# Letko, Brosseau & Associates Inc.

## Economic and Capital Markets Outlook

September 2015


**Summary**

- Concerns over slowing activity in China undermined investor confidence and led to a decline in the MSCI World Index of 10% between July and September. China is slowing, but still growing. It will take time for government stimulus and reform measures to cushion the economic adjustment and prevent a more serious downturn.

- Low interest rates, subdued inflation and lower oil prices provide a generally accommodative macroeconomic backdrop. The U.S. and Europe remain on an improving track. We expect the global economy to advance by 3.0%-3.5% for the next 2-3 years.

- U.S. corporate profit growth is likely to be flat in 2015 largely due to a weaker oil and gas sector and a stronger dollar which reduces the value of foreign earnings. As the impact of these two factors tapers, earnings growth is widely expected to recover. On that basis, the S&P 500 trades at 16.7 times 2015 earnings and a reasonable 15.1 times 2016 earnings.

- We reiterate our view that long-term bonds are an unattractive investment. The duration of the bond portfolio is being kept very short as we await a better time to acquire long-dated instruments.

- Stocks continue to offer a much better risk/reward profile than bonds.


### Recent stock market volatility triggered by concerns over China

The S&P 500 has corrected by about 10% or more no fewer than five times between March 2009 and September 2015. During this same timeframe, capital invested in global equity markets has more than doubled: U.S. equities rose a cumulative 176%, while equity markets in Canada and Europe were up 84% and 143% in local currency.

This strong performance was driven by improving company profitability, but valuations were also a contributing factor. Indeed, the 10% decline in the MSCI World Index since July has occurred against a backdrop of somewhat more expensive valuations. Referring to past *Economic and Capital Markets Outlook* reports, we cautioned that at 17.9X earnings, the S&P 500 was trading well above its long-term average of 14.4X. We maintained that while valuations were not excessive, particularly in an environment of extremely low interest rates, U.S. equities were nonetheless vulnerable to unanticipated events.

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The trigger behind recent market volatility appears to be centered on events in China. China's domestic stock market correction, currency devaluation and decreasing foreign reserves have heightened concerns that the economy is in rapid decline. Gauging the state of China's economy is particularly challenging given the questionable quality of government statistics. However, our analysis which combines published data with in-house research on the economy, suggests that activity is slowing, not collapsing. The crucial question to answer, therefore, is whether activity will continue to deteriorate from here and if government-enacted reforms and stimulus measures can stabilize the economy and restore confidence.

## The path for China's economy: rebalancing or collapse?

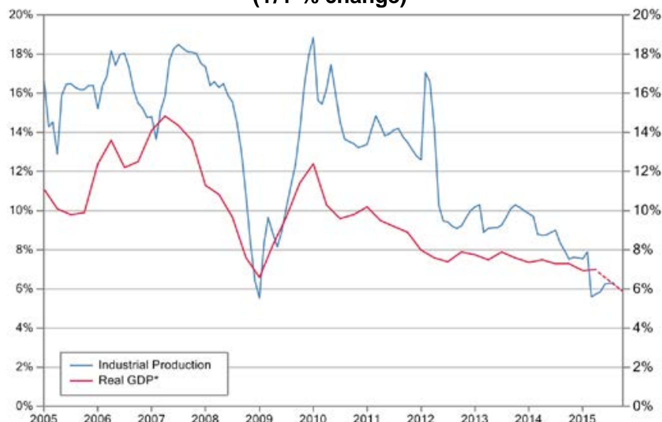
In our Q1 2014 *Economic and Capital Markets Outlook*, we highlighted two key risks to China's future growth. First, a long period of strong capital investment was accompanied by a misallocation of capital toward unproductive and uneconomic projects. Second, the emergence of a parallel financing system, the so-called "shadow banking system", channelled funds to borrowers of uncertain quality. These lenders experienced steep losses as some borrowers, particularly real estate developers, began to declare bankruptcy.

Over the last 18 months, the Chinese authorities have addressed these imbalances by liberalizing the financial sector, reforming local government funding and clamping down on corruption. While these reforms will set the foundation for a more structurally sound economy, in the interim, they restrained growth in credit, consumption and residential construction.

Chinese consumer spending growth has slowed to 3% even while personal incomes are advancing at a healthy 8% rate of growth. Annual growth in car sales turned negative in June and a survey of 200 large retailers suggests that retail sales have been stuck at a sluggish 2% annual growth rate for the last nine months. On the housing front, new home construction was down 17.6% in August versus the prior year. Credit is still expanding at a double-digit pace, but has decelerated since the government introduced measures to tighten shadow-bank lending. Total credit growth slowed from 18% during 2013-2014 to 12% in July of this year, the lowest rate of growth in a decade.

