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

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Economic and Capital Markets Outlook

About us

Letko Brosseau & 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

- The economic impact of Brexit will likely be contained to the U.K. There is no similarity to the negative spillovers of the Lehman Brothers' bankruptcy or the Greek debt crisis.
- Although the U.K.'s vote outcome is unfavourable, there is no immediate threat to the Euro or Eurozone activity.
- The initial adverse equity market reaction was not a function of actual company fundamentals, but rather the effect of portfolio activity triggered by negative sentiment. The macroeconomic backdrop remains broadly supportive for equities and we expect markets to readjust in time towards fundamental valuations.
- Our base case forecast is for moderate global economic growth led by a solid expansion in the U.S. World real GDP growth is estimated to advance by 3.0%-3.5% in 2016-17.
- Given recent events, bond prices may well receive a temporary boost from safe haven flows. Nonetheless, we continue to believe that the risk/reward relationship for long-term bonds is unappealing.
- In the past year, U.S. earnings have been depressed by a strong U.S. dollar, collapsing oil prices and legacy bank costs related to the aftermath of the financial crisis. These factors are expected to temper, leading to a catch-up phase of higher earnings growth.
- Our portfolio equity valuations are fair. Dividend yields are attractive and substantially above government bond yields.
- We continue to favour equities over bonds within balanced mandates.

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The end of the second quarter was marked by substantial market volatility linked to the U.K.'s historic vote to exit the European Union. The uncertainty relating to the economic and political impact of this decision quickly spilled over into financial markets. It is no surprise that the initial market reaction was adverse, although the subsequent rebound suggests it may have been short-lived. The MSCI World Index (expressed in Canadian dollars) was down –1.8% during June while 10-year government bond yields reached new lows in Canada (1.1%) and the U.S. (1.5%).

We caution investors against embracing a too negative view based on these developments. The world economic and financial system is on a more stable footing today than following the financial crisis. The macroeconomic backdrop of low interest rates, low inflation and low commodity prices remains favourable and conducive to growth.

The implications of the U.K.'s decision are not like those previously faced by Greece: there is no suggestion of a repudiation of debt or bank insolvency. Unlike Greece, the U.K. has its own currency, which provides continuity and monetary stability. There is currently no direct threat to the structure of the European Monetary Union (EMU). We expect that the brunt of the negative economic impact will be felt by the U.K. rather than Europe.

It is too early to draw conclusions regarding the domino effect on European secessionist movements and/or the existential risk to the Eurozone. Past efforts to support Greece and other peripheral European members demonstrate the recognition that European integration has largely been a success and there is a strong desire to maintain the common market.

In the meantime, central banks will act quickly to provide liquidity should it become necessary. We believe the risk of a global recession remains limited although the risks to the U.K. economy have risen. Our outlook is for continued moderate global growth, led by a solid expansion in the U.S.

U.S. economic activity remains resilient

Strong consumer demand, driven by steady increases in job and income growth, is a key support underpinning the U.S. economic expansion. An average of 170,000 jobs per month was created over the last 6 months and hourly earnings were 2.5% higher than a year ago in May. Disposable income is growing at an annual rate of 4.1%, supporting a 3.7% increase in spending.

Growth is also being supported by a rebounding housing market. Residential investment was up 13% year-on-year in the first quarter. New construction rose 15% while spending on home renovations increased by 12%. In April, an annualized 1.2 million new houses were built, double the depressed levels associated with the Great Recession. There is still upside potential as we estimate the fair level of housing starts consistent with household formation to be between 1.3 million-1.5 million.

Corporate investment has been negatively impacted by cutbacks in the energy sector. Investments in oil & gas were close to $52 billion in Q1 or 70% lower than at the peak in Q2 2014. Excluding this area, non-residential investment increased at an annual rate of 4.6%. Going forward, profit growth should continue to support capital spending. Recent improvements in energy prices should also contribute to a gradual recovery in drilling expenditures.

