Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

March 2014

Summary

- Steadily improving economic conditions in developed markets, led by the U.S., will drive global growth in 2014.
- The challenges facing developing economies are cyclical in nature. Long-term economic fundamentals remain strong.
- Credit misallocation in China represents a risk. The situation is manageable and China remains a resilient economy.
- Bond yields will face upward pressure as they adjust to the expanding global economy. Fixed income securities represent a poor risk-return investment.
- Adding value in the current investment environment requires thoughtful analysis of future growth drivers of companies and industries. A diversified portfolio of carefully selected stocks will deliver superior returns over cash and bonds.

Global economic growth is improving and is set to pick up further on a strengthening U.S. economy. Conditions in developed markets suggest economic activity is accelerating and will be supported by a renewed credit cycle, with the possible exception of Canada. Emerging economies are stabilizing and growth will average two to three times faster than developed nations over the next three years, even without the support of foreign capital. Rising financial risk in China are not expected to derail the global recovery.

The impressive rise in global equity markets during the past two years has reflected renewed optimism in the sustainability of global economic progress. This can be measured by the expansion of market multiples, the significant driver of recent stock market performance. At current levels, equity markets offer reasonable value. Over the longer-term, equity prices are driven by economic growth, the principal factor which underpins corporate profitability. Our analysis of global economic trends lends support to a positive backdrop for a continued expansion in earnings.

The world, as always, is filled with investment opportunities. Understanding which companies will progress in the current environment and ensuring that a fair price is paid for an ownership stake in such companies is the best way to achieve the highest return. In contrast, the minimal fixed return that bonds offer may not compensate for inflation. We therefore continue to favour equities over both cash and bonds over the medium-term.

LETKO BROSSEAU

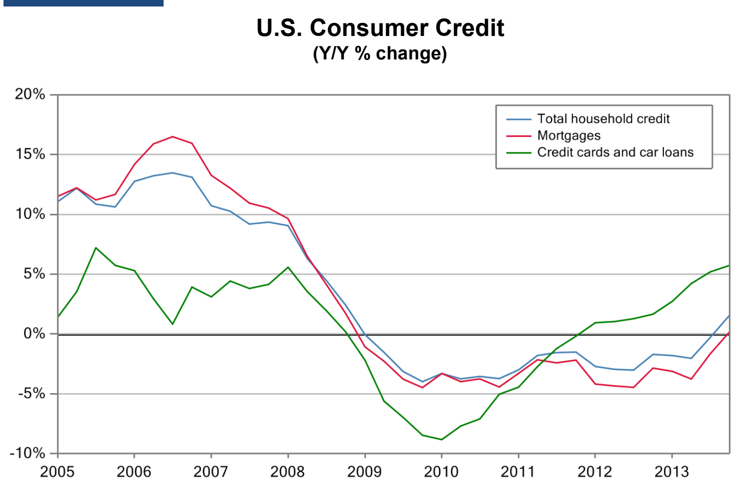
Private sector credit to grease the wheels of U.S. economic progress

The U.S. economy is gradually returning to a more normal path following a protracted period of subdued growth as excesses in both private sector and public sector borrowing were corrected. This process is now nearing an end. Real GDP growth rose 2.6% in Q4 2013 versus a year ago, boosted by the consumer sector (+3.3%), residential investment (+13.4%), business investment (+3.8%) and an improving trade balance (+11.4%). We believe that these sectors will continue to be the growth drivers in 2014.

Household consumption accounts for about 70% of U.S. GDP and personal spending is funded by disposable income and borrowing. In the aftermath of the financial crisis, disposable income growth was held back by the level of slack in the labour market. Private sector borrowing remained anemic despite record low interest rates and accommodative monetary policy. Households lacked an appetite to borrow as consumers were repaying debts and banks were unwilling to lend as they were recapitalizing their balance sheets. There are clear signs both factors are now at a turning point, suggesting a pick-up in consumer spending.

Recent employment creation has been steady with an average 187,000 new jobs per month over the last year. Disposable income growth is averaging 3.0% on an annual basis and should remain strong given an improving jobs market. Meanwhile, borrowing is recovering as both demand and supply are in an upswing. An improving labour market along with a significant increase in household net worth due to recovering home values and rising equity markets have fuelled gains in consumer confidence, thereby stimulating the demand for consumer loans. Bank willingness to extend credit to households is accelerating as most U.S. banks have now repaired their balance sheets and are compliant with Basel III capital ratios. After many years of decline, total consumer credit is up 1.6% year-over-year, credit card auto loan growth is 5.7% and mortgage lending is up 0.2% (Chart 1).

