Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

June 2014

Summary

- Steadily improving economic conditions in developed markets, led by the U.S., will drive global growth in 2014.
- The decline in bond yields since the beginning of the year has been triggered by temporary rather than fundamental factors, among which geopolitical tensions in Eastern Europe and the Middle East.
- Long-term yields will face upward pressure as they adjust to an expanding global economy. Two fundamental drivers of sovereign bond yields – growth and inflation expectations – are at a turning point.
- Equities are well supported by solid corporate profits growth. Both profit margins and valuations are in line with long-term average levels and far from extremes.
- We continue to favour equities within balanced portfolio mandates. The duration of the bond portfolio is being kept very short as we await a better time to acquire long-dated instruments.

Global equity markets have continued their ascent, rising 6.6% since the beginning of the year. This has been driven by an improvement in general economic activity and a corresponding increase in corporate profits. Despite these positive developments, global bond yields have trended lower. The 10-year Government of Canada bond yield retraced about 55% of its 96 basis point rise during 2013; at 2.24% it still remains 1.18% below the average level during the 2008-09 recession. In light of this conundrum, we thought it important to reassess our medium-term return expectations for both asset classes.

Several technical factors may have helped push bond yields lower in recent months. In our view, however, the two fundamental drivers of longer-term sovereign bond yields – growth and inflation expectations – are at a turning point. Growth is continuing to accelerate while inflation has started to rise from its lows. As yields converge upwards towards the level supported by current fundamentals, the total return generated by fixed income instruments will be minimal.

Positive macroeconomic fundamentals, while a headwind for bond prices, will continue to be supportive of corporate profits. Although profit margins and equity market multiples have expanded as the global economy recovered from one of the deepest and longest recessions since the 1930s, they are far from extreme levels. We continue to believe that a well-diversified portfolio of quality companies should continue to outperform both cash and bonds over the medium term.

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Why bond yields are not rising (yet)

Economic activity in the U.S. decelerated in the first quarter, growing at 1.5% year-over-year, down from 2.6% in Q4 2013. There are clear indications, however, that the economy is picking up and that the slowdown during the first quarter resulted from the harsh winter weather.

New housing construction is back above the 1 million unit level while industrial production is growing at 4.3% compared to last year. Indicators for future manufacturing production signal a pickup: durable goods orders are up 2.9% on an annual basis, while total factory orders are up 2.4%. Employment growth has averaged a healthy 238,000 per month over the past 3 months, leading to an annual increase of 3.6% in disposable income. As a result, consumer spending remains resilient. Retail sales are up 4.3% versus last year and auto sales are running at 16.7 million units per year. The contribution of the energy sector to the economy's upside potential cannot be underestimated. For the first time since 1984, the U.S. is producing more oil and liquids than it is importing, which will help the trade balance going forward.

In light of these very positive developments in the U.S. economy, it is puzzling to see bond yields continue to decline. Several reasons may explain this trend. First, despite the pick-up in economic activity and accommodative monetary policy, the unemployment rate has remained above 6.0%. Adjusting the rate to include discouraged workers, unemployment stands at 12.3% of the workforce versus the pre-crisis level of 9.0%. Given the Federal Reserve's dual mandate of maintaining stable prices and maximum employment, it has signalled that the policy rate may remain low for a longer period of time. Bond investors have therefore adjusted their expectations accordingly and longer-term interest rates have declined. This is, however, a short-term phenomenon. The Fed is still expected to end its purchases of Treasury and Agency securities by year-end and raise its policy rate thereafter. The economy, as noted above, is continuing to improve. While the *timing* may be uncertain, we believe that the *direction* of the future path of interest rates is the key factor to focus on.

Second, bond yields have reacted to geopolitical and macroeconomic events in the Middle East and Europe. Rising tensions between Ukraine and Russia have in part revived "flight to safety" flows into bonds, albeit on a lesser scale than that experienced during the sovereign debt crisis in 2011. Eurozone economic activity, while recovering, remains sluggish and potentially vulnerable to further escalation of tensions in the region. First quarter real GDP growth was 0.9% versus a year ago and tight credit conditions continue to be a headwind. This subdued growth has translated into a slowdown in inflation, which is now running at 0.5% year-over-year.

