun to overhaul its financial system and shift its economy more to the private sector. In this context, 2013 appears to be a year of transition toward a more robust global economy with a higher rate of growth. But, for that to happen, strong policy implementation must continue in many countries, especially in the eurozone and emerging market economies.