Chart 1



Source: Federal Reserve Bank of New York

Credit is increasingly likely to flow to corporations as well as consumers as significant capital spending will be required in the years ahead simply to meet increasing demand. In addition, industry capacity utilization is running at almost 80%, a significant jump from the trough of 67% reached in mid-2009. Together with a high level of fixed asset utilization, we note that the average age of these assets is at a 45-year peak. Substantial business investment will be required to renew the stock of existing assets. Private investment is therefore expected to be solid in the years ahead.

While the demand for funds by the private sector will be supported by both consumers and corporations, public funding needs will be reduced as the government budget balance improves. The federal deficit declined from 9.3% of GDP in Q2 2009 to an estimated 3% of GDP in 2014. The bi-partisan agreement enacted in late 2013 has reduced the size of future spending cuts. With fiscal tightening subsiding, the government will no longer be a drag on economic activity.

Consumer spending, cyclically-sensitive sectors (housing, cars and capex) and further improvement in the trade balance driven by reduced imports and increased exports of petroleum products are expected to drive growth forward in 2014. Our central forecast for U.S. real GDP growth in 2014 is in the range of 2.5%-3.0%.

Canadian consumer debt overhang needs to further unwind

While in the U.S., employment growth and a pickup in credit will support consumer spending, these trends are reversing in Canada. Retail sales are currently growing in line with disposable income at 3.7% annually, but slower job and credit growth will hinder future household spending.

The trend in employment growth is currently modest, just 0.8% on an annual basis. Credit growth decelerated from 6.3% at end-2010 to 4.5% at end-2013. The ratio of household debt-to-income is at a peak of 162% and is constraining further credit growth.

The housing market is already feeling the effect of a slowdown in credit. Housing-related investment fell to 1.0% year-on-year in 2013 from 8.7% in 2012 and is expected to remain soft. Total public and private non-residential capital spending was also modest, up 3.0% in 2013, and capital intentions for 2014 suggest an increase of only 1.3% for the year, as commodity prices remain low.

Sluggish consumption and moderate investment growth will temper economic activity but are unlikely to push the economy into a significant slowdown. The drop in the Canadian dollar to $0.88, close to its purchasing power parity, is having a positive impact on competitiveness and trade. This is occurring at the same time that the U.S., its main trading partner, is accelerating. The federal government also recently signed a free trade agreement with South Korea and is in ongoing negotiations with the European Union, Japan and India, which will broaden the range of Canada's export markets. Furthermore, fiscal finances are in very good shape. The federal government is expecting a budget surplus this year, excluding the amount it sets aside for extraordinary events, providing some room for government stimulus, either in the form of additional spending or tax cuts.

We forecast that the growth of the Canadian economy will remain lower than in the U.S. for the medium term and is expected to be 1.5%-2% in 2014.

Gradual progress in Europe notwithstanding tight credit conditions

Developments in Europe are slow but positive. Most countries have emerged from recession and recent data show a sustained improvement in economic activity. Non-financial corporate profit growth turned positive in Q3 2013 (on a quarter-over-quarter basis), the first time since mid-2011. Industrial production rebounded across the Eurozone, expanding by 1.6% on an annual basis in January. Manufacturing PMI for March was reported at 53.0 and has been in an upswing for the past 18 months. As corporate bottom lines improve, labour markets will gradually recover and support consumer spending.

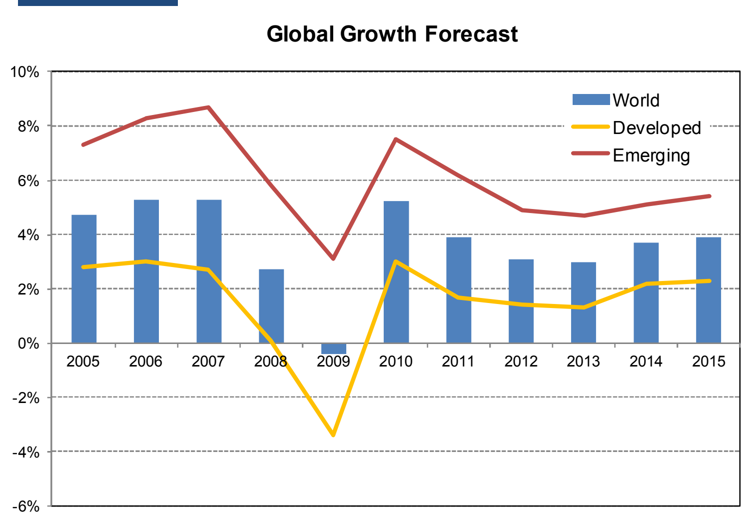
However, unlike the U.S., access to credit in Europe remains constrained by region, borrower size and quality due to the ongoing recapitalization of the banking sector. As discussed in our December 2013 *Economic and Capital Markets Outlook*, lending activity in most countries remains subdued and continues to represent a significant headwind to economic activity. While lending growth is positive in Germany and France, it remains negative on an annual basis in Italy, Spain, Ireland, Portugal and Greece. Increased comparability of the reporting of impaired assets across the different countries, a better general level of capitalization for European banks and improved economic conditions are laying the foundations for a pick-up in credit in the second half of the year and beyond.