The European Central Bank, in recognition of the importance of credit in oiling the wheels of the recovery, will implement a series of measures to incentivize banks to restart lending. Banks will have access to financing for up to four years at a very low rate: the cost of funds is now a fixed 0.10% above the ECB main lending rate, which currently stands at 0.15%. In addition, the interest rate paid on bank reserves parked at the ECB has been set to –0.10%, a clear signal that the central bank wants to redirect excess bank funds to the real economy. A program to purchase asset-backed securities is also being considered by the central bank for future implementation. While the injection of liquidity has driven yields lower in the short term, the ECB's actions to support growth by unclogging credit markets will ultimately increase the supply of financing to the private sector, a negative development for bonds.

Third, the demand for long-term bonds by pension plans and insurance companies has remained firm due to pressure to close the maturity mismatch between assets and liabilities. Both entities have long-dated liabilities, in the form of disbursements to pension beneficiaries or holders of insurance products. Both have shorter dated assets, in the form of cash received from pension contributions or the sale of insurance products. Given the mismatch in timing of current assets and future liabilities, regulatory agencies and accounting standards require that liabilities be discounted to the present.

In the case of pension plans in Canada, one discounting method requires the use of current long-term interest rates. As yields declined following the financial crisis, the accounting value of the liabilities increased and the gap between assets and liabilities, also known as the funded status, was exacerbated. Towers Watson estimates that the Fortune 1000 pension funds had, on average, a pension solvency ratio of 77% at the end of 2012. This forced plan sponsors to contribute significant amounts of new money into company pensions. Some pension plans and insurance companies have adopted a strategy to ''immunize'' their portfolios from this maturity mismatch. In other words, by buying long-dated bonds with a view to matching the duration of liabilities, the investor becomes, in theory, indifferent to the future path of interest rates. As yields increase, the value of the assets will decline, but so will the value of the liabilities.

On average, the solvency ratio for pension plans rose to 93% in 2013 on the back of higher equity markets and an increase in interest rates (i.e. a higher discount rate applied to the liabilities). Rather than dampening the urgency for immunization strategies, plans which are now in a surplus position appear eager to lock in this ratio. Pension industry data indicate that only $9 billion of new funds were used to purchase bonds in Q1 2014. This is 70% less than the average quarterly inflows during 2013, a period of rising interest rates, suggesting that new demand to buy bonds by institutional investors was not a factor in the recent decline in yields. Rather, pension plans increased the duration of their portfolio by selling short-dated instruments and buying longer-term bonds.

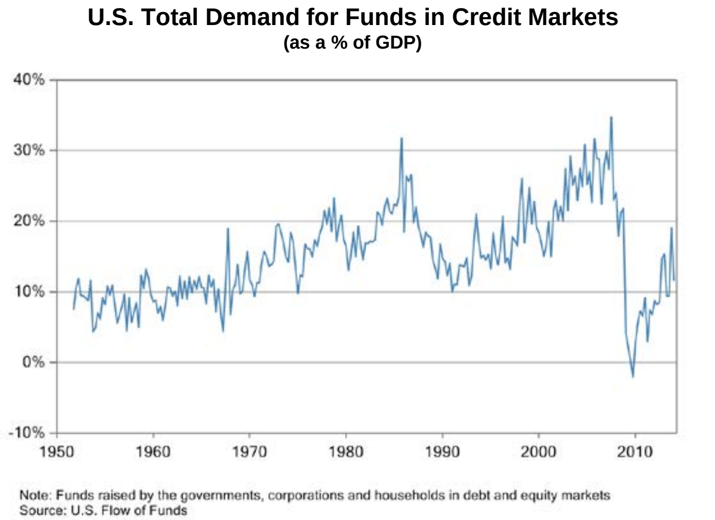
While such investment decisions may have had an impact on long-term yields, they are temporary in nature. Once the rebalancing is complete, the distortion on yields will recede. Fundamentally, the expected return on assets, rather than the accounting methodology for liabilities, will drive investment decisions. Strategies which dictate the purchase of an asset even when that asset is expected to decline in value are bound to perform badly.

Why bond yields will rise (in the medium term)

The supply and demand for bonds may be impacted by short-term factors as described above, but in the longer-term there are only two core drivers: real economic growth and inflation. Currently, both are in an uptrend in the U.S.

