Letko, Brosseau & Associates Inc.
Global Investment Management Since 1987

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Economic and Capital Markets Outlook

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Letko Brosseau and Associates Inc. is an independent, global investment management firm dedicated to building long-term value for our institutional and private clients.

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Research

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Summary

- While fears of a global recession triggered by China destabilized markets early in the year, our outlook suggests that the likelihood of such an event is remote.
- The global economy is forecast to advance at a moderate 3%-3.5% rate of growth, supported by low interest rates, subdued inflation and low energy prices.
- In the U.S., growth remains driven by consumer spending backed by jobs growth and rising wages, an ongoing recovery in housing, and investment in non-energy-related industries.
- Canada is gradually reaping the benefits of a lower Canadian dollar. Notwithstanding weakness in the energy sector, growth is holding steady at a modest rate.
- Strong policy measures by the ECB should grease the wheels of Europe's recovery.
- Key emerging economies such as Brazil and Russia are facing challenging domestic environments but this should not unduly impact the world economy.
- China is undergoing structural economic change resulting in slower growth in the short-term. Government measures to tackle the country's internal imbalances are setting the foundations for sounder economic growth in the years ahead.
- Our medium-term total return expectations for equities remain in the 7-8% range, supported by a rise in earnings in line with nominal economic growth.
- Bonds remain unattractive. Yields are below inflation and long-term fixed income securities offer a poor risk-return trade-off.

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Steady growth ahead for the U.S. economy

Cutbacks in energy-related corporate investment, a strong dollar and a rise in the household savings rate detracted from U.S. growth in 2015. Despite these issues, real GDP expanded by 2.4% year-on-year, in line with our forecast. Looking ahead, growth will continue to be supported by consumer spending, housing and non-energy investment. We expect that the negative impact of a strong U.S. dollar and weak energy sector will continue to detract from growth in 2016 but will fade thereafter.

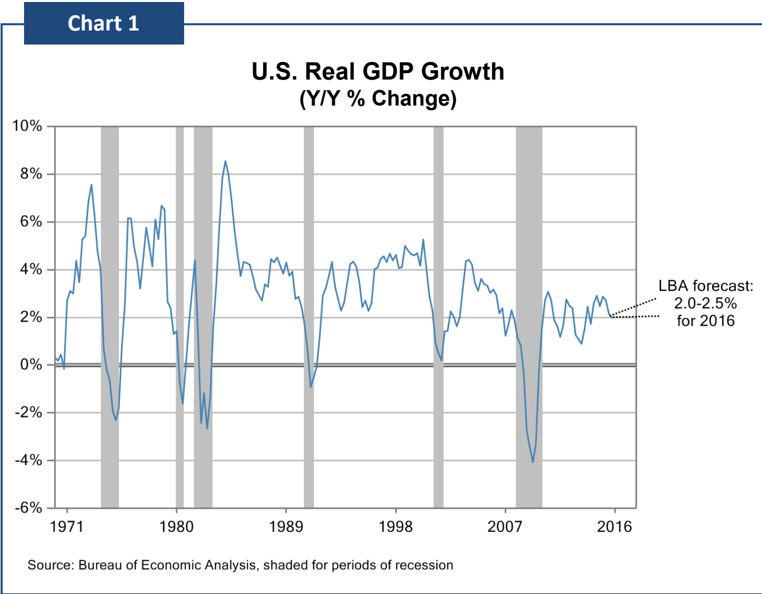
An improving jobs market and healthy household balance sheets resulted in solid consumer spending in 2015. Recent indicators support the view that U.S. consumers continue to drive growth. An average of 209,000 jobs per month were created during the first quarter while hourly earnings rose 2.3% year-on-year in March. Disposable income is growing at an annual rate of 3.7%, supporting similar growth in consumer spending; with a savings rate of 5.4%, households have flexibility should they decide to further boost consumption. For example, pent-up demand still exists for cars: the proportion of household disposable income spent on cars is as low as in the 1940s. The car fleet's average age has risen to 11.5 years, compared with 9.6 years in 2001, even as car sales rebounded to 17.3 million units in 2015. Under a scenario where the average age of the car fleet falls by less than 1 year to 10.8 years, auto sales could rise to 18-22 million units per year for several years.

