Letko, Brosseau & Associates Inc.

Global Investment Management Since 1987

December 2016

Economic and Capital Markets Outlook

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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 global economy is moving onto a path of synchronized growth as activity is picking up in major developed and developing countries. Real GDP is forecast to improve from 3.1% in 2016 to 3.4% in 2017.
- We expect U.S. real GDP to accelerate to 2.5% in the year ahead, driven by consumer spending, housing and corporate investment. The new Administration's stimulative fiscal agenda provides potential upside to this base case.
- Canada will benefit from healthy income growth, higher oil prices, a competitive Canadian dollar and a stronger U.S. economy. This boosts our forecast for real GDP growth to 1.5%-2.0% in 2017. However, looking ahead, consumers will have to adjust both spending and debt levels downwards, tempering the economy's growth prospects in the medium-term.
- The U.S. Federal Reserve hiked interest rates by 0.25% in December and intends to raise interest rates further. The pace of rate hikes will be gradual and is unlikely to derail the U.S. economy or equity markets.
- Our expectations for stock market returns have moderated given that valuations have reached the higher end of their fair value range. We estimate equity total returns will average around 6% per annum in the medium term.
- Longer-term Canadian bond prices are down 12.7% in Q4 as a result of a modest 68 basis point rise in yields. We continue to caution investors that fixed income instruments are overvalued and thus vulnerable to further price correction.
- Our decision to favour a portfolio of carefully selected stocks over fixed income instruments, while maintaining a high quality portfolio of bonds with low exposure to interest rate volatility, has been – and will continue to be – a successful one.

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Review of 2016: the year ended quite differently than how it began

Fears of a pronounced slowdown in China and weaker U.S. growth destabilized financial markets in early 2016. By mid-February, oil and base metal prices hit new lows, the S&P 500 Index had declined by 11% and the 10-year Canadian bond yield hovered around 1%. Political uncertainty surrounding a referendum in the U.K to exit the European Union and the election of Donald Trump to the U.S. Presidency added to investor concerns.

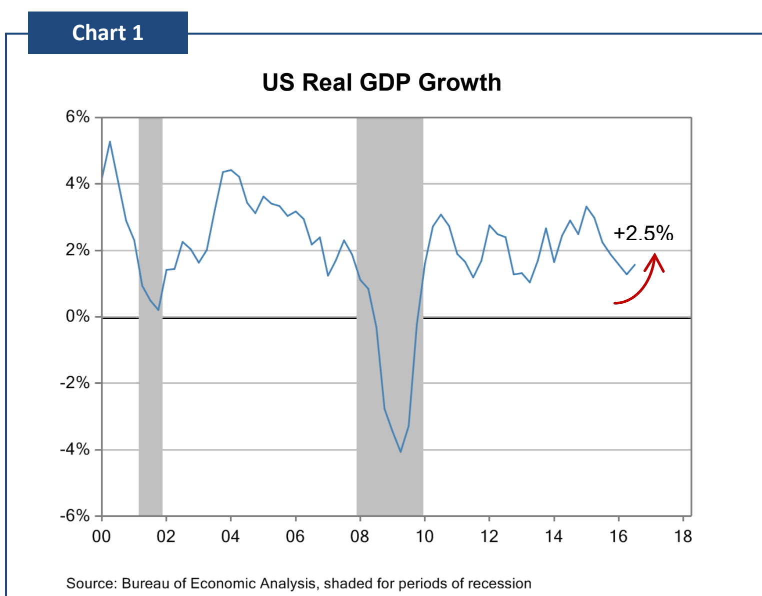
Despite these events, global economic activity steadily improved throughout the year. By year-end, most major equity markets were up while U.S. and Canadian long-term interest rates rose by 75 and 68 basis points respectively in anticipation of stronger growth. Commodity prices rebounded and oil and mining were the best-performing sectors in the equity market.

Our forecast remained unchanged throughout this tumultuous year. Real GDP is on track to accelerate from 3.1% in 2016 to 3.4% in 2017 as growth synchronizes across the developed and developing world.