We expect U.S. growth to accelerate to 2.5%-3.0% and remain buoyant next year. When the economy grows, the demand for credit by households and corporations tends to increase (Chart 1).

Chart 1



We are already witnessing this trend in the U.S.: consumer credit is up 6.0%, mortgage credit rose 2.9% and non-financial business credit grew by 9.3%. This demand for credit is translating into a rise in the supply of fixed income instruments and competition for bank deposits, both of which should put upward pressure on yields.

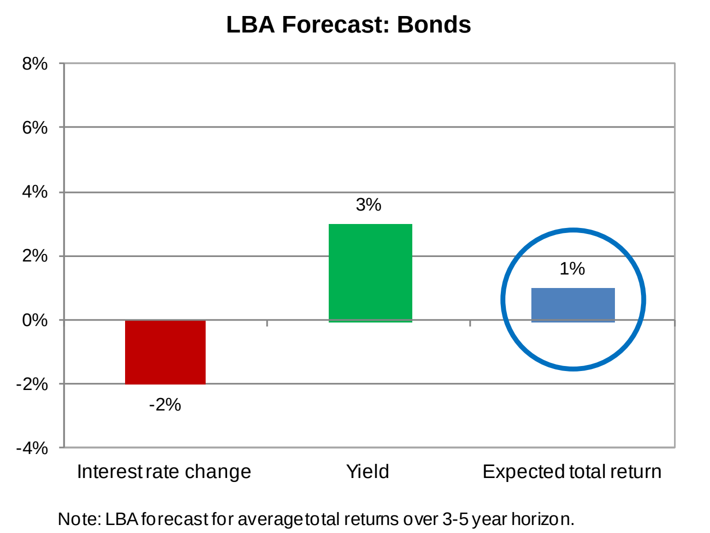
Bond yields are also sensitive to inflation expectations. In fact, inflation does not need to increase by much to erase the purchasing power of fixed income investors. An investor who purchases a 5-year Government of Canada bond with a face value of $1 million dollars and a coupon of 1.5%, would see a loss of about $25,000 in purchasing power if inflation remains at the current level of 2%. If inflation increases to 4% over the 5 year period, the purchasing power erosion jumps to $119,000, in other words more than 10% of the value of the amount invested. This relationship underlies the reason bond yields tend to move in tandem with inflation.

Recent data suggest that inflation may be at an inflection point. The consumer price index (CPI) has risen from 1.0% at end-2013 to 2.2% in Canada and from 1.5% to 2.1% in the U.S. Meat prices in May were up 7.8%, energy prices rose 3.4% and housing related costs were up 2.8%. Employee wages, a key determinant of inflation, have also been on an uptrend. The aggregate U.S. wage bill, including both existing wage increases and the addition of new workers in the labour market, saw a strong rise of 4.4%. In Canada, the annual growth in private wages is 3.7%.

Current bond yields do not compensate for this level of price increase. Moreover, as bond yields eventually adjust to slightly higher inflation, bondholders of long dated instruments are set to suffer the most from this re-pricing.

We expect that bonds will generate total returns of around 1% per year over the next 5 years. While the running yield is estimated to contribute about 3% per year, as interest rates normalize towards their fundamental value, capital losses will detract 2% from the return (Chart 2).

Chart 2



Why equities are the better investment

Just as economic growth ultimately influences bond prices via the demand for funds in an economy, growth is the principal factor which underpins corporate profitability and, by extension, drives stock prices. Corporate earnings typically track the nominal growth rate of an economy over a very long period. However profit growth can either exceed or undershoot economic growth at certain points over an extended cycle.

