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

- Global economic growth is accelerating and the expansion is increasingly synchronized. The risk of recession is low.

- Our 2017 forecast for U.S. real GDP growth is 2.5%. The pickup in capital spending appears to be in its early stages and surveys indicate a buoyant business climate.

- Canada's trade sector should benefit from a weak currency and stronger U.S. and international growth. We forecast real GDP to expand by 2.0% this year.

- Eurozone growth continues to gather momentum and is on track to reach 1.5%-2.0% in 2017. Progress on the jobs front is spilling over to improved confidence and higher consumer spending.

- China's stimulus measures have had positive repercussions across the developed and developing world. Emerging market economies are forecast to grow at 4.5% in 2017.

- Global equity indices recorded positive total returns during the first half of the year, reflecting a supportive macroeconomic backdrop. While geopolitical risk remains a concern, rising earnings, low interest rates, subdued inflation and the absence of significant financial excesses provide key support to equities. Stock selection is paramount given higher market valuations, but extreme cautiousness is not warranted at this time.

- The era of ultra-loose global monetary policy may finally be approaching an end. Long-term bonds are increasingly vulnerable to a correction and are best avoided.

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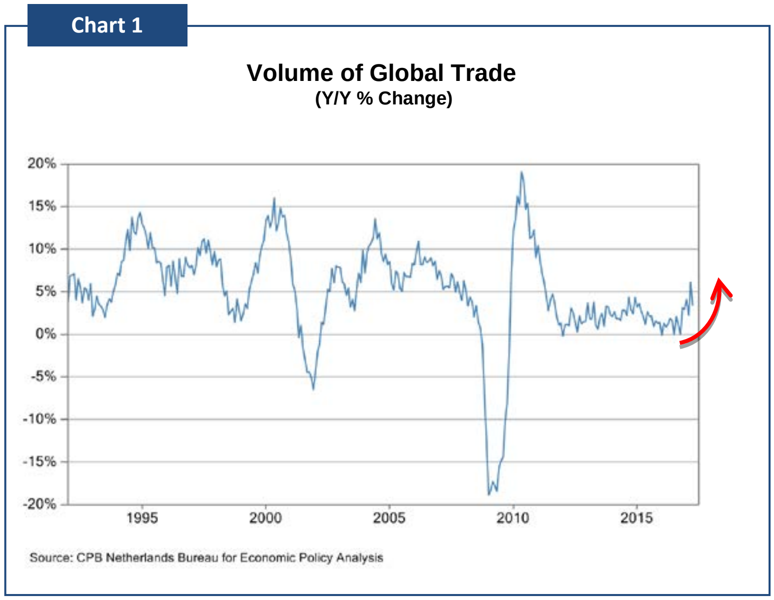
Global growth on an upswing

The pace of global economic growth is accelerating. Investment, consumer spending and industrial production are on the rise across North America and Europe. Developing economies are also improving, as fears of a slowdown in China have receded and prospects for India remain bright. Even Russia and Brazil, both of which have faced significant challenges in the past two years, are forecast to experience positive, albeit modest growth in 2017.



The synchronized nature of the expansion is having a positive impact on global trade which, despite fears of protectionism, is growing at its fastest pace in 6 years (Chart 1). The current economic outlook is positive and the risk of recession is low.

U.S. economy on solid ground

U.S. real GDP growth expanded 2.1% year-on-year in the first quarter, driven by consumption, business investment and the housing sector. Consumer spending remains well supported by employment and wage growth. On the jobs front, 121,000 jobs per month were created on average during the last three months, while hourly earnings increased by 2.5% year-on-year in May. Other sources of income are growing more strongly: rental income was up 6.8% year-on-year in May while income from financial assets was up 3.8% during the same period. Overall, disposable income increased 3.7% year-on-year in May, leading to a 4.2% rise in consumer spending. The saving rate remains healthy at 5.5% and household net worth reached a new peak of $95 trillion.

Business investment has rebounded from lacklustre levels in 2016. Capital spending expanded by 4.2% year-on-year in the first quarter, led by investment in R&D, which rose 8.8%. The pick-up in corporate investment appears to be in its early stages. Surveys of both small and large corporations indicate business confidence is buoyant. In addition, after-tax corporate profits were up 3.3% in Q1 driven by robust earnings growth in the financial and IT sectors.

