Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

March 2015

Summary

- On balance, the global economy stands on a stronger footing and we currently see no impediment to the expansion lasting for some years. This, together with healthy profit growth and a low interest rate environment should continue to benefit equity markets.
- At 17.5 times 2015 forecast earnings, U.S. stocks are above the 9-12 times P/E range which prevailed in the early years of the economic upturn. These valuations are not excessive but U.S. stocks may be more sensitive to unanticipated events.
- Our base case assumes U.S. profits growing in line with the economy, suggesting more modest, mid-single digit returns in the next few years. In the near term, company earnings may be subject to pressure from a strong dollar and weak oil prices.
- Elsewhere around the world, the ECB's efforts to stimulate credit and a moderating of the conflict in Ukraine are key factors behind improved prospects in Europe. The fundamental growth drivers remain strong in emerging economies. These regions offer an enormous market of unmet needs and substantial economic opportunity.
- The timing of the Federal Reserve's rate hikes remains uncertain and it is likely that the central bank's initial steps will be modest. However, underlying economic fundamentals argue for higher interest rates.
- Bonds remain an unattractive investment on an absolute and relative basis. Their return potential is minimal and likely negative in the short-term. Exposure to long-term fixed income securities should be avoided.
- Our decision to favour equities over cash and bonds should continue to be the best strategy.

LETKO BROSSEAU

Better U.S. growth ahead

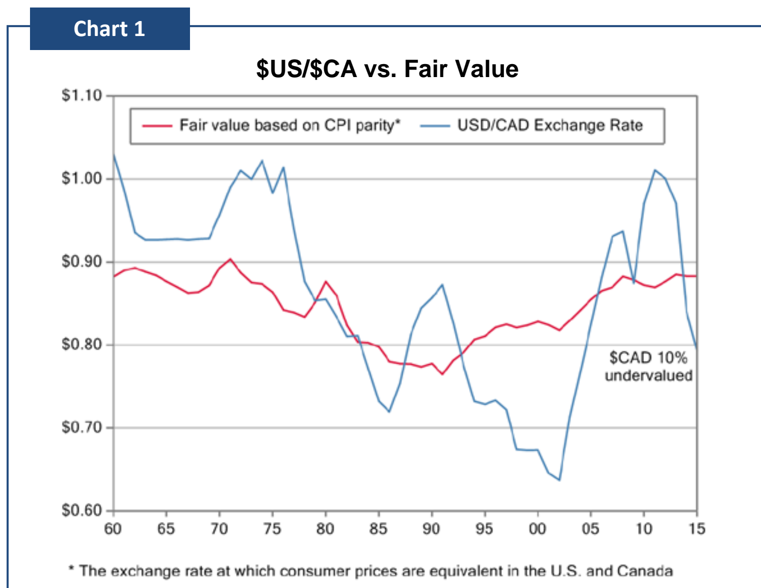
Indicators of U.S. economic activity continue to point to improving underlying conditions. The leading sub-indicators of the ISM manufacturing survey which anticipate trends in new orders, supplier deliveries and order backlogs, generally point to an expanding economy. Employment growth is buoyant; an average of 261,000 new jobs per month were created during the past 6 months ending March. Disposable income growth is 4.3% year-over-year and U.S. households have seen a boost to spending power due to a 50% decline in fuel costs.

The recovery in the housing market has further room to run as demand for housing is likely to be stimulated by higher household formations. Corporate spending on investment is also expected to contribute to economic activity. Notwithstanding a slowdown in oil and gas related capex, corporate spending on technology, R&D and plants will remain solid, supported by strong balance sheets, profits and cheap credit.

The base case forecast for U.S. real GDP is a gain of 3.0% in 2015 compared with 2.4% for 2014. This will be driven by accelerated growth in personal incomes and consumer spending, the benefits of lower oil prices as well as improvements in residential construction and corporate investment. A slight headwind may emerge from a stronger U.S. dollar. The currency's substantial appreciation versus its major trading partners, if sustained, could negatively impact U.S. exports and corporate profits.

