Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

June 2015

Summary

- Major structural adjustments to banking, fiscal and consumer balance sheets are by and large behind us. We believe the current global economic expansion should continue for several more years.

- While growth is not fully synchronized across developed and developing countries, a pickup in activity in the U.S. and Europe will lead to a gradual acceleration of the global economy.

- The positive economic backdrop continues to be supportive of equity markets. Our base case assumes U.S. profits grow in line with the economy, suggesting modest, mid-single digit returns. More attractive investment opportunities may be found elsewhere around the world and in select industries.

- Equity market valuations are not excessive. However, certain sectors, such as select biotechnology and IT stocks, do trade at very high valuations. Care with respect to company selection continues to be very important.

- Global bond markets have seen unusual volatility during the first half of this year. We continue to caution investors that fixed income instruments are extremely overvalued and thus vulnerable to further price correction.

- Equities have generated considerably higher returns than bonds over the past several years. Our decision to favour stocks over fixed income instruments, while maintaining a high quality portfolio of bonds with low exposure to interest rate volatility, has been a successful one. We believe that this strategy will continue to work well in the medium term.

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Economic overview

Now in the sixth year of recovery from the global financial crisis, the world economy has made considerable progress. We currently see no significant obstacles ahead and expect the global economic expansion to continue for several years.

Growth is currently being led by the U.S., which has perhaps made the most headway in addressing its structural imbalances. Employment is now above pre-recession peaks. Household debt as a share of disposable income has fallen from 130% at end-2007 to 102% and net worth stands at a record $85 trillion, 27% above that in 2007. Bank balance sheets have been restructured and industrial capacity utilization is back to pre-crisis levels. The government deficit, which had ballooned to 10% of GDP during the recession, is now at a more sustainable level of 3% of GDP.

Real GDP was up 2.9% on an annual basis during the first quarter of 2015, despite recent softness in manufacturing data due to lower energy-related investment and the impact of a strong U.S. dollar on the trade balance. Recent data indicate domestic demand is improving.

Labour markets continue to tighten: an average of 208,000 new jobs have been created monthly during the first half of this year. Stronger employment income, as well as the benefits of lower gasoline prices, have supported consumer spending. Car sales reached an annualized level of 17.6 million units in June and restaurant receipts are up 8.2% year-on-year. One million new homes on an annual rate were built in the month of June. Household formation is currently running at 1.4 million, a level consistent with lower housing inventories and healthy construction activity going forward.

As the economy moves closer to its full potential, early signs of inflationary pressures are emerging. The housing component of the consumer price index is up 2.8% year-over year and gasoline prices appear to have bottomed. Wages are increasing at a slightly faster pace: average hourly earnings and the employment cost index are up 2.0% and 2.6% respectively against last year. These developments will require monitoring, particularly in light of the significant amount of liquidity that has been injected into the economy.

We expect the U.S. economy to strengthen during the second half of the year and grow by 2.5%-3.0% in 2015. A further appreciation of the U.S. dollar represents the main risk to this base case forecast. A strengthening currency could negatively impact exports and overseas profits of domestic companies.

Unlike the U.S., Europe’s recovery from the financial crisis has been erratic (Table 1). Troubles in the periphery countries eroded confidence, monetary stimulus had to wait for the banking system to be brought under ECB control and Russia’s incursion into Crimea sparked geopolitical tensions. Recent developments in Greece have added to the uncertainty surrounding the Eurozone.

Problems in Greece stem from long-standing structural defects. Tax avoidance, low productivity, low domestic savings, lack of private investments and economic growth supported by foreign lending has made Greece particularly vulnerable. The current pressing need to receive financial support, made worse by a run on its banking system, is obliging Greece to finally make fundamental choices. Although Greece could choose the difficult but in some respects easier route of separation and devaluation, this would do little to solve its underlying structural problems. Rather, the country seems to have chosen the more challenging path of change by negotiating an agreement with its lenders. This should, in the end, lead to a better outcome and draw greater help from other nations in Europe, particularly those which have also depended on official bailouts. In this vein, the Greek economy stands to benefit from the €35 billion set aside for infrastructure investments included in the most recent agreement and additional investments and debt relief could be forthcoming.

While the path to economic recovery will be long and challenging, Greece accounts for just 2% of Eurozone GDP and the bulk of Greek debt is no longer held by private banks. More importantly, significant structural progress has been achieved throughout the rest of the Eurozone. The European economy is on a more solid footing and monetary stimulus together with a weaker Euro will likely boost its growth prospects. Ireland and Spain are enjoying the benefits of early structural reforms, including measures targeting rigidities in labour markets. Even Italy, a laggard in terms of reform which has seen its economy struggle, has finally begun to introduce more labour market flexibility and economic activity turned slightly positive in Q1.