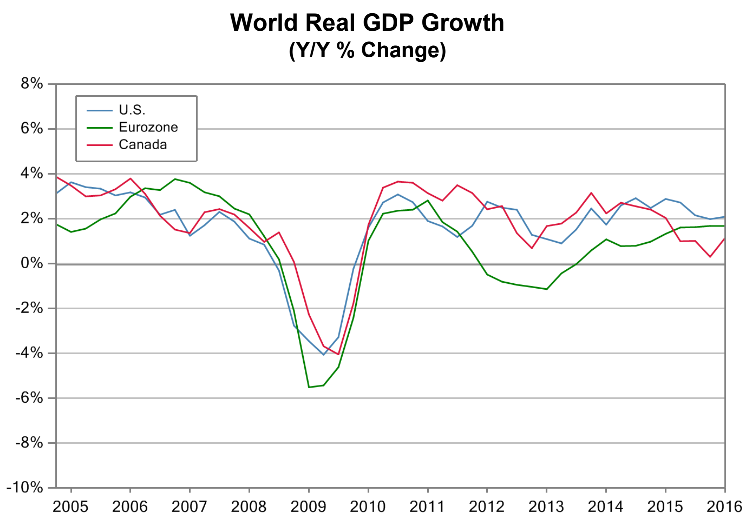
Our forecast for U.S. real GDP growth in 2016 is 2.0%-2.5%, similar to the rate experienced in the past two years (Graph 1).

Slow but steady growth in Canada

Despite undergoing a shallow economic downturn in early 2015, the Canadian economy quickly recouped all the lost activity in line with our expectations. Real GDP expanded by 1.1% year-on-year in Q1 and growth has been positive on a quarterly basis since Q3 2015.

As in the U.S., consumer spending and housing were the two main contributors to growth. Canada's nominal GDP increased by $26 billion in Q1 compared with a year ago. Personal consumption increased by 3.7% year-on-year or $41 billion and residential investment by 7.7% or $11 billion. The sharp decline in oil and gas investment activity and its relative importance to the Canadian economy was behind the $20 billion or 8.1% decline in non-residential capital spending.

Chart 1



Activity was unsynchronized across provinces. Over the last year, Alberta lost 32,000 jobs, Saskatchewan 7,000, New Brunswick 5,000, and Manitoba 2,000. In contrast, Ontario created 87,000 jobs and B.C. 84,000. On a net basis, 127,000 new jobs were created in Canada in the last 12 months. Similarly, retail sales in March were down 2.7% in Alberta versus last year, but up 5.2% in Ontario and 5.2% in B.C.

We expect the Canadian economy to expand by 1.5% in 2016, driven by income and consumption growth, a positive contribution from the housing market and increased government spending.

Brexit may temper but not derail Europe's progress

As noted above, the U.K.'s vote to exit the 28-member states of the EU does not have direct implications for the Euro or the 19 countries linked by monetary union. Moreover, the Eurozone has managed to withstand substantial pressure over the last five years; it is premature to predict that secessionist movements across the continent risk derailing the union. Indeed, it is doubtful that any other European government will call a referendum on this issue in the near future.

Prior to the June 23rd vote, economic activity across the Eurozone was picking up, supported by the European Central Bank's liquidity measures. During the first quarter, Eurozone real GDP growth rose 1.7% against last year. Growth increased by 3.4% in Spain, 1.6% in Germany, 1.3% in France and 1.0% in Italy. Over the last two years, 3.5 million jobs were created in the Eurozone, of which 960,000 were in Spain, 870,000 in Germany, 630,000 in France and 340,000 in Italy.

Disposable income has been in an uptrend, rising 1.2% in 2014 and 1.9% in 2015, after having remained relatively flat for several years prior. The improvement in job-related incomes led to the release of pent-up demand in many sectors. For example, car sales jumped to an annualized 11.4 million in April, a 9.6% increase over last year. Europe has yet to recoup all the jobs lost since the Great Recession and continued steady improvement on the employment front should support growth. The risk of knock-on "Brexit" effects damaging the Eurozone's activity is limited in the short-term, although we will be monitoring indicators for business confidence closely. We expect Eurozone real GDP to expand by about 1.5% in 2016.