Canada's growth trajectory moderating

The Canadian economy has been recently buffeted by countervailing factors. An improvement in U.S. activity and a lower Canadian dollar should boost growth prospects in the medium-term. Three-quarters of total exports are destined for the U.S market of which two-thirds are non-energy related and span a wide range of industries, from cars to industrial machinery. Ontario is emerging as a major beneficiary; the province has seen 39,000 jobs created over the last twelve months ended February and real GDP growth was up 2.5% in Q3 against the previous year. In the near-term, however, lower oil prices are likely to negatively impact Canada's trade balance and energy-related investment spending.



Lower oil prices will clearly impact activity in Alberta and affect Canada's trade balance, which in turn has contributed to Canadian dollar weakness. The exchange rate has fallen from $0.92 to $0.79 since end-July 2014. On a purchasing power parity basis, we estimate that the currency is 10% undervalued versus the U.S. dollar (Chart 1).

Another factor that pushed the currency lower was the decision by the Bank of Canada to cut the overnight rate from 1% to 0.75% in January, despite inflation (excluding food and oil) running at 2.1%.

It justified the rate cut by pointing to a timing difference between the negative effects of lower oil prices on the economy versus the positive benefits of the lower dollar on exports.

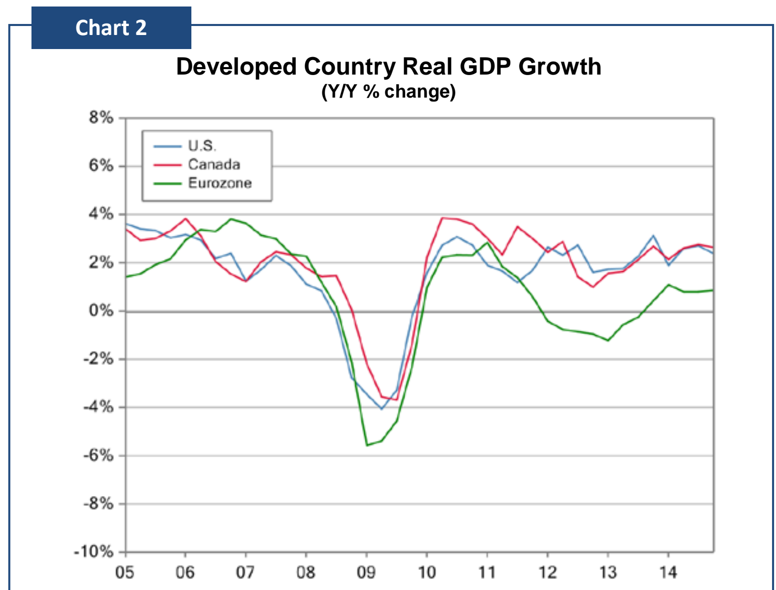
Our base case forecast for the Canadian economy is for growth to range 1.5%-2.0% in 2015. In the medium-term, the economy faces structural headwinds in the form of an over-indebted consumer and an overvalued housing market. As consumers readjust spending to a more sustainable path, Canada should still remain on a moderately positive trajectory.

Modest improvement in Europe

Eurozone real GDP expanded 0.9% in 2014, following two years of contraction (Chart 2). During the fourth quarter, real GDP growth on a year-over-year basis was 2.0% in Spain, 1.3% in Greece, 1.5% in Germany, 1.0% in the Netherlands, 0.2% in France while growth in Finland and Italy was still negative at –0.2% and –0.5% respectively.

Since 2010, growth has been uneven as a series of events have called into question the stability of the Eurozone's currency union. Throughout this turbulent period, however, structural reforms have been implemented, notably in Spain, Portugal and lately in Italy directed towards improvements in labour market flexibility. European banks on the whole are now significantly better capitalized and interbank lending has restarted. Overall employment has begun to rise, as 700,000 jobs have been created in the Eurozone over the past 6 months. Based on these positive developments as well as lower oil prices and a weaker exchange rate, the European Central Bank (ECB) lifted its 2015 real growth forecast from 1.0% to 1.5%.

Two caveats remain: first, tensions in Ukraine are still hurting confidence. The German IFO Business Climate Index, which measures entrepreneurs' sentiment about current expected business conditions, has recently shown some signs of improvement. However, it remains below the level seen before the conflict started. Second, lending to the non-financial sector is still contracting. Further economic progress remains tied to the ECB's success in restarting the flow of credit. To this end, the central bank launched a program in March to buy €60 billion of European government and private sector bonds per month. This program is set to last until at least September 2016, equalling a total balance sheet expansion of €1.1 trillion.