Pent-up demand is also present in the housing sector. The growth in household formation, which was restrained in the period following the financial crisis, improved to 1.2 million per year during 2014 and 2015. Over the two-year period, 1.0 million new houses were built each year and the shortfall was absorbed by the stock of existing housing. This led to a rise in both house prices and apartment rents, up 5.7% and 4.6% respectively in 2015.

Our estimate of new home construction consistent with longer-term growth in household formation ranges from 1.3 million to 1.5 million units per year. As of February, housing starts were running at an annualized level of 1.2 million, indicating that prices and rents should continue to see upward pressure. In turn, this will make the economics of building houses more favourable, which should incentivize more construction.

Corporate investments excluding those in the energy sector continue to be the third engine of growth, rising 6.6% in 2015. Domestic corporate profits (ex. energy), a key driver of capital investment, rose 7.6% year-on-year in Q4. Some industries are now running near full capacity suggesting the need for more investment. For example, the electrical equipment and appliances sector, which includes the manufacture of lighting fixtures, electrical motors, generators and batteries, is at 90% utilization.

While we expect a further decline in oil & gas investment in 2016 as a result of current low oil prices, the impact on the economy is likely to fade going forward. Aggregate energy investment is estimated to total $50-$75 billion this year, compared with $175 billion at its peak in 2014 and will account for only 3% of total capital spending.



A strengthening U.S. dollar was the largest drag on the economy last year, subtracting –0.5% from U.S. real GDP growth. As the dollar's rise made imports cheaper and exports less competitive, the trade balance widened to $540 billion in Q4. While the dollar has recently pulled back from its highs, measured against a basket of currencies of its trading partners, it remains 19% above its Q1 2014 level. We expect that the currency's negative impact on trade and overseas profits of domestic companies will peak in 2016 before gradually tapering off in the years ahead.

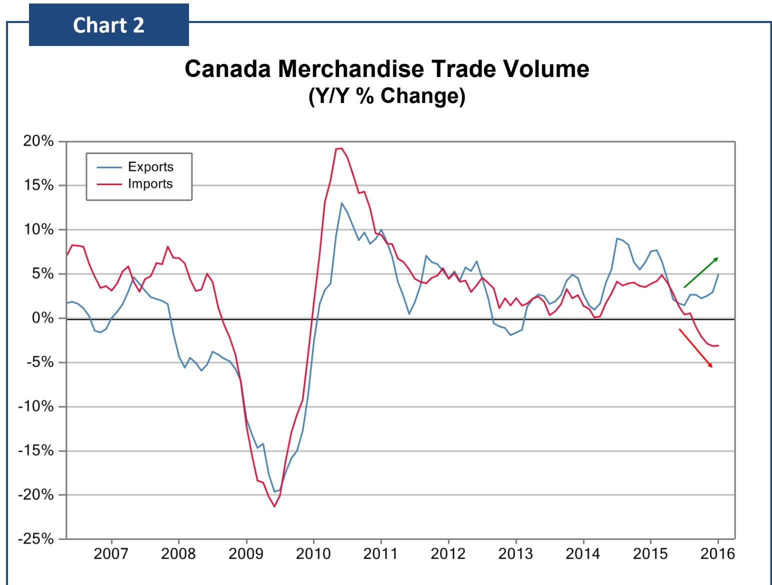
Our base case forecast for U.S. real GDP growth in 2016 is 2.0%-2.5% (Chart 1).

The Canadian economy is adjusting to lower oil prices and a lower currency

While the Canadian economy initially withstood the impact of declining oil prices in 2014, real growth declined to 1.2% in 2015, from 2.5% in 2014. Capital spending in the resource industry declined by $16 billion (19%) and is expected to account for only 14% of total corporate investment in 2016, compared with 23% in 2013. Over the past two years, 31,000 jobs were lost in Alberta, Manitoba, Saskatchewan and Newfoundland.