On the monetary front, there are tentative signs that the central bank's stimulus measures are working. By lowering interest rates to zero and embarking on a bond buying program, the ECB is aiming to support the economic expansion by kick-starting a new credit cycle. Data for the month of April indicate that private credit growth has finally turned positive following two years of deleveraging. Real GDP growth for the region improved to 1% during the first quarter and may well rise above this level for the year as a whole.

Table 1: Selected Developed and Emerging Markets Growth Rates

	2014 Nominal GDP (US$ bn)**	2014 Share of world GDP (%) ***	2009	2010	2011	2012	2013	2014	2015	2016
U.S. *	$17,419	16%	-2.8%	2.5%	1.6%	2.3%	2.2%	2.4%	2.6%	2.7%
Canada *	$1,789	1%	-2.7%	3.4%	3.0%	1.9%	2.0%	2.4%	1.5%	2.0%
Japan	$4,616	4%	-5.5%	4.7%	-0.5%	1.8%	1.6%	-0.1%	1.0%	1.2%
Eurozone *	$13,391	11%	-4.5%	2.0%	1.6%	-0.8%	-0.5%	0.9%	1.3%	1.5%
China	$10,380	16%	9.2%	10.4%	9.3%	7.8%	7.8%	7.4%	6.8%	6.3%
India	$2,050	7%	8.5%	10.3%	6.6%	5.1%	6.9%	7.2%	7.5%	7.5%
Indonesia	$889	2%	4.7%	6.4%	6.2%	6.0%	5.6%	5.0%	5.2%	5.5%
Brazil	$2,353	3%	-0.2%	7.6%	3.9%	1.8%	2.7%	0.1%	-1.0%	1.0%
Russia	$1,857	3%	-7.8%	4.5%	4.3%	3.4%	1.3%	0.6%	-3.8%	-1.1%
Developed	$47,044	43%	-3.4%	3.1%	1.7%	1.2%	1.4%	1.8%	2.4%	2.4%
Emerging	$30,258	57%	3.1%	7.4%	6.2%	5.2%	5.0%	4.6%	4.3%	4.7%
World	$77,302	100%	0.0%	5.4%	4.2%	3.4%	3.4%	3.4%	3.5%	3.8%

** Forecasts for the U.S., Canada and the Eurozone are from LBA, all others are from the IMF*
*** Based on 2014 exchange rates*
**** Based on purchasing-power-parity (PPP) exchange rates*
Source: IMF, LBA, April 2015

The Canadian economy has slowed following the sharp drop in the price of oil. Real GDP in Q1 contracted 0.1% versus Q4 but was up 2.1% year-over-year. Cutbacks in energy-related capital spending and announced job cuts are undoubtedly having an impact on Alberta's economy. Meanwhile, the currency has depreciated by 14% versus the U.S. dollar since mid-2014 and is down 23% from its mid-2011 peak, providing a boost to other areas of the country. Real GDP growth in Ontario was 2.7% in Q4 2014 and car sales in the province were up 12% year-on-year in April. While we expect growth in the first half of this year to be flat or marginally negative, an improving trade balance should mitigate the effects of lower energy investment in the latter part of the year. We expect Canada's real GDP to expand by about 1.5% in 2015.

Activity in Japan remains subdued following a 3% hike in the value-added-tax. The Japanese economy contracted by 1% year-over-year during the first quarter and further planned tax increases have now been put on hold. The IMF forecasts a modest 1% expansion in 2015 which should be supported by the almost 40% depreciation of the yen against the U.S. dollar since 2012.

Emerging markets continue to experience diverging levels of growth relative to their specific economic and political situations (Table 1). China's ongoing real estate market correction has contributed to lower construction starts, less commodity demand and lower industrial production. However, growth in the service industry and stronger consumer spending have somewhat compensated for the slowdown in its traditional industries. While China's growth rate will gradually decelerate as the economy matures, mid-to-high-single digit growth in consumer demand will drive the economy in the future.

Strong growth and the promise of structural reforms have bolstered investor confidence in India. The country is forecast to expand at a rate of 7.5% in 2015, above that of the Chinese economy. Indonesia, another large Asian economy, is experiencing real GDP growth of about 5% and is benefitting from lower energy prices and an acceleration of investment spending. Together, China, India and Indonesia represent 40% of the world's population.

Two important countries that are struggling currently are Brazil and Russia. High official debt levels have forced the Brazilian government to implement an austerity program: Brazil has so far raised taxes on consumer loans and cut energy subsidies as well as subsidies on infrastructure and development loans. The outlook for 2015 calls for negative growth of around 1%. Meanwhile, the Russian economy continues to suffer from the impact of lower energy prices and economic sanctions. Russians' purchasing power has severely deteriorated as the ruble has lost 37% of its value against the U.S. dollar over the last year. The country is expected to see a significant contraction in economic activity in 2015.

The global economy is expected to grow by about 3.5% in 2015. The U.S. remains the driving force, but improvements in Europe suggest a gradual re-synchronization of activity in developed markets.