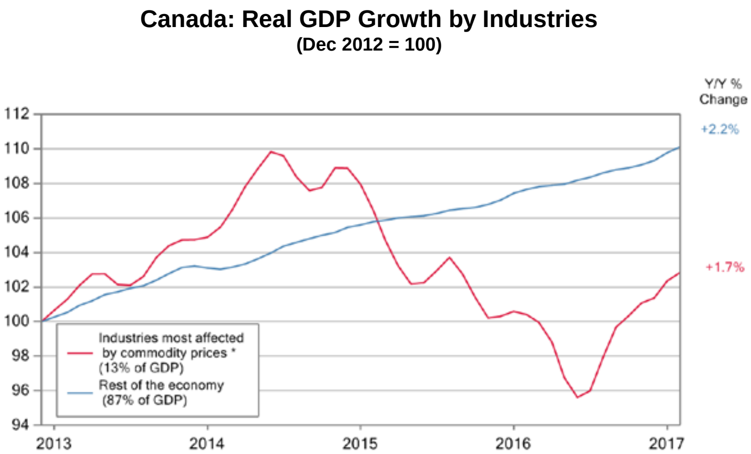
Residential investment is in its 7th year of expansion, driven by rising prices, higher sales and the construction of new homes. The median sales price of existing homes was up 5.8% in May against a year ago, while home sales increased 3.3% and an annualized 1.2 million new homes were built during the month.

Together, these cyclical growth drivers should continue to exert a positive effect on the U.S. economy. Our 2017 forecast for U.S. real GDP growth is 2.5%. New government measures to cut taxes or increase infrastructure spending could push growth higher, although the impact may not be felt until 2018.

Canada bouncing back

Weak commodity prices contributed to sluggish economic activity in Canada in 2015 and early 2016. Chart 2 shows that industries exposed to commodities contracted sharply relative to the rest of the economy. During the past three quarters, the uptrend in prices for oil and base metals has stimulated a rebound. In Q1, Canadian real GDP expanded by 2.3% year-on-year on the back of a pick-up in business investment, while consumer spending and housing remained buoyant.

Chart 2



* Includes mining, oil and gas, engineering, non-residential construction and related manufacturing and professional services
Source: Statistics Canada, Bank of Canada, Letko Brosseau, 3-month average

Retail sales rose 7.0% year-on-year in April and growth was widespread across all provinces. Sales in Ontario increased by 8.3%, British Columbia 7.1%, Quebec 6.8% and Alberta 6.0%. These strong numbers were supported by solid employment gains as the economy added 317,000 jobs over the past twelve months to May.

Canada's housing sector continues to exhibit solid growth. Over the three months to May, an average annualized 220,000 new homes were built per month, up 14.0% over a year ago. Home prices increased 13.9% nationally year-over-year in May, with Toronto housing prices up 28.7%.

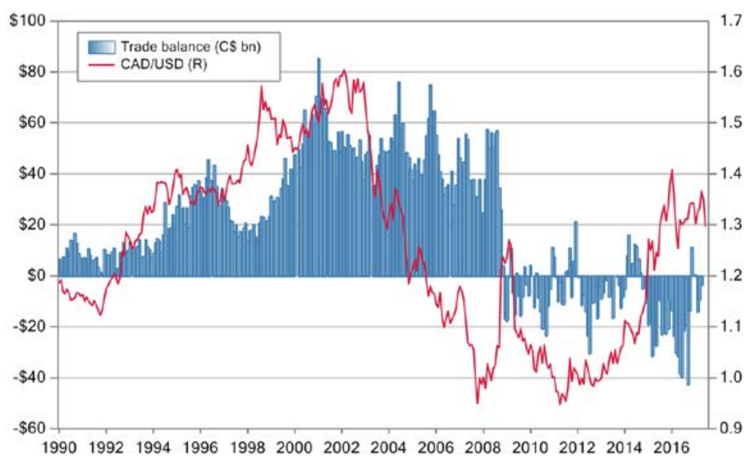
The Canadian housing market's affordability has notably deteriorated. Average home prices are now more than five times household disposable income. In comparison, the average American home is priced at three times U.S. household disposable income. Both the Bank of Canada and the IMF have voiced reservations about Canada's housing market, highlighting the vulnerabilities for the Canadian financial system. In May, Moody's downgraded the credit rating of Canada's Big Six banks by one notch, citing concerns that elevated consumer debt and overheated house prices have left lenders vulnerable to potential losses on loans.

