Letko, Brosseau & Associates Inc.

Global Investment Management Since 1987

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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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Summary

- The global economy is gaining momentum and growing in a synchronized fashion. Real GDP is forecast to rise by 3.5% in 2017 and 3.6% in 2018.

- All major economies are seeing a sustained pickup in activity. The U.S. Federal Reserve and the Bank of Canada have begun to tighten policy rates in response to positive fundamentals.

- Oil has lagged the rally in other commodities. We believe the need for new supply to satisfy increasing demand and to offset the natural decline rate of existing wells will lead to a gradual rise in oil prices.

- The macro environment is supportive of earnings growth and thus remains favourable for stocks. However current equity valuations, particularly in the U.S. market, are at the higher end of their fair value range. A focus on price discipline and prudent stock selection remains key.

- At this stage of the business cycle, price pressures normally begin to emerge. This puts long-term bond investors at risk of significant losses. We are maintaining a short duration position and are underweighting this asset class within balanced mandates.

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Global economic growth is picking up

In the **United States**, real GDP expanded 2.2% year-on-year in the second quarter. Consumer spending, non-residential investment and housing continue to underpin economic activity.

Household consumption grew 4.3% in nominal terms versus last year, supported by steady job gains and moderate wage increases. U.S. employment creation averaged 160,000 per month over the last twelve months to August and the nationwide unemployment rate was 4.3%. Consumer credit (including mortgages, auto loans and credit cards) expanded by 4.5% year-on-year in Q2. Credit expanded at its fastest pace since the Great Recession, providing a further boost to consumer spending.

Business investment rose 5.3% in Q2 against a year ago, driven by robust corporate spending on structures. Oil & gas investments, including construction of new rigs, increased 72.1%. Meanwhile, non-energy related investments in structures were up 3.0% year-on-year, due to strong growth in new office construction (+10.3%). Investment in machinery and equipment and R&D remained steady, up 3.6% and 4.0% respectively against a year ago. Looking ahead, the upward trend in corporate profits supports continued solid growth in capital spending.

Growth in new home construction has recently tapered. An average annualized 1.2 million homes were built in the three months ending June, only 0.8% higher than at the same period a year ago. Residential investments nonetheless grew 5.7% year-on-year in the second quarter mainly due to a 9.1% increase in the construction of more expensive single-family homes.

Our base case is for U.S. real GDP to expand by 2.5% in 2017 and 2018. This forecast does not factor in additional fiscal stimulus planned by the Trump administration. The proposal to significantly reduce the corporate tax rate from 35% can provide a meaningful lift to company earnings. Should tax reform, deregulation and/or infrastructure spending be implemented, the U.S. economy could grow more quickly.

Canada has experienced a more volatile growth trajectory compared with the United States. A sharp decline in oil prices resulted in a slump in growth during 2015, but the economy has since rebounded strongly. Real GDP expanded by 3.7% year-on-year in Q2, driven by a resurgence of oil & gas-related investments, a low currency and strength in consumer spending and housing.

Disposable income grew 5.3% in June against a year ago, lending solid support to household consumption. A rise in household net worth (+6.5%) and consumer credit (+5.6%) contributed to a boost in consumer spending in Q2. Retail sales growth accelerated, up 7.8% in July over the same period last year.

Business investment expanded for the first time in over two years, up 2.2% year-on-year in Q2. After-tax corporate profits rose 27.9% during the same period, suggesting that the pick-up in capital spending has further room to run. On the trade side, exports in goods and services were up 13.7% year-on year, supported by a rise in oil prices, while imports increased 8.9%. The trade balance improved from –C$66 billion in Q2 2016 to –$43 billion in Q2 2017.