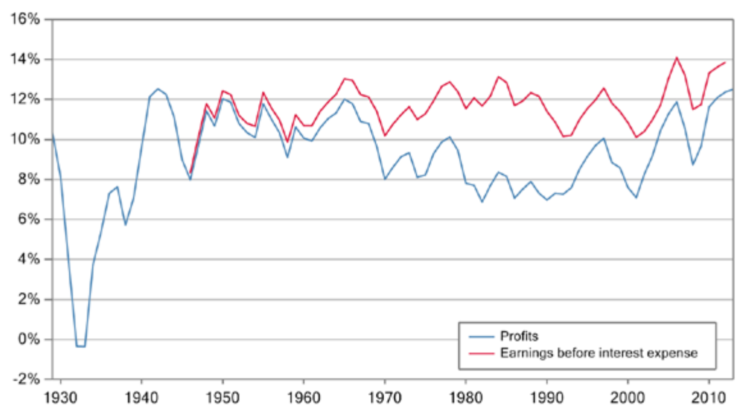
Over the last 30-years, U.S. profits have on average grown faster than the U.S. economy. As a result, corporate profit margins have been on an upward trend and are now at levels prevailing during 1940 – 1965 (Chart 3). Our research indicates that two factors have been behind the expansion in profit margins over the last three decades: productivity and interest rates.

Corporate cost cutting and technological improvement have played a significant role in the expansion of profit margins. Productivity as measured by output per hour has increased more than four-fold since the 1950s. Over the last 15 years, the U.S. population increased by 40 million, businesses managed to produce 42% more output and yet aggregate hours worked in the U.S. business sector remained flat.

A popular conclusion is that rising profitability has come at the expense of workers; after all, aggregate wages as a share of GDP declined from 49% to 42% since the 1950s. This is a misconception. In fact, the decline in share of aggregate wages has been offset by a rise in other employee compensation such as contributions from employers to pension, private insurance and social insurance programs.

Chart 3

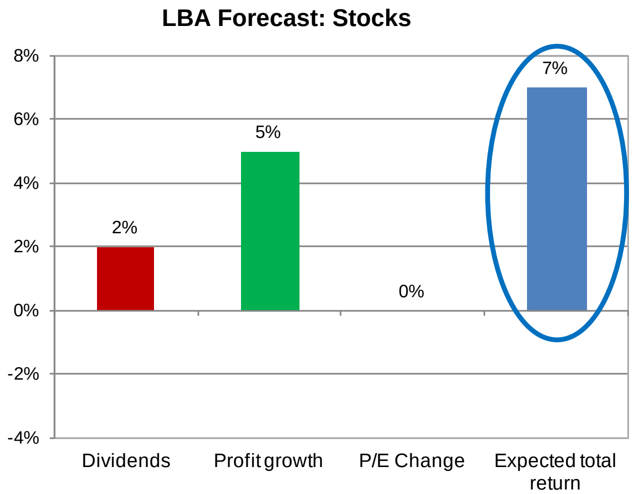
U.S. Corporate Margins*



Source: BEA. * After-tax national corporate profits & earnings before interest expense as a % of GDP

Concerns have been expressed regarding the sustainability of margins at current high levels. Profit margins peaked just prior to 1970 at levels similar to today. They then entered a period of secular decline before reaching a trough of 7% of GDP in 1990. The reason for this contraction was the high level of interest rates which prevailed during much of this period, leading to high corporate financing costs. In fact, profit margins before interest expenses have been remarkably stable since the post-war period (Chart 3). Margins are high, but hardly inflated from a historical perspective. A rise in interest rates will eventually put pressure on corporate margins but the impact will take place gradually. Corporations have taken advantage of low interest rates by issuing a large amount of long-term debt. Profitability will only be impacted by higher interest rates several years after they have increased as existing debt comes due and must be refinanced at higher levels.

Chart 4



Note: LBA forecast for average total returns over 3-5 year horizon.

Our base case scenario for stocks therefore assumes stable margins and no change in the price-to-earnings (P/E) multiple. As mentioned in the March 2014 *Economic and Capital Markets Outlook*, the P/E ratio for both developing and developed markets is far from bubble-type levels. Equities will therefore be driven by company earnings and, by extension, global economic growth. We expect 3% real growth and 2% inflation, providing the backdrop for a 5% annual increase in corporate profits. Along with a projected 2% dividend yield, stocks are expected to generate 7% per year on average over the next 5 years, significantly better than the expected return of fixed income instruments (Chart 4).

Our investment strategy remains unchanged. We are maintaining a very short duration in our bond portfolios and are underweight bonds within balanced mandates. We believe that a portfolio of carefully selected stocks will continue to outperform cash and bonds over the medium term.

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

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