Overall, the Eurozone economy is expanding at 0.5%, in line with our forecast of 0%-1% real GDP growth in 2014.

Global growth in an upswing, despite tensions in emerging markets

Improved conditions in developed markets that are supported by a renewed credit cycle and a stabilization of economic activity in developing economies are both positive backdrops for global growth in 2014. The IMF recently revised upwards its world real GDP growth forecast to 3.7% for this year and to 3.9% for 2015 (Chart 2). With financial risk building in China, however, this economy warrants further attention.

Chart 2



Note: Based on IMF Forecasts, January 2014

China has been expanding at an average rate of 10% for the past 10 years and currently accounts for 15% of global output. Much of China's progress has been stimulated by rapid growth in infrastructure-related investment. As the economy matures, it will increasingly rebalance to other sources of growth, such as the manufacturing of valued-added products and consumption.

Complicating the transition process has been an apparent misallocation of capital which has accompanied this period of strong capital investment. Given the strict constraints of the Chinese banking sector, a parallel financing system emerged, the so-called “shadow-banking” system which is estimated to account for almost 50% of new credit in the economy. This credit has been lent to borrowers of uncertain quality and then repackaged into high-yielding savings products which were sold to Chinese households. Reports that a few borrowers have declared bankruptcy and many others may be insolvent has raised concerns that losses could build-up in the financial system hastening a contraction in lending and consequently leading to a more pronounced economic slowdown.

The situation in China is multifaceted and complex. The government controls the major banks as well as the total amount of lending in the economy. Important reforms are currently being implemented. We view very favourably the planned introduction of a bank deposit guarantee and the anticipated removal of a cap on the interest rate banks pay depositors. These structural changes should dampen the appeal of the shadow banking system and stimulate the flow of deposits back into conventional banks. As this occurs, low quality borrowers will lose access to financing and losses will emerge, but given China’s sizable $4 trillion of foreign exchange reserves, they can easily be absorbed by the government through the banking system.

The central authority ultimately controls the amount of lending, therefore a U.S. or European-style credit crunch is unlikely to occur. Rather, a more probable scenario is one of slower lending growth, more stringent regulations and an improvement in the allocation of future capital. As this unfolds, we do not think that growth in China will be unduly impaired. A recent gauge of data on Chinese industrial output shows car production is up 23% year-over-year, copper products +28%, aluminium products +16% and cement production +11%, while total freight through rails, highways and ports is +5.2%. Longer-term economic fundamentals remain strong and a moderate slowdown in the rate of growth of the Chinese economy over the next few years should not impact our global growth forecast.

Although some developing countries are currently experiencing a cyclical slowdown, it should be noted that in aggregate this region is still expected to expand at a two to three times faster pace than the developed world over the next few years.

Overview of fixed income and equity markets

Over the last two years, equity markets across the world have risen impressively. The total return (in Canadian dollars) of the MSCI World Index is 44%. In contrast, fixed income instruments generated poor returns as U.S. 10-year government bonds yields increased 51 basis points to 2.72% while Canadian yields are up 35 basis points to 2.46%. Yields remain well below fair value thresholds and an improving economy will continue to pressure rates to rise.