Although real GDP growth slowed, the economy did not fall into recession. First, disposable income was strong, growing at an average rate of 3.4% per year over the last two years with consumer spending rising 3.8% per year over the same period. Second, the housing market was robust: an average of 191,000 houses annually were built in 2014-2015, a level similar to when the oil price was above $100. Finally, government spending rose by an average of 3% during 2014 and 2015.

There are tentative signs that the sluggish economy is set to pick up. After having declined by 25% against the U.S. dollar since 2012, the lower Canadian dollar is finally starting to positively impact the competitiveness of Canadian products. Exports of goods (in volume terms) were up 7.0% in February versus last year while imports were down 1.0% (Chart 2). Ontario created 74,000 jobs in the past twelve months to February and



car manufacturing in the province was up 23.5% year-on-year in January. While the Canadian dollar has recently rebounded from January's 13-year low of US$0.69 cents, the currency still remains 14% below its fair value level based on purchasing-power parity. We expect that this will gradually lead to an improvement in the trade balance.

The recently released federal budget confirms that fiscal stimulus is in the pipeline. Government spending will increase by $20.5 billion in 2016, up 6.9% versus the prior year. The government projects that the resulting deficit will positively impact real GDP by 0.5% in 2016 and 1.0% in 2017.

Our forecast for the Canadian economy is for 1.5% real GDP growth in 2016 as a weak energy sector is offset by the stimulative impact of a lower Canadian dollar and government spending. Longer-term, we believe that the growth rate of the Canadian economy will remain constrained by the high level of household indebtedness and developing imbalances in the housing market.

Added policy measures in Europe underpin the economic recovery

The Eurozone's gradual yet significant structural progress over the last five years has spilled over to the real economy. The periphery countries, most notably Spain and Ireland, implemented reforms and reduced government deficits. Banks across the region deleveraged and improved their balance sheets. The European Central Bank (ECB) implemented successive measures to stimulate credit growth to further grease the wheels of the economic recovery. Recent indicators confirm the improvement: between 2011 and 2014, Eurozone real GDP growth averaged 0.3% per year while in 2015 the economy expanded by 1.6%.

Last year, 525,000 jobs were created in Spain, 192,000 in Germany, 184,000 in Italy and 21,000 in France and the Eurozone unemployment rate declined from a peak of 12.1% in Q1 2013 to 10.3% in February. For the Eurozone as a whole, bank credit to the non-financial sector is growing again, albeit at a modest pace, and bank survey data indicate credit demand is picking up. Non-financial corporate profits were up 10.5% year-over-year in Q3 and capital spending averaged 4.6% at an annualized rate during the first three quarters of 2015.

While acknowledging that both economic and financial conditions in the Eurozone had clearly improved, in March the ECB introduced additional monetary stimulus amid concerns that the recovery was still vulnerable to potential external shocks including low inflation. The central bank reduced the rate it pays on reserves deposited by commercial banks from –0.3% to –0.4%. It increased the breadth of its bond buying program by allowing corporate bonds to be purchased along with government bonds and asset-backed securities. It also expanded the depth of the program by raising the target from €60 billion to €80 billion per month. Finally, a new lending facility was introduced whereby banks can borrow from the ECB at negative rates provided their lending to the real economy increases.

The combined measures have a dual aim: to ease credit conditions further and signal that the central bank is prepared to fight against low inflation with all the tools at its disposal. We expect that easy monetary conditions will continue to be supportive of growth and forecast that Europe's real GDP will expand by about 1.5% in 2016.

Emerging market headwinds unlikely to derail global growth

Emerging markets in aggregate expanded by 4.0% in 2015, twice the pace of real GDP growth in developed economies. While economic growth was robust in several countries, including India where real GDP advanced by 7.3%, a few key large economies experienced setbacks. Brazil and Russia contracted by 3.8% and 3.7% respectively while China's reported data shows that the economy slowed from 7.3% in 2014 to 6.9% in 2015.