Given that our equity portfolios hold positions in four of the largest banks in Canada, we reviewed their exposure to Canadian residential real estate and concluded that they are in solid financial shape. First, Canadian banks have diversified revenue streams, with significant contributions from international operations, i.e. 25% or more. Second, the mandatory requirement to purchase default insurance for down payments of 20% or less, a unique feature of Canada's mortgage system, indirectly transfers the risk of a significant portion of the bank's mortgage loan book to the AAA-rated Canadian government. This, together with the household sector's high levels of home equity, leaves the banks with a small uninsured mortgage exposure of less than 7% of their total assets. Third, Canadian banks fund their loans with consumer deposits, one of the most stable forms of funding. Finally, bank leverage is reasonable at 18 times assets to equity. In contrast, the leverage ratios for Lehman Brothers and Bear Stearns during 2007, just prior to the financial crisis, were 28 and 33 times respectively.

Looking ahead, the rate of house price increases and new home construction in Canada is expected to slow from current unsustainable levels. As the economy rebalances away from consumer spending and residential investment, the trade sector is likely to pick up the slack. Chart 3 shows that the trade deficit recently narrowed, although the improvement was mostly due to rising energy prices.

Chart 3

Canada's Trade Balance for Goods



We expect that trade will benefit from three cyclical tailwinds. First, the Canadian dollar remains 12% undervalued versus the U.S. dollar (based on our purchasing power parity model) which should positively impact export competitiveness. Second, as growth in both the U.S. and the rest of the world picks up, the demand for Canadian products will increase. Finally, in the medium term, Canada is likely to benefit from the government's push for increased trade integration with many of its partners.

We forecast Canada's real GDP to expand by 2.0% in 2017.

Europe on synchronized growth path

Growth in Europe continues to gather momentum. Eurozone real GDP was up 1.9% in Q1 versus a year ago, with Spain (+3.0%), Portugal (+2.8%) and the Netherlands (+2.5%) leading the region. Germany expanded by 1.7%, while Italy grew at 1.2% and France 1.1% year-on-year.

Notable progress on the jobs front is spilling over to improved confidence and higher consumer spending. The unemployment rate for the Eurozone was 9.3% in May, compared with 11.1% two years prior and close to levels which prevailed during 2004-2006. Household pent-up demand for cars drove vehicle sales to an annualized level of 11.2 million in May, up from the trough of 8 million reached in 2013.

Consumer spending should be supported by rising disposable income and a continued pick-up in household credit. We expect Eurozone real GDP to expand between 1.5% and 2.0% in 2017.

In the U.K., Brexit will continue to weigh on the British economy as the recent election of a minority government may complicate negotiation talks with the European Union. U.K. real GDP is forecast to grow 2.0% in 2017.

China stimulus a positive spillover

Aggressive fiscal and monetary stimulus led China's economy to rebound from a 2015-16 soft patch. Real GDP expanded 6.9% in Q1 against a year ago as the deficit-to-GDP ratio hit 3.8% in 2016 and total credit rose 12.9% year-on-year in May. Indeed, over the past twelve months, total credit creation summed to $2.8 trillion, equivalent to the size of the U.K.'s GDP.

China's stimulus measures have had repercussions across the developing world. As consumption picked up and commodity prices rose, Chinese imports jumped, growing 15.3% year-on-year over the 3 months to May. Imports from Africa increased 52.0%, Latin America 28.9% and Southeast Asia 20.2%. Imports from Brazil were up 40.3% while imports from Russia were up 24.2%, helping to stimulate production in the two sluggish economies. The Emerging Markets Purchasing Managers' Index (PMI) for Manufacturing was in expansion territory, reaching 50.5 in May compared with 49.6 during the same period last year.