The U.S. is in the midst of a long economic cycle

The U.S. economy hit several milestones over the last several quarters. First, the number of full-time jobs surpassed its pre-recessionary peak. Second, nationwide house prices rose above their 2007 level. Third, due to a rebound in oil prices, the number of oil & gas rigs was up 63% from the trough reached in May. Fourth, both money supply and credit grew at a robust pace.

Going forward, fiscal policy may provide a further boost to the U.S. economy if Trump's agenda of infrastructure spending and lower taxes is implemented. Four important elements of the economy – consumption, housing, investment and government spending – are expected to contribute to growth. Overall, this suggests that U.S. activity will accelerate, perhaps markedly over the next year (Chart 1).



Our base case is for U.S. real GDP to expand at a rate of 2.5% in 2017, with potential for an upside.

Canada: short-term progress vs. longer-term challenges

Canada's sluggish growth has coincided with weak commodity prices, which have impacted both exports and capital spending. Indeed, despite a relatively weak Canadian dollar, the trade deficit stood at –C$54 billion in Q3 2016 compared with –C$45 billion in Q3 2015.

For the first 9 months of 2016, Canadian exports to the U.S. fell by 2% against the same period last year, with lower oil prices representing most of the decline. This decline was partly mitigated by demand from two key

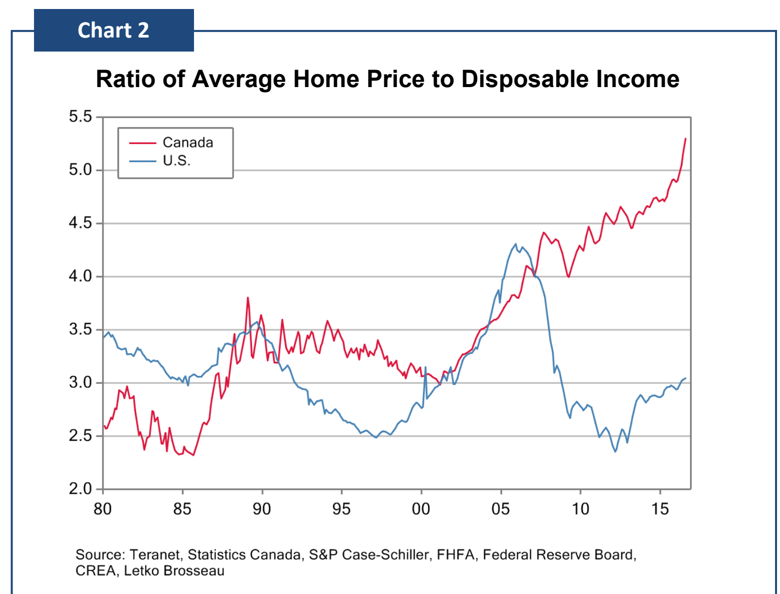
drivers of U.S. growth: housing and consumer spending. Exports of forestry products (a proxy for housing demand) grew 4% year-on-year while motor vehicle exports were up 3%. We expect the pick-up in U.S. economic activity in the year ahead will translate into increased demand for Canadian goods. A competitive Canadian dollar, currently 14% undervalued against its U.S. counterpart on a purchasing power parity basis, should further support exports.

Higher oil prices will also have a positive impact on the trade balance and should temper cuts to energy-related capital spending. In turn, this should ease the main short-term drags on economic activity. Oil & gas investment in Canada shrank by more than 50%, or about C$40 billion, over the past two years while the economy expanded by C$35 billion over the same period. Economic growth would have been more than double without these cutbacks. As long as oil prices remain firm, companies are unlikely to slash capex further.

Canadian consumer spending will continue to be an important driver of activity in 2017. Disposable income increased 4.3% year-on year in Q3, supported by employment and wage growth. Residential investment, on the other hand, has begun to show signs of moderating. While house prices hit new highs, new home construction recently slowed. During the three months to November, housing starts declined 7.5% against the same period last year. In addition, mortgage rates have been on the rise. The 5-year fixed rate offered by the Royal Bank of Canada increased from 2.64% to 2.94% in November and new Federal regulations have tightened mortgage qualification criteria. Both factors are likely to curb new construction further.