Brazil and Russia are both facing difficult economic conditions. A drought, political instability and falling investments are exacerbating uncertainty in Brazil. The Brazilian Real declined by 37% against the U.S. dollar during the past two years and inflation has reached 10.4%. The government has a tough choice between stimulating growth, boosting debt levels and potentially stoking inflation or cutting spending to rein in the fiscal deficit and inflation thereby exacerbating the recession. In Russia, international sanctions and a sharp decline in the Ruble are responsible for the country's high inflation and declining economic activity.

As a result, the IMF forecasts another year of weak activity for 2016 followed by improvement in 2017. Real GDP in Brazil is expected to be –3.5% this year and 0% next year while the forecast for Russia is –1.0% and +1.0%. The two economies together account for only 6% of world GDP and they import a combined 0.5% of world GDP therefore the impact on global activity should remain relatively muted.

China rebalancing, not collapsing

Given its size, China is more likely to have a greater effect on global growth if its economy were to deteriorate significantly. Gauging the state of China's economy is notoriously challenging due the questionable quality of official data. However, various indicators confirm activity is sluggish, particularly in the industrial sector. The Caixin Manufacturing PMI has been below 50 – signalling a contraction in activity – every month since March 2015. Railway freight was down 8.3% on an annual basis while electricity consumption was 2.2% lower year-on-year in December.

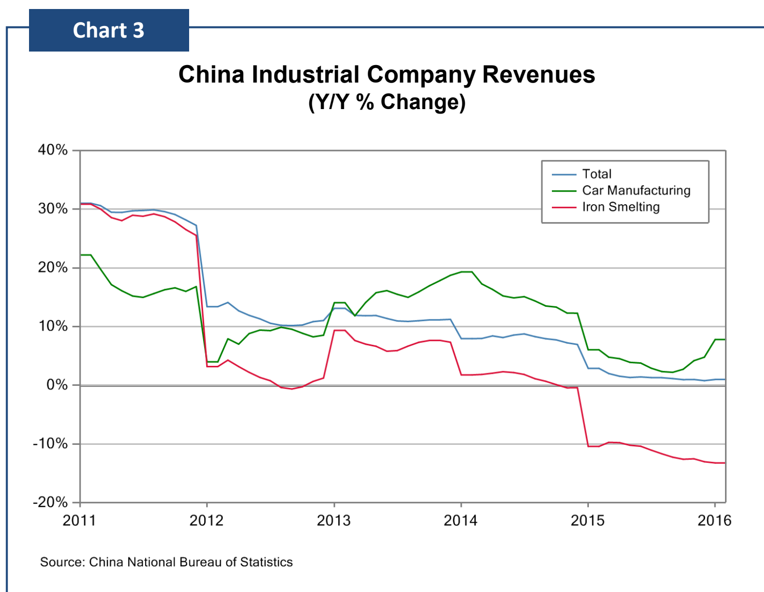
We reviewed the causes of China's slowdown in our *Q3 2015 LBA Economic and Capital Markets Outlook.* Key imbalances included a misallocation of capital following a period of strong investment growth and the channelling of funds to borrowers of questionable creditworthiness through an unregulated shadow banking system.

Last year, government measures to reform the financial system and clamp down on corruption led to a decline in credit growth. While such structural reform represented a move in the right direction, in the short-term it prompted a pullback in the industries most impacted by the misallocation of capital: real estate, steel, cement and coal.

In addition, China's anti-corruption measures have had a negative effect on consumer spending and likely provoked an outflow of capital from the country. The government's mixed signals with respect to the currency's direction exacerbated the outflows as Chinese households and corporations feared that the Yuan would be devalued significantly. China's foreign exchange

reserves declined from $3.8 trillion in December 2014 to $3.2 trillion in February 2016 on the back of these capital outflows.

While China is not yet showing signs of a sustained rebound, further fiscal stimulus should ease the pressure caused by structural reform and support activity during this period of transition. Last year's hike in government spending spilled over to the consumer-sensitive sectors of the economy. Revenues of food producers, car manufacturers and pharmaceutical companies are up 8% year-on-year in February, while revenues for retail-oriented manufacturing such as furniture and clothing companies are up around 6%. This is partially offsetting weakness in the manufacturing sector, for example revenues in the iron smelting sector were down 13% and other primary industries suffered similar levels of declines. In aggregate, revenues for all industrial companies grew only 1.0% in February against last year (Chart 3).