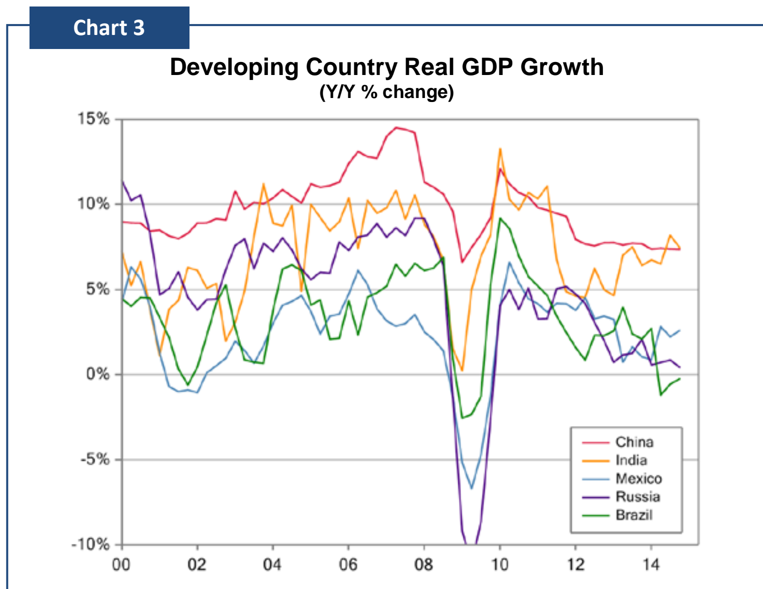


It is not yet clear whether the additional liquidity will stimulate credit creation and spill over to the real economy. It has, however, begun to affect financial assets as the recent strength in Euro stocks and bonds attest. For example, the DAX is up 40% in local currency since October and bond yields across different European countries and maturities have slid to negative levels.

We forecast that the Eurozone real economy will grow by 1.0% or more in 2015 with upside to the base case coming from monetary stimulus and the sharp drop in the value of the Euro.

Emerging markets continue to offer long-term investment opportunities

Activity in developing economies varies greatly across countries (Chart 3). In 2014, both India and China expanded in real terms by 7.4%, yet the former's economy was accelerating while the latter was slowing. Brazil only grew by 0.2%, against 2.7% in 2013, as the economy battled rising inflation and budgetary issues. Russia suffered from the effects of international sanctions linked to the conflict in Ukraine and real output only expanded by 0.6% last year. In contrast, the Southeast Asian economies saw solid growth of 5% or more.



Although the pace of advancement differs per economy and industry, the region's future growth potential is substantial. Large growing populations seeking improved standards of living and the requirement for significant investments in infrastructure are structural factors that will sustain development on a secular basis.

In India, the government recently released its federal budget, which aims to increase infrastructure spending and progressively lower the national corporate tax rate. Future growth will be driven by fulfilling the country's tremendous infrastructure needs. Furthermore, increased urbanization and female labour force participation, currently only 32% and 27% of the population respectively, will drive growth in employment.

China currently faces low inflation, substantial spare capacity and a weak housing market. As a result, monetary policy authorities have lowered interest rates to increase domestic demand. Despite this cyclical adjustment, fundamental trends remain strong. Urbanization is still bringing an estimated 10 million people to the cities every year.

In Brazil, the government has cut spending and raised taxes in an attempt to control its fiscal deficit and the central bank has raised rates to tackle inflation. Once the difficult but necessary cyclical adjustment comes to an end, the stage will be set for a pick-up in investment spending.

Much like in India, the Indonesian government took advantage of lower energy prices to cut costly fuel subsidies. This has freed up fiscal dollars to be invested in ports, power plants and roadways to increase national competitiveness.

Russia's economic picture is unclear due to geopolitics. The economy is expected to fall in recession this year and this situation could persist well into 2016 as the full impact of international sanctions and the currency's depreciation is felt. The Russian central bank sharply raised interest rates at the end of 2014 to stabilize inflation and the ruble but it has since eased monetary policy to help provide liquidity to banks and national corporations.

Overall, the IMF projects growth in the emerging markets to remain broadly stable at 4.3% in 2015 and to increase to 4.7% in 2016.