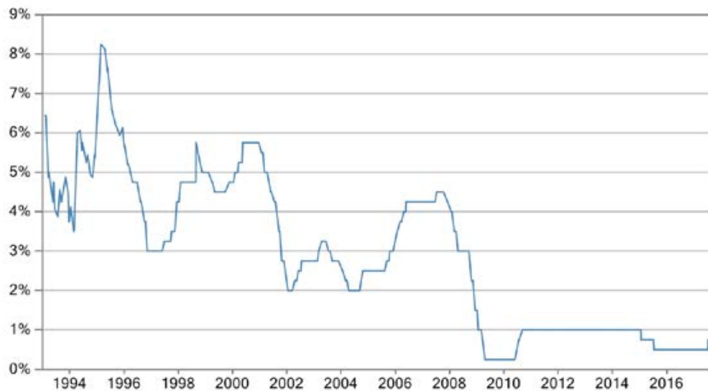
Canada’s housing sector grew 5.4% year-on-year in Q2. The Ontario government implemented new measures in April to cool the housing market in Toronto and this resulted in a sharp drop in home sales. The number of homes sold in the city declined 35% in the three months to August

against the same period last year. Across the country, however, the construction of new homes continued to rise. An annualized level of 219,000 new housing units was built in August, up 9.8% year-on-year. Nationwide, house prices increased 13.8% over the same period.

The strong performance of the Canadian economy pressured the Bank of Canada to raise the overnight target rate twice in the second quarter, from 0.5% to 1.0% (Chart 1). Gradually rising interest rates should curb the overheated housing market, not crush it.

Despite the hikes, monetary policy remains extremely stimulative. The Bank of Canada's target rate is only back to the level that prevailed from 2010 to early 2015. This is unlikely to derail the economy's cyclical upturn. Rising employment and wages reduce the likelihood of any forced selling in the housing market. As last reviewed in the June 2017 issue of our *Economic and Capital Markets Outlook*, Canada's banking sector is well capitalized and its mortgage loan exposure does not pose a systemic risk to the economy. Most risky mortgages are backed by the Canada Mortgage and Housing Corporation (CMHC), a government entity. The country's fiscal position is sound with low levels of debt and deficit.

Chart 1



Source: Bank of Canada

We forecast real GDP in Canada to expand by 2.5%-3.0% in 2017. Over the medium term, economic growth should moderate towards 2% as households temper their spending rate and the housing market's contribution to growth diminishes.

Economic activity is also accelerating in **Europe**. Eurozone real GDP was up 2.3% year-on-year in the second quarter, its fastest rate since 2010. Spain grew 3.1%, Germany 2.1%, France 1.8% and Italy 1.5%. Portugal and Greece, amongst the hardest hit during Europe's debt crisis, grew 2.9% and 0.8% respectively. We expect the Eurozone to expand by about 2.0% in 2017 and 2018. Meanwhile, the U.K. will experience softer growth of 1.7% in 2017 and 1.5% in 2018 as Brexit weighs on economic activity.

Elsewhere in the world, the IMF's projection for real GDP growth in **Japan** this year is 1.3% while **emerging economies** are seeing a sustained pickup in activity. For the region as a whole, growth is forecast to reach 4.6% in 2017 and 4.8% in 2018. The IMF expects real GDP to expand by 1.9% in Mexico, 6.7% in China and 7.2% in India. Following two years of contraction, the economies of Brazil and Russia are expected to grow in 2017 and 2018.

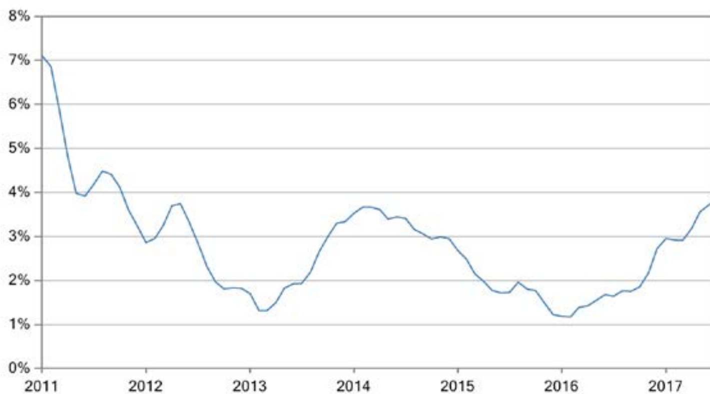
Overall, real GDP for the global economy is forecast to rise by 3.5% in 2017 and 3.6% in 2018, up from 3.2% in 2016.