In early March, China announced its new 5-year plan for the period 2016-2020. Among the immediate measures to promote growth, the government expects to run a higher budget deficit equivalent to 3.0% of GDP in 2016 versus 2.4% in 2015. Fiscal spending will rise by 6.7% this year to $2.8 trillion, with $253 billion earmarked for road construction. Longer-term, the government aims to stimulate reform of resource-intensive industries and direct investment to the consumer-oriented services sector as well as higher-valued industries. China has also targeted pollution control as a national priority requiring significant investment. Solar power capacity is projected to triple by 2020 while the approval of new coal plants will be curtailed. Capacity additions in wind and nuclear energy are also planned. On the back of these initiatives, the government projects real GDP growth to average 6.5%-7.0% over the next 5 years.

Transforming an economy the size of China takes time and the country is still in the early stages of development. In making progress towards fixing past imbalances, the country is laying the foundation for growth going forward. Meanwhile, the country's high household saving rate of 33%, substantial foreign exchange reserves and strong international financial position serve as a buffer against worsening economic conditions.

While we remain attentive to risks that could upset our forecast, our outlook calls for positive and steady world economic growth. We believe that the likelihood of global recession taking hold is low and the world economy should continue to expand by 3.0%-3.5% in the medium-term.

Equities remain the preferred investment

In the first two months of the year, global markets suffered notable declines as a downtrend in activity in China triggered fears of a global recession. Stock markets partially recovered in March as central banks in China, Europe and Japan loosened monetary policy. In the U.S., the Federal Reserve signalled a more gradual path to policy rate increases. During the first quarter, the total return for the S&P 500 (in C$) was –4.9%, the S&P TSX 4.5%, and the BE 500 –8.6%. In Asia, the Shanghai Exchange was off –19.9%, the Shenzhen –21.9%, the Hong Kong market –10.7% and the Nikkei –11.1%.

While this level of choppy trading stems from investor uncertainty as to the forward path of the world economy, we believe the economic backdrop remains supportive for equities. We forecast earnings to grow about 5%, in line with nominal GDP growth. Adding to this a dividend yield of 2%-3% should result in equities generating 7%-8% total returns in the years ahead.

Valuations, however, have risen beyond their long-term averages, so caution must be exercised in equity selection. Using our more modest medium-term earnings growth assumption of 5% for this year (compared with 17.5% estimated by a consensus group of analysts) the S&P 500 trades at 18.4 times forward earnings. We have trimmed positions in a select group of holdings where the valuations generously reflected future growth potential. As a result, our equity portfolios remain valued at a very reasonable 14.5 times 2016 earnings.

Government of Canada 10-year yields briefly hit a new low of 1.12% in January before ending Q1 at 1.22%. After adjusting for inflation, real bond yields across most maturities have been in negative territory for a considerable time. This led many investors to search for higher yielding alternatives and pushed corporate bond prices into expensive territory.

Over the last four years, a portfolio of BBB-rated corporate bonds which maintained an 8.5 year duration and offered 200 basis points above federal securities would have generated an additional return of 8.2%. Between May 2015 and March 2016, corporate spreads widened by about 65 basis points. As a result, the same portfolio would have lost 5.5% of its capital, thereby offsetting a considerable part of the benefit of those last four years.

The extreme volatility in corporate bond prices observed in recent months serves as a reminder that these instruments, despite yielding a fixed coupon, can behave like equities given their underlying credit risk. While we recently took advantage of lower corporate bond prices to build a modestly higher position in high quality securities, we continue to believe that company risk is best compensated by equity markets, where expected returns are much higher. Indeed, in the past four years, the additional return of the MSCI World Index (vs. government bonds) was 81.6% compared with 2.7% for corporate bonds. Most of the bond portfolio remains invested in provincial government securities. On average, provincial bonds yield about 70 basis points more than Federal instruments in the 5-year term while offering no greater level of credit risk.

We remain cautious with respect to the outlook for long-term bonds and are more concerned with avoiding losses. We continue to favour equities over bonds within balanced mandates.

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