**Chart 1**

**China: Growth in Real GDP and Industrial Production (Y/Y % change)**




*Dotted line is LBA forecast
Source: National Bureau of Statistics, LBA

Non-residential investment, a long-standing driver of China's economy, is also showing signs of softness. Industrial production slowed from 9% year-over-year in 2014 to 6% (Chart 1). The Purchasing Managers' Index (PMI), an indicator of manufacturing activity, fell to 47.3 in August, a level consistent with slowing output. The services sector, on the other hand, remains robust. The Services PMI, the most comprehensive gauge of activity for this sector, stood above 50 while airline passenger traffic was up 17% year-on-year. A reported 20 million Chinese *per month* are subscribing or upgrading to more costly 4G data plans.

Likewise, our in-house indicators suggest that the economy is slowing, not collapsing. An aggregate of around 2,500 listed Chinese companies shows that annual revenue growth was flat during both the first and second quarters of this year. Our model of Chinese growth, which uses proxies for consumption, investment and government spending, indicates that the domestic economy expanded by 4%-5% during the first nine months of the year, down from 7% in 2014.

Although the Chinese government's approach has been gradualist, we view very favourably the various measures put in place in reaction to the decline in activity. Year-to-date, government spending is up 15% against last year, which represents $208 billion in additional fiscal stimulus. On the monetary front, reserve requirements for banks have been cut by 200 basis points and the 1-year lending rate was reduced from 6% toward the end of 2014 to 4.6% at the end of September. The government has also injected $110 billion into state-owned banks to bolster their capital base and encourage lending.

It will take time for the government's actions to bear fruit. At this juncture, it is difficult to assess whether China's imbalances require much easier domestic monetary policy, a more open capital market, further adjustments to the exchange rate and/or more financial system support. While the economy is not yet showing signs of a pickup, it is premature to extrapolate the current slowdown into the future. The country's longer-term economic fundamentals remain strong and the risk of a financial collapse is low. China has no external net debt and owns $3.5 trillion in foreign exchange reserves.

## The global picture is still more positive than negative

While we believe that a moderation in China's rate of growth is the likely outcome of the present situation, there is a risk that a substantially weaker economy could have knock-on effects on other countries reliant on China through trade and capital flows. China accounts for 12% of global trade, and its imports have declined in conjunction with its economy. Australia exports 34% of its goods and services to China, while Korean exports to China account for one-quarter of its total trade. The Chinese market accounts for 18% of Brazil and Japan's exports and about 10% for several Asian economies including Malaysia, Thailand and Indonesia.

The potential slowdown in certain Asian and other emerging economies could have consequences for global economic activity. However, it is unlikely to lead to a significant deterioration in the growth picture of most major developed markets. First, trade represents a small portion of economic activity in the majority of developed economies and the exposure to China is limited. For example, U.S. exports to China in relation to total exports is 8%, while it is 4% for the Eurozone and 4% for Canada.

Second, the U.S. and the E.U., which together account for 46% of global activity, are seeing improving growth and America remains the world's economic engine. Year-to-date, the U.S. economy created an average of about 200,000 new jobs per month and this is supporting annual disposable income growth of 3.6%. During the second quarter, real GDP growth advanced 2.7% year-over-year, a pickup from 2.1% during the same period in 2014. The economy appears on track to achieve 2.5% real growth this year and our base case forecast is for 2.5%-3% in 2016.

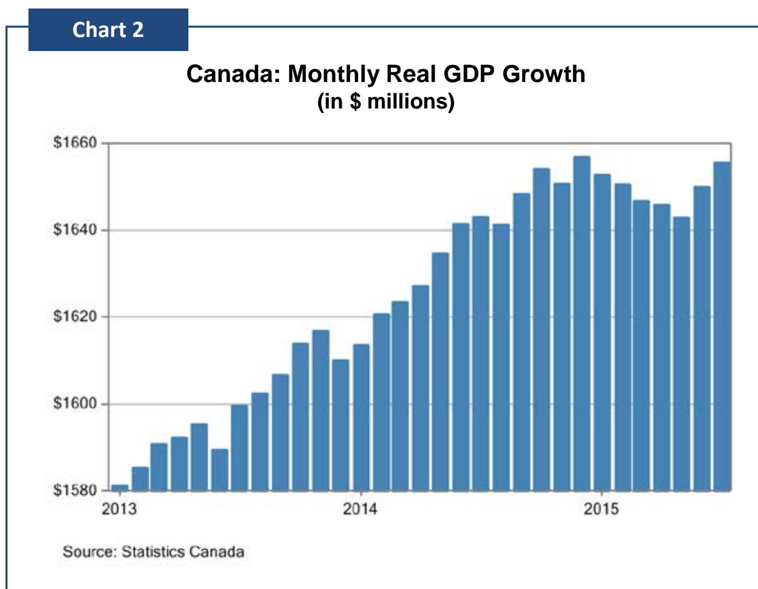
Europe continues to recover, with real GDP up 1.5% year-on-year in Q2. Spain advanced 3.1% while Germany and France grew 1.6% and 1.0% respectively. Following the European Central Bank's (ECB) multiple stimulus measures, credit growth finally turned positive in Q2 and August data indicate it is up 0.8%. We expect that the Eurozone will see steadily improving growth of around 1.5% this year and next.