An update on oil

The dynamics behind the sharp drop in the price of oil was discussed extensively in the December 2014 issue of the *Economic and Capital Markets Outlook*. A surge in U.S. oil production led to a growth in overall supply at the same time as global demand for oil weakened somewhat. This mismatch between supply and demand will gradually correct itself although the timing of the readjustment is uncertain.

Global oil production and demand are running at record levels of 94.6 million barrels per day. Announced cuts in capital spending by U.S. energy companies indicate that investment will contract by about 45% over the next year. Although U.S. oil production is expected to be stable in 2015, capex cuts are likely to feed through to lower U.S. supply in 2016. In the meantime, current data indicate a pick-up in global demand. U.S. consumption of fuel and distillates during the first 3 months of 2015 was up 4% compared with the same period last year. The International Energy Agency (IEA) expects rising oil consumption in emerging markets to boost global demand growth from 0.7 million barrels per day in 2014 to 1 million barrels per day in 2015.

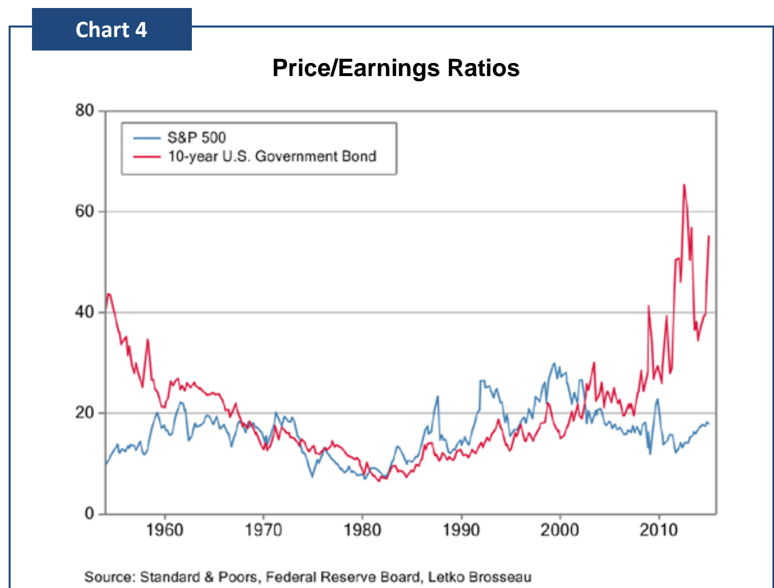
Oil prices remain depressed but this is unlikely to be sustained in the medium term. The realignment of supply and demand is slowly unfolding.

Careful stock selection increasingly paramount

Equity prices are up year-to-date yet have diverged considerably across markets. The total return for the MSCI World Index is 11.9%, with European and Japanese indices outperforming the rest of the world (in Canadian dollars): S&P 500 +10.2%, S&P TSX +2.6%, DAX +17.7%, CAC-40 +14.2%, FTSE-100 +8.5%, Nikkei +20.4% and MSCI Emerging Markets Index +11.6%.

The first stage of the recovery from the 2008 financial crisis saw a strong increase in U.S. corporate profits and an expansion in price-earnings multiples. Domestic earnings by American companies grew by 93% between 2008 and 2014 and the S&P 500 P/E ratio expanded from 12X to 18.5X (based on trailing earnings). At current levels, the S&P 500 P/E ratio has approached the higher end of a reasonable valuation range. Some sectors, for example biotechnology as well as small cap stocks, trade at more expensive P/E ratios of 20 times or more. On a P/E equivalent basis, however, bonds trade at extreme levels of more than 50 times the current yield with no prospects for income growth (Chart 4).

Looking ahead, this next stage will involve a transition to an environment where earnings progress in line with GDP growth. Our expectations are for mid-single digit earnings growth or 5%-7%. In addition, we expect 10-year bond yields to rise to 3.5%-4% over the next 5 years. This combination should allow for stock market gains similar to that of profit growth, yet still well above bond market returns. Equity valuations, however, may be more subject to unanticipated events.