Oil lags rally in other commodity prices

Global industrial production is in an upswing (Chart 2). Business investment is picking up in most advanced economies following a prolonged period of disappointing growth. Emerging economies are experiencing a solid expansion in both business and public infrastructure investment. These developments have boosted demand for industrial commodities, generating higher production and a rise in base metal prices. The price of copper ended the third quarter at $2.95/lb, up from $2.20/lb a year ago (+34%). During the same period, the price of iron ore rose by 34%, zinc, 25% and aluminum, 23%.

Chart 2

Global Industrial Production
(% YoY)



* 3-month moving average. Source: CPB Netherlands Bureau for Economic Policy Analysis

One notable exception to the commodity rally is oil. The price per barrel of WTI crude is roughly at the same level as last year. An analysis of oil market dynamics suggests that price pressures may soon begin to develop.

Global demand for oil has remained firm, growing on average 1.5 million barrels per day (mb/d) annually during 2009-2016. Total consumption of the commodity is now around 98 mb/d. Oil price weakness resulted from an excess of supply, not a dearth of demand. Between 2014-2016, an excess of 1.0 mb/d was produced on average. As lower oil prices forced companies to cut back on investments, production in non-OPEC countries, including the U.S., started to shrink. Supply pulled back further after OPEC countries agreed to a production cut in November 2016. (Table 1).

Table 1 – Global Crude Oil and Products: Demand, Supply and Inventories

mm bbl/day		Q4'14	Q1'15	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16	Q1'17	Q2'17	Q3'17E	Q4'17E
Demand		**93.8**	**93.8**	**94.4**	**95.9**	**95.6**	**95.3**	**95.6**	**96.7**	**96.8**	**96.5**	**97.9**	**98.2**	**98.7**
	OECD	46.3	46.6	45.6	46.9	46.5	46.7	46.0	47.3	47.4	46.7	46.2	47.2	47.2
	Non-OECD	47.6	47.2	48.8	49.0	49.2	48.7	49.6	49.4	49.4	49.8	51.7	51.0	51.5
Supply		**95.2**	**95.3**	**96.5**	**97.2**	**97.4**	**96.6**	**96.0**	**97.0**	**98.3**	**96.7**	**96.9**	**97.2**	**98.0**
	Non-OPEC	58.3	58.1	58.2	58.6	58.8	57.7	56.7	57.2	58.0	57.8	57.7	57.9	58.7
	OPEC NGLs	6.4	6.4	6.5	6.5	6.6	6.7	6.8	6.9	6.9	6.9	6.9	6.9	6.9
	OPEC Crude	30.5	30.8	31.8	32.1	32.0	32.3	32.5	32.9	33.4	32.1	32.3	32.4	32.4
Supply less Demand Balance		**1.4**	**1.5**	**2.1**	**1.3**	**1.8**	**1.3**	**0.4**	**0.3**	**1.5**	**0.2**	**-1.0**	**-1.0**	**-0.7**
OECD Industry Stocks, mm bbl		2,704	2,789	2,878	2,954	2,986	3,014	3,054	3,060	2,985	3,045	3,021	2,930	2,866