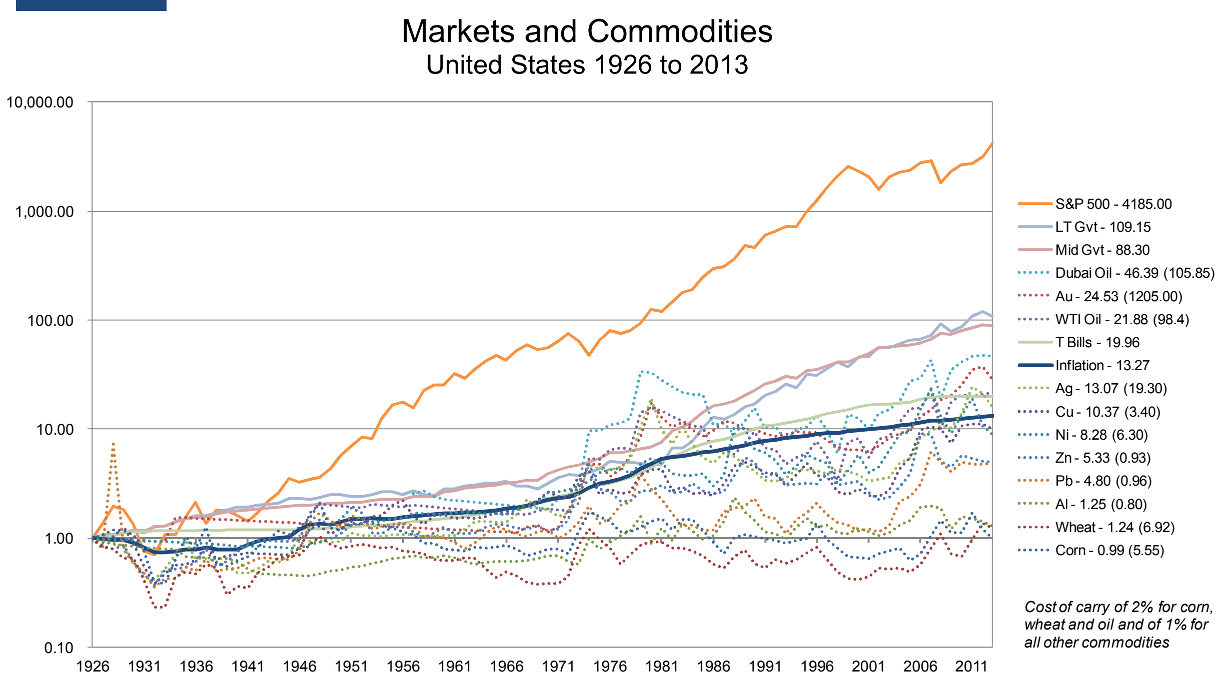
The expansion of market multiples has been a key driver of recent stock market performance and the significant discounts that were apparent two years ago have subsided. Today, our equity portfolios trade at a reasonable price-to-earnings ratio of 13X projected 2014 earnings.

Over the longer-term, equity prices are driven by one principal factor: economic growth, which translates into sales and profit growth. As noted above, our economic forecast calls for a pick-up in both developed and emerging economies which should support a healthy expansion for company sales. With profit margins remaining stable or declining modestly from current levels, earnings are expected to grow in line with the global economy.

Adding value in the current investment environment requires a careful and thoughtful analysis of the global opportunity set. We regularly assess future growth drivers of the industries we invest in. In the banking industry, for example, loss provisioning and other legacy costs from the financial crisis will continue to diminish while the demand for loans rises and interest margins improve. The case of Bank of America is very telling as legacy legal costs represented 20% of total operating expenses for 2013. We expect these costs to return to a more normal environment within three years and the positive impact on earnings will be significant. The potential for future appreciation of our global bank holdings remains therefore compelling.

Opportunities abound across industries over the longer term. There is an enormous market of unmet needs in health care, telecommunications and energy consumption. The consulting firm McKinsey estimates that the world will require $57 trillion in infrastructure investment by 2030. Furthermore, the world economy will see 3 billion new consumers entering the middle-class by 2030. As standards of living in the developing world rise and converge towards that of developed markets, so will the penetration rate of various consumer goods. This will create new markets across the supply chain, from innovation to development and from parts to final products.

Chart 3



The development of products and services that fulfil unmet needs and compensate entrepreneurs in the form of profits is the main catalyst for share price increases. History demonstrates that while equity prices see occasional periods of underperformance, over long investment horizons, stocks outperform bonds and other asset classes by a considerable margin. Since 1926, $1 invested in the S&P 500 is worth over $4,000 today, while $1 invested in U.S. long-term Treasuries would be worth $110 (Chart 3). Indeed, the economy would cease to function if the entrepreneurs and risk-takers were not better compensated than investors in government securities.

Provided an investor's horizon is sufficiently long to allow the cycle of profit creation to play out, detecting these opportunities, understanding which companies will benefit and, ultimately, paying a reasonable price for an ownership stake in these companies is the best way to achieve the highest return. In contrast, fixed income investments do not stand to benefit from economic progress and innovation. Moreover, as economic activity improves, today's minimal fixed return may not compensate investors for inflation. We therefore continue to favour carefully selected equities over both cash and bonds over the medium-term.

All dollar references in the text are U.S. dollar unless otherwise indicated.

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