The U.K. accounts for only 2% of world GDP and is therefore unlikely to upset global growth. However, the risk of a recession in the U.K. has risen as the short and medium-term outlook for trade, the financial sector and business investment has deteriorated. While 44% of U.K. exports are shipped to the EU (13% of U.K. GDP), only about 6% of EU exports are directed to the U.K. (3% of EU GDP). The financial industry, which accounts for 8% of U.K. GDP, may be vulnerable. Concerns for U.K.'s access to the EU common market may adversely impact private investment (10% of U.K. GDP) until the new rules are clarified.

Emerging markets: more balanced growth ahead

Growth across emerging economies varied greatly by country and region. Last year, India's real GDP expanded by 7.3% and robust growth was seen in a number of Asian countries including the Philippines (5.8%), Malaysia (5.0%), Indonesia (4.8%), and Thailand (2.8%). In Eastern Europe, activity was generally solid with Romania growing by 3.7%, Poland, 3.6% and Hungary, 2.9%. At the other end of the spectrum, both Brazil and Russia continued to face domestic troubles and remained in recession with growth reported at –3.8% and –3.7% respectively. As a group, emerging markets expanded by 4.0% last year and the IMF forecasts the region to grow by 4.1% in 2016.

A slowdown in activity in China last year provoked concerns that the economy was on the verge of collapse. According to official statistics, Chinese real GDP growth was 6.9% in 2015, although several alternative measures of activity suggested that growth may have been closer to 5%-6%. In response, the Chinese government implemented a fiscal stimulus program while also introducing measures to stabilize capital outflows. These actions, together with the release of the country's 5-year plan to promote growth, helped to relieve uncertainty and prevented a more serious downturn.

Activity in China appears to have stabilized and begun to trend upwards. Revenues of industrial companies were up 2.9% year-to-date to May against last year while profits were up 6.4% over the same period. This compares with 0.8% and –2.3% respectively during 2015. Our internal analysis using data from more than 2,500 publicly listed companies shows a similar trend: company revenues rose 2.8% year-on-year in the first quarter.

A gradual recovery has taken hold in Chinese cyclically-sensitive industries that experienced notable contractions in activity in 2015. For example, year-to-date cement production was up 3.7% in May vs. –5.1% for the same period last year. The pick-up in house prices, up 5.0% year-on-year in May, should increasingly support industries linked to construction. Meanwhile, consumer-sensitive industries are seeing strong increases in production. Between January and May, the manufacture of mobile handsets and televisions increased by 19% and 13% respectively year-on-year.

While we are encouraged by indications of improvement in the Chinese economy, the country is still in the process of addressing past imbalances. We therefore remain attentive to risks that may unsettle current progress. Longer-term, China's fundamentals remain strong given that it is still in the early stages of development.

Summing up our forecasts for the different regions, we continue to expect world real GDP to expand by 3.0%-3.5% per year in 2016-2017.

Investment conclusion: favour equities over bonds

In light of market volatility following the U.K.'s historic vote, major European equity markets are down since the beginning of the year. Year-to-date in Canadian dollars, the total return on the DAX is –15%; the FTSE-100 –10% and the CAC-40 –10%. Elsewhere, the total return on the Nikkei is –10%, the S&P 500 is –3% (although +4% in U.S. dollars) while the S&P TSX is up 10%. Emerging market equities are flat year-to-date.

We do not believe our equity holdings will suffer permanent impairment from the U.K.'s decision to exit the EU. We note that only 3% of the total equity portfolio is exposed to U.K.-domiciled companies, of which the majority are large multinationals with minimal exposure to the U.K.'s domestic economy. We do not own any U.K. banks or hold pound sterling.

Recent events have reminded investors that they have had a volatile time with equities since 2006. The S&P 500 has declined by 10% or more at least seven times in the last decade (Chart 2) and we have faced the worst bear market since the Great Depression of 1929. Nonetheless, patience has been amply rewarded. The cumulative total return from January 2006 to end-June 2016 is 110%.