We have for some time cautioned about the structural challenges facing the Canadian economy: consumer spending and debt levels are elevated and housing prices are too high. As house prices have increased far more rapidly than incomes over the past two decades, affordability measures have become stretched. Canadian house prices are on average 5 times household income while the comparable measure in the U.S. is 3 times (Chart 2). Are rising interest rates—and by extension higher mortgage rates—a harbinger of trouble?

In trying to assess the potential impact of higher interest rates on the economy, we note that two-thirds of outstanding mortgages carry a fixed rate, typically for 5 years. This proportion jumps to 80% for new mortgages underwritten in 2016. Moreover, variable-rate mortgages often have fixed monthly payments in which only the portion applied to paying down the principal varies with interest rates. For the majority of mortgage holders, rising interest rates only impact household debt service costs over time.



Source: Teranet, Statistics Canada, S&P Case-Schiller, FHFA, Federal Reserve Board, CREA, Letko Brosseau

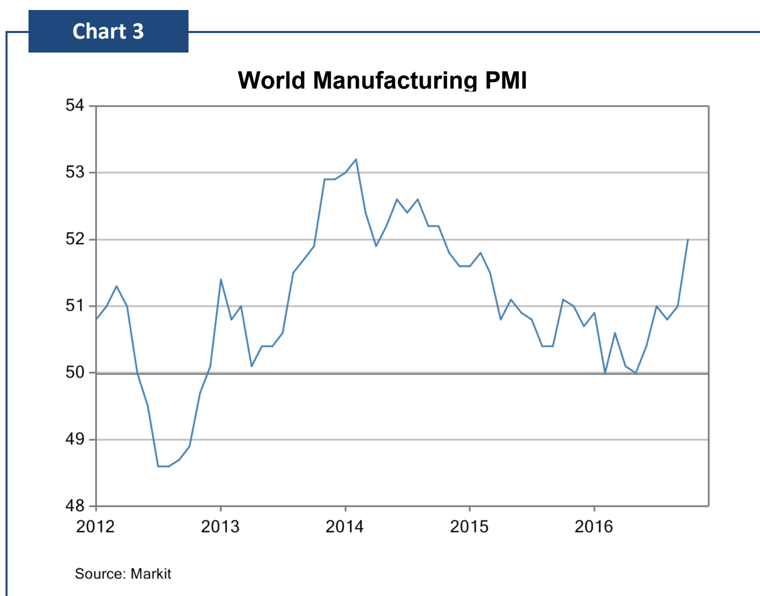
For example, mortgage loans up for renewal in 2017 would have been underwritten in 2012 when the mortgage rate was around 3.5%. Borrowers who are refinancing 5-year fixed rate mortgages will therefore see a decline in their mortgage payments.

As interest rates continue their ascent however, borrowers will have to divert an increasing share of their incomes towards interest payments. Assuming mortgage rates rise an additional 1% to 3.9%, a household carrying a mortgage of $200,000 (the Canadian median) would face a $105/month rise in monthly payments. We believe that this should be manageable. Such an increase represents only 2.3% of Canada's median disposable income and is equivalent to the Conference Board of Canada's forecast for the private sector's salary increase.

In the longer-term, we believe that the housing market may well see a pullback, and this could dampen economic activity. In the shorter term, however, Canada will benefit from job and income growth, a rebound in oil prices and a stronger U.S. economy. We forecast that the Canadian economy will expand by 1.5%-2.0% in 2017.

Global growth on a synchronized path

Recent data confirm that global industrial production is picking up. The global Purchasing Managers' Index (PMI) for manufacturing troughed in Q2 (Chart 3) with the U.S., Germany, the U.K., Japan and key emerging economies including India and China all reporting moderate to strong increases.



The improvement is particularly notable in China where most indicators of activity are seeing robust growth following significant fiscal and credit stimulus. As of October, Chinese passenger vehicle sales rose 20% year-on-year, while airline passenger traffic is up 13%, railway freight up 11% and electricity consumption up 9%.