Chart 4

Looking ahead, growth in Chinese consumer spending will continue to support emerging economies for years to come. The region's growth is expected to accelerate to 4.5% in 2017 from 4.1% in 2016.

With economic activity in both developed and developing markets accelerating, the IMF expects that global real GDP growth will increase from 3.1% in 2016 to 3.5% in 2017 (Chart 4).

Valuations warrant caution, stock selection remains key

Global equity indices recorded positive total returns during the first half of the year (in C$), reflecting the supportive macroeconomic backdrop. The S&P 500 was up 5.7%; S&P TSX 0.7%; DAX 12.1%; FTSE-100 6.4%; the Nikkei 6.1% and the MSCI Emerging Markets Index 14.6%.

As stock prices have climbed to new highs, valuations have reached the higher end of a fair value range. At the end of June, the S&P 500 traded at 18.7 times estimated 2017 earnings and 16.7 times estimated 2018 earnings. However, excluding the richly valued ''FANG'' tech stocks (Facebook, Amazon, Netflix and Google), the U.S. market's valuation is 16.9 times estimated 2017 earnings. Elsewhere around the world, valuations are more reasonable: Canada trades at 16.8 times, Japan 17.5 times and Europe 16.1 times.

These valuations require that we remain alert to the risks that could negatively impact financial markets. While geopolitical risk always remains a concern, rising earnings, low interest rates, subdued inflation and the absence of significant financial excesses depict an environment that remains conducive to higher equity prices. Stock prices may experience a pause after the recent strength, but the bull market in global equities is very much intact.

Our equity portfolio is priced at a reasonable 13.2 times estimated 2017 earnings and is invested in a diverse set of companies and industries with appealing upside potential. Our exposure to emerging markets, currently around 12% of total equities, allows us to benefit from higher expected levels of growth and more attractive valuations. Our emerging market investments trade at 9.7 times estimated 2017 earnings and offer an aggregate 3.3% dividend yield.

Low bond yields at odds with growing economy

Over the last several years, central banks have generally been reticent to increase rates, probably because they have questioned the sustainability of economic growth and been underwhelmed by inflation. The upswing in global growth has recently led central bank policymakers to change their tune.

The U.S. Federal Reserve is already tightening monetary policy and is expected to begin shrinking its $4.5 trillion balance sheet this year. It raised rates by 0.25% in June, the third increase in the last six months, and will likely raise them once more before year end. In Europe, the ECB alluded to a tapering of its bond purchases while key members of the Bank of England have begun to speak of raising rates. Meanwhile, in the context of strong real estate prices and very good economic data, it is surprising that the Bank of Canada has done nothing more than hint at future rate increases.

While central bank policymakers are signalling that the era of ultra-loose money is at an end, bond yields of long maturities remain near end-December levels. The 10-year U.S. Treasury bond closed the second quarter at 2.3%, down from 2.4% six months ago. In Canada, the 10-year Federal bond moved from 1.7% to 1.8% during the same period.

Current yield levels are increasingly at odds with economic developments. Accelerating growth and higher inflation should, in time, push yields higher. Meanwhile, we continue to believe that long-term bonds offer an unfavourable risk-return relationship and, as such, are best avoided. The yield differential between a 5-year and 30-year Federal bond is only 0.75% and at its lowest spread since 2008. Given that long instruments are very sensitive to changes in interest rates, a mere 0.05% rise in yields will completely offset the extra yield offered by the longer instrument. As rates rise further, the incurred loss rapidly becomes significant. For example, if interest rates increase by 0.5%, the price of a 30-year bond will decline by 10% while the 5-year bond will be down by only 2%.

In this context, our primary objective is capital preservation. We are maintaining zero exposure to bonds with maturities above 10 years and have minimal exposure to corporate credit. We prefer investing where the risk-return relationship is far more favourable: in equities. This asset allocation decision has worked well since its implementation seven years ago. By continuing to focus on maximizing the overall return of our portfolios, we are confident that this strategy will continue to perform well in the future.

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