Chart 2

Ultimately, share prices reflect expectations for companies' future progress. The recovery from the Great Recession was associated with a return to profitability and this, together with attractive valuations, was the catalyst for the equity market's upward trend. We believe that prospects for revenue and profit growth remain positive and valuations are currently not extended. While temporary factors have been depressing U.S. corporate profits, these factors should fade in the short-term.

As measured by aggregated operating earnings per share of S&P 500 companies, profits have declined every quarter since Q3 2014. Indeed, this so-called earnings' recession seems to be at odds with reported positive economic data such as GDP.

In fact, the collapse of profitability in the energy sector appears to be the main culprit behind the weakness in S&P 500 index earnings. Prior to the decline in oil prices, energy accounted for 10%-15% of index operating earnings. As the price of oil collapsed and earnings turned negative, the impact on aggregate index earnings was notable. S&P 500 operating earnings declined from $113 in 2014 to $100.50 in 2015, a $12.50 decline. Earnings for the energy sector fell by $16.80, indicating that all other sectors combined saw their earnings improve. This was also the case in Q1 as energy revenues fell by 32% against last year while non-energy revenues increased by a healthy 6%.

In addition to the drag caused by the energy sector, two other factors are also temporarily weighing on corporate profits. First, a strong U.S. dollar has reduced the value of foreign profits consolidated into U.S. financial statements. Second, financial companies' earnings are still below their normal run rate largely due to legacy costs, including legal fees, linked to the Great Recession.

We believe that the above-mentioned negative effects on earnings will diminish as the price of oil normalizes, the dollar retrenches from its highs and legacy costs for financial institutions disappear. Earnings for S&P 500 companies may therefore enter a catch-up phase and grow at a 10%-12% pace for the next two years.

While equity markets may appear to be at the higher end of a reasonable range, we do not believe that stocks are overly expensive. The S&P 500 currently trades at 18.4x 2016 estimated operating earnings but the multiple falls to 16.5x if we exclude the energy sector, where earnings are temporarily distorted by the collapse in oil prices.

Dissecting the earnings multiple further reveals sharp divergences in company valuations. Reasonable valuations prevail for a large subset of the market, but are excessive for a certain number of companies. For example, Amazon trades at more than 100x estimated earnings while Facebook is valued at close to 50x earnings.

In contrast, our equity portfolio is priced at a reasonable 14.5x earnings (12.5x excluding energy stocks) and offers a 3.0% dividend yield. As such, we believe that it is very well positioned to provide attractive returns over the next few years as corporate earnings continue to expand.

The portfolio's dividend yield is notably above government bond yields across the maturity spectrum. At the end of Q2, a 5-year federal bond yielded 0.60%, the 10-year 1.10%, and the 30-year 1.7%. Investors are poorly rewarded for adding credit risk: a 10-year BBB-rated bond yielded only 3.60%.

Given recent events, governments will remain stimulative and bond prices may well receive a temporary boost from safe haven flows. These price distortions, however, do not tempt us to alter our investment position. We remain of the opinion that long-term bonds are expensive and current interest rates are almost certain to provide a return after inflation close to zero, if not negative.

In addition, bond investors are likely to suffer significant losses even if interest rates only start to increase by a modest level several years from now. This is especially true for long instruments given their sensitivity to even minor changes in yield. For example, a 30-year federal bond yielding 1.7% would generate a total cumulative loss over 10% after 5 years if rates were to stay flat and then increase by only 1% in 2021. If yields were to rise instead by 2%, the capital loss jumps to over 30%. Comparing these potential losses with the current yield that these bonds provide, we believe the risk-adjusted return is extremely unfavourable.

We continue to invest our portfolios where risk is much better compensated: in equities. Over the past 6 years, we eliminated exposure to long-term bonds and minimized credit risk in the fixed income segment of the portfolio with the objective of preserving capital. To maximize returns, we maintained an above-average weight in a select group of well-valued equities. This strategy provided significant added value to balanced mandates without exposing the portfolio to additional risk. We are confident that this will continue to be the case in the years ahead.

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