One such risk on the horizon is an increase in cost pressures due to rising wages. There are tentative signs that labour markets are tightening and wage inflation is accelerating. U.S. salaries are up 2.1% per year and the unemployment rate has declined from 10% at the recession's peak to 5.5%. According to data from the Bureau of Labour Statistics, the number of people reporting that they have quit their jobs to pursue better career opportunities is at a 7-year high and the number of strikes is rising. The minimum wage has been raised in 20 U.S. states and several companies have begun to increase base salaries for their employees. Wal-Mart announced a 24% rise in pay for its minimum-wage earning employees while T.J. Maxx, Starbucks, McDonald's and Marshalls have also announced wage increases.

While we are not forecasting an imminent spike in cost pressures and/or compression in corporate margins, careful attention must be paid to avoid investments with stretched valuations. A fundamental assessment of the intrinsic value of a business as well as price discipline in executing buy and sell decisions will dictate returns. To that end, we continue to find opportunities that offer attractive valuations and robust profit growth. For example, global bank and insurance firms trade at a discount to book value and this sector's recovery from the financial crisis has further room to run. Opportunities also exist in areas that have recently seen significant share price declines. Energy shares are at depressed levels yet the long-term outlook for the oil industry remains favourable. In the mining industry, some key base metals prices are approaching their marginal cost of production, which is typically associated with a turning point.

Furthermore, other regions offer more reasonable equity valuations. Overall profit growth in the Eurozone non-financial sector was up 6.5% on an annual basis in Q3 and is expected to improve going forward. On a forward earnings basis, the Bloomberg Euro 500 Index trades at 16.8 times, the German DAX at 15.4 times, the French CAC-40 at 16.6 times and the Spanish IBEX at 16.7 times. Emerging markets, in aggregate, are in the early stages of economic transformation. Despite elevated growth prospects for the longer term, emerging market stocks trade at a discount relative to developed markets.

Overall, our global equity portfolios remain broadly diversified across all geographies and economic sectors and are priced at a very reasonable 14X 2015 earnings.

Avoid exposure to long-term bonds

In January, the yield on the 30-year Government of Canada bond reached 1.85%, the lowest level in the recorded history of interest rates since Confederation. Choosing to lend money at such yields implies a belief that either the Canadian economy will stagnate or that inflation will be 0% (or less) for the next three decades. In our view, these scenarios are extremely unlikely.

It appears that the recent decline in yields was driven by foreign flows and investor concerns of deflation. In a deflationary environment, aggregate prices decline and this pushes up the purchasing power of money invested in fixed income instruments. An economy-wide price decline is an extremely rare event. During the past century, neither Canada nor the U.S. experienced sustained periods of falling prices. This is despite undergoing two World Wars, the 1930s Depression, the 2008-09 financial crisis as well as numerous economic contractions.

Post-recession periods are typically associated with low levels of inflation. Inflation in the U.S. averaged 1.6% between 2009-2014 and the recent drop in energy prices compressed overall inflation to -0.1% in February. Since 2008, price pressures have been subdued as developed economies

operated with considerable slack in output and labour markets. Credit remained constrained while global banks raised capital and repaired balance sheets. Today, however, global structural imbalances have largely been addressed and credit growth is positive, except perhaps in the peripheral European countries.

Inflation is in fact starting to appear in many sectors of the economy. For example, prices of food and housing in the U.S. were up 2.8% and 2.7% year-over-year respectively in February. Together these account for 40% of the basket of goods consumed by an average American household. Furthermore, as noted above, wages are rising and labour markets are tightening.

As deflation fears start to recede and the Federal Reserve normalizes its policy rate, the bond market could react negatively. Strategies which seek to boost yields by either extending duration or taking on credit risk do not offer sufficient return potential. They fail to compensate investors for the risks of rising interest rates or company failure. Companies are currently taking advantage of these low borrowing rates by issuing debt to invest in order to bolster future sales and profits. The greater investment rewards lie in participating in the growth potential of successful businesses through an equity stake rather than the low yields offered by corporate debt issuers. While the risk of a failure is similar, the return potential is significantly greater.

Our strategy to favour equities over fixed income instruments and cash has been a successful one. Since July 2012, the last time bond yields hit levels close to those prevailing today, the returns generated by long-term Federal bonds in the U.S. and Canada were a cumulative 12.9% and 14.7%. During this same period, U.S. equities returned 59% (94% in Canadian dollars) while Canadian equities generated 37%. We believe that this strategy will continue to pay off in the medium term.

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

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