Asset allocation strategy

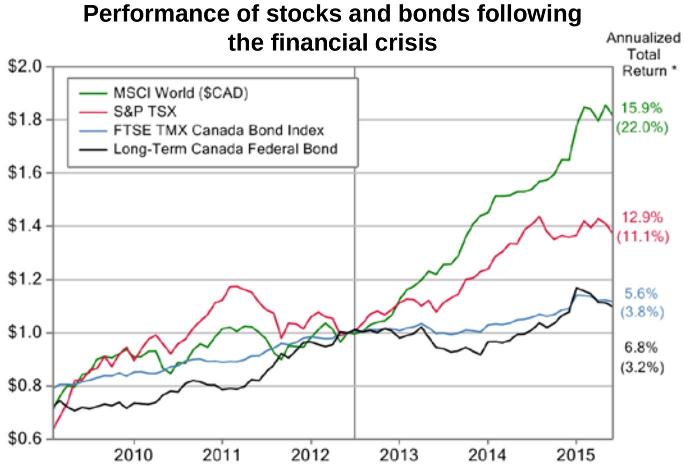
Positive economic conditions and low interest rates have been key factors sustaining global equity prices. Since the 2008-09 recession, companies have seen an improvement in top-line growth and corporate profit margins. Furthermore, equity valuations have progressed from inexpensive levels of 12X earnings to above-average levels of 17.1X for the MSCI World Index. More recently, equity markets have been bolstered by merger and acquisition activity, the value of which has exceeded $2.7 trillion year-to-date, and by share repurchase programs.

These developments have been associated with exceptionally strong stock market returns. From March 2009 to June 2015, the total annualized return for global equities (in C$) and Canadian equities was 15.9% and 12.9% respectively (Chart 1).

Given that global equities currently trade at the higher end of a reasonable valuation range, careful stock selection will be a critical determining factor for a successful portfolio strategy. Valuation risk has developed in some sectors such as biotechnology and internet software where P/E multiples have reached 40X or more.

Chart 1

Performance of stocks and bonds following the financial crisis



Index based to: July 2012 = $1
Annualized total return since March 2009 and, in parantheses, since July 2012

Meanwhile, emerging market stocks in aggregate offer double-digit topline growth and trade at a very attractive 12.7X 2015 earnings. An exception in emerging markets has been the largely inaccessible domestic Chinese stock market measured by the Shanghai and Shenzhen indices. Both are up over 100% during the last year and now trade at high valuations.

European company profits have considerable upside as economic activity is improving and corporate margins remain below pre-crisis levels. Our global equity portfolios remain broadly diversified across all geographies and economic sectors and are priced at a reasonable 14X 2015 earnings.

Bond holders have been rewarded with far more modest gains compared with equity investors since 2009. Overall Canadian bonds have returned 5.6% annually while long-term federal bonds have offered 6.8%. (Chart 1).

More importantly, central banks' manipulation of short-term interest rates together with massive purchases of about $10 trillion of global fixed income instruments has created an extreme overvaluation in bonds. During July 2012, fears of a slowdown in the European economy and expectations that the Fed would embark on yet another round of asset purchases sent interest rates to new lows. Some investors speculated that central banks' actions would support bond markets indefinitely and thus chose to search for additional yield by lengthening duration. Since mid-2012, the main benefits of the improvement in economic activity accrued to equity investors, with annualized returns on global equities reaching 22.0% or 82% on a cumulative basis (Chart 1). In contrast, annualized returns for long-term bonds are just 3.2% or a cumulative 10%.

Chart 2

Price of 30-Year German Bund

Recent volatility in the bond market should remind investors that extreme price movements are possible given such excessive valuations. Over the course of the last 3 months, 30-year German bond prices dropped by 20%, even as the ECB was a buyer of German Bunds (Chart 2). The Canadian 30-year benchmark government bond saw its price begin the year at $125, briefly hit close to $140 in January and then correct back down to $126 at the end of June. Despite the volatility, yields fell by just 3 basis points during the period.

The timing of the Federal Reserve's rate hikes remains uncertain and the central bank's initial steps to normalize policy will probably be modest. However, long-term bond yields are far below levels associated with economic fundamentals. To paraphrase ECB President Mario Draghi, bond buyers beware, they should get used to periods of higher volatility.

For balanced portfolios, our strategy to underweight bonds rather than adopting some other more risky bond strategy and favour equities instead has been very beneficial. As noted above, long-term bonds have delivered a cumulative return of 10% versus 82% for global equities over the past 3 years. While equities are unlikely to repeat the double-digit gains of the past few years, we still expect returns to be well above those offered by bonds. The next stage in the cycle will involve a transition to an environment where earnings progress in line with GDP growth and this, in combination with dividends, should yield broad equity market returns in the range of 5%-7% per annum. We will try to improve upon this through stock selection.

Long-term bonds remain extremely overvalued and the risk of loss is significant. We are therefore maintaining a very short duration in our bond portfolios and are underweight bonds within balanced mandates.

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

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