Russia and Brazil, whose economies have lagged the rest of the emerging world, should benefit from the rise in commodity prices. Over the last year, the price of oil increased 52%, iron ore rose 101%, copper was up 17% and metallurgical coal, the main input in steel production, increased 250%.

For the first time in several years, global growth is expected to move in synch. The IMF forecasts world real GDP growth to accelerate from 3.1% in 2016 to 3.4% in 2017.

Valuations warrant caution, stock selection remains key

It has been a volatile year for financial markets and global equities closed 2016 with a mixed performance. Over the last 12 months, the total return for the S&P 500 (in C$) was +8.6%, S&P TSX +21.1%, DAX 0%, CAC-40 +2.7%, FTSE-100 –4.0% and the Nikkei +2.5%. Developing markets performed well with the MSCI Emerging Markets Index returning 7.9%.

The strong performance of U.S. stocks begs the question of whether recent market movements are overdone. It is important to note that profits, the fundamental driver of equity prices, are

underpinned by improving economic activity. In addition, the P/E multiple of US stocks as measured by the S&P 500 Index, stands at 19x 2016 earnings and 16.5x expected 2017 earnings. While above the long-term average P/E level of 15x, these multiples are not unreasonable when taking into account the very low level of interest rates.

As interest rates start to increase, the more highly valued pockets of the market could be under pressure. History shows, however, that rising rates are not necessarily associated with overall poor performance for stocks. For example, beginning in 1950, interest rates entered a long secular uptrend but the S&P 500 generated a return of 8.9% per year from 1950-1960. More recently, interest rates increased significantly between 2003 and mid-2007 when the Fed raised the fed funds rate from 1.25% to 5.25% and the 10-year yield moved from 4% to 5%. During this period, the S&P 500 generated a total annualized return of 14.6%.

With equity markets well supported by profit growth and attractive dividend yields, but valuations at the higher end of their fair-value range, we expect market returns to be somewhat lower than in recent years. Over the medium-term, we estimate that equities should deliver a return of about 6% per annum (including dividends). In the shorter-term, earnings may face pressure should the U.S. dollar continue to rise.

We note that our equity portfolios trade at a more reasonable 13x expected earnings. As such, we believe they are better positioned to capture the potential from profit growth and dividends while being less exposed to valuation risk.

Bonds: the point of NO return

Following the results of the U.S. election and the Federal Reserve's increase in the Fed Funds rate, longer-term interest rates in the U.S. and Canada increased by 75 and 68 basis points respectively in Q4. This caused long-term Federal bond prices to fall almost 13% (Table 1).

Notwithstanding the recent rise, interest rates across the yield curve remain well below what is consistent with economic activity and inflation. Nominal GDP should reach close to 4% in Canada in 2017 yet the 30-year Canadian bond yield is only 2.34%. With respect to short-term rates, the Bank of Canada estimates that the neutral policy rate consistent with full employment, trend growth and stable prices is between 2.75% and 3.75%. The overnight rate is currently 0.5%, implying that the Bank of Canada forecasts that its policy rate should "normally" be 2.25%-3.25% higher than it is now.

Table 1: Impact of interest rate increases on Canadian bonds

Term	September 30, 2016	Current Rate	Price Impact since 30.9.2016	Normal Rate	Potential Further Price Impact
Short-term Canada Bond	0.5%	0.7%	-0.2%	3.0%	-2%
FTSE TMX Universe	1.7%	2.1%	-3.4%	4.2%	-16%
Long-term Canada Bond	1.7%	2.3%	-12.7%	4.0%	-34%
LBA Portfolio	1.1%	1.4%	-0.5%	3.8%	-5%

If one were to assume that the policy rate rises to the midpoint of the Bank of Canada forecast, and both longer-term yields and corporate spreads increase towards their historical averages, the potential price impact for longer-duration bonds is substantial. For example, the price of the long-term Federal bond stands to lose a further 34% while the FTSE TMX (the benchmark bond index) will decline by 16% (Table 1). In contrast, our bond portfolio is well positioned to preserve capital given its short duration and very low exposure to credit risk.

We believe that fixed income instruments still offer a very poor risk-return trade off. As a result, we continue to favour equities over bonds and aim to protect capital within fixed income portfolios.

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