Third, low interest rates, subdued inflation and lower oil prices provide a generally accommodative macroeconomic backdrop. The decline in oil prices will on balance benefit the global economy, although oil exporters such as Canada are feeling the brunt of the adjustment.

Economic growth in Canada turned slightly negative in Q1 and Q2 on the back of cuts to energy-related investment spending. The lower Canadian dollar, however, appears to be filtering through. The economy rebounded in June and July on the back of an improvement in the trade balance while in August non-energy exports were up 10% year-on-year (Chart 2).

Our forecast for modest economic growth in Canada is unchanged. Real GDP is expected to expand at a 1.5% growth rate this year and next.

We remain constructive on the balance of global risks and opportunities. While concerns of a slowdown in emerging markets due to a continued deceleration of economic activity in China should not be dismissed, we believe that the risk of a global recession is low.




With the correction of major imbalances in the U.S. and Europe largely behind us, developed economies are expected to advance around 2.0% in 2015 and 2%-2.5% in 2016. As China addresses its own domestic imbalances, global growth is likely to be positive but modest. Assuming that economic growth in China stabilizes at around 6%, Brazil and Russia begin to improve in 2016 and India maintains its robust pace, our base case is for emerging markets to achieve twice the rate of expansion of the developed world. On balance, we forecast the global economy to advance by 3.0%-3.5% for the next 2-3 years.

## An update on oil markets

Oil prices have ranged between $45/barrel and $60/barrel during the past year as market equilibrium has been disrupted by additional supply. At current levels, the price of oil is below what is required by many companies to break even on their costs. Capital spending, mainly across North American producers, has been slashed by about 30% this year.

Recent data suggest that this is beginning to impact oil production, which together with rising demand for the commodity, is adjusting to restore equilibrium to the market. U.S. production fell about 500,000 barrels/day over the past five months and is expected to continue to decline. At the same time, global demand was up a robust 2.4 million barrels/day in Q2 compared with last year, bringing total global consumption of oil to 95 million barrels/day. Despite these developments, the global surplus supply of oil did not diminish as OPEC, particularly Saudi Arabia and Iraq, stepped up production. Barring substantial additional investment, these countries are now hitting their maximum production capacity just as global demand for oil is expected to remain resilient. We remain of the view that tight excess capacity, a projected decline in North American production and resilient global demand will begin to exert upward pressure on the price of oil in the medium term.

## Investment summary: balancing risks versus rewards

The macroeconomic backdrop remains broadly supportive for corporate profits over the medium term. Recent share price weakness should not divert attention away from the fundamental value embedded in companies held in our equity portfolios. On average, our stocks are priced at a very reasonable 12.3X 2016 earnings.

Investment opportunities are present across different industries and geographies even as uncertainties remain regarding the path of the world's second largest economy. For example, recent additions to the portfolio include world class technology company Oracle, the largest provider of enterprise hardware and software specialized in storing and maintaining databases. We also purchased shares in Merck, a leading pharmaceutical company developing vaccines as well as medicines to combat cardiovascular diseases and cancer. These are two examples of the many attractive opportunities which we believe will deliver long-term rewards to patient investors.

In our view, the risks of a meaningful price correction remain greatest in the bond market due to the extreme valuations reached during this extended period of low interest rates. Even small increases in yields could lead to notable losses on fixed income instruments. Over the past 6 months, a modest 8 basis point rise in 10-year yields and a 35 basis point widening in A-rated credit spreads generated negative returns on most bonds. The FTSE DEX Universe Bond Index was down 1.6%. In addition, corporate bonds suffered bigger declines than government bonds across all maturities. The total return on corporate bonds maturing in more than 10 years between end-March and end-September was –5.1% compared with –4.6% for long-term government securities. Given that our fixed income portfolios were invested in high quality Canadian government bonds of relative short maturities, bond portfolio capital was preserved and losses were avoided.

For the past several years, long-term bonds and corporate paper have traded at rich valuations, offered mediocre yields on an absolute basis as well as very little incremental yield over shorter-term high quality bonds. We therefore elected to allocate investment capital where risk is best compensated.

In portfolio terms, the result has been a higher equity exposure and a fixed income strategy dedicated to preserving capital. This strategy has been very beneficial in recent years and should continue to perform well in the future.

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

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