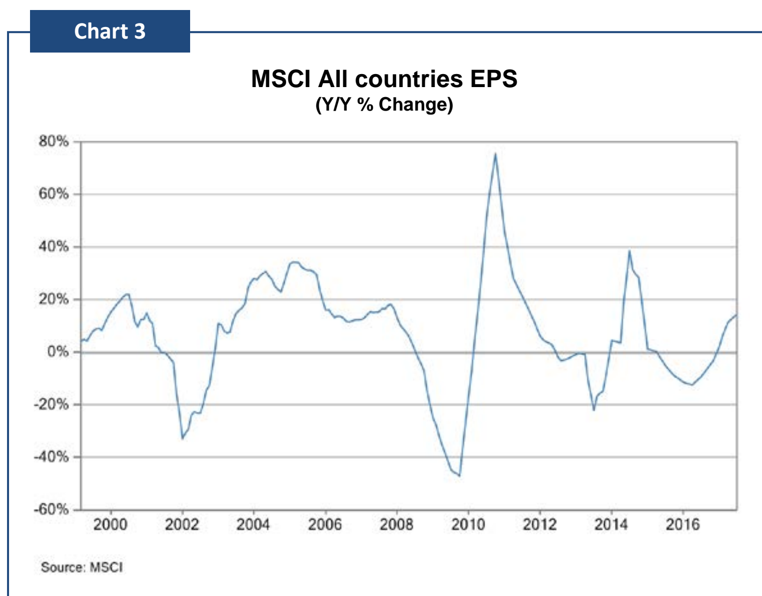
Source: IEA, EIA and LBA estimates

Global demand for oil currently outstrips supply and the market is drawing down on inventories to bridge the gap. We believe this imbalance will persist and begin to exert upward pressure on the price of oil. As demand for the commodity remains underpinned by global economic strength, new supply will be required both to satisfy increased demand and to offset the natural decline rate of existing oil wells. At current prices, however, oil producers are not incentivized to grow production. Based on project costs and financial constraints for 50 of the world's largest oil & gas

companies (representing 80% of non-OPEC production), we estimate that a price of close to $70/barrel, i.e. 40% higher than the current level, is required to stimulate new capital spending to increase supply. Our expected evolution of WTI oil prices is: $50/barrel in 2017, $60/barrel in 2018 and $70/barrel in 2019.

It is a stock picker's market

During the last couple of years, earnings slumped due to sluggish economic growth and the energy sector's weakness in the face of declining oil prices. Energy prices have since recovered from their trough and global economic growth is on an accelerating path. This has boosted earnings, providing another leg up in equity markets (Chart 3).



Despite the appreciation in the Canadian dollar, which rose by 8.5% year-to-date, the total return for the MSCI World (in C$) since the beginning of the year was 8.1%. Stock markets advanced in all major regions: the S&P 500 6.2%, S&P TSX 4.4%, DAX 15.8%, CAC-40 16.9%, FTSE-100 9.8%, the Nikkei 4.0% and the MSCI Emerging Markets 19.0%.

In the U.S., price/earnings multiples are currently at the higher end of fair value. The S&P 500 trades at 19.1x 2017 earnings, a level that is above its long term average of 15x. Other geographies trade at more reasonable levels. Using MSCI indices for comparability, Canada trades at 16.9x expected earnings, Europe 16.0x, Japan 14.4x and emerging markets 13.6x. Through a rigorous effort at stock selection and by diversifying across geographies and sectors, our equity portfolios are priced at a reasonable 14.1x estimated 2017 earnings and offer a 2.8% dividend yield.

While economic and market fundamentals are progressing in line with our forecasts, equity markets could be vulnerable to external events given higher valuations. Escalating geopolitical tensions with North Korea and rising trade protectionism are two such examples. Our response to such risks is to reduce exposure to companies that do not have as generous a cushion to absorb an unexpected shock. We have sold holdings where valuation levels saw a substantial increase. We are also focused on owning companies which are both attractively valued and offer dividend support. This discipline ensures that our portfolio remains reasonably priced while still offering good prospects for future appreciation.

Long-term bonds still an unattractive investment

Global bond yields climbed in the third quarter, most notably in Canada. The federal 10-year bond yield ended Q3 at 2.1%, up from 1.8% at the end of June and 1.7% at year-end 2016. The FTSE TMX Universe index recorded a loss of 1.3% in the quarter while 30-year federal bonds suffered a 6.1% loss. As economic activity continues to strengthen and price pressures pick up, central banks will continue to tighten monetary policy. Long-term bonds remain at risk of further price correction.

Despite the recent rise in yields, fixed income instruments still poorly compensate investors given interest and credit risks. Even when considering higher yielding bonds, the risk-return relationship favours equities. A recent bond issuance of Capital Power, an electricity producer with facilities in Canada and the U.S., illustrates this point.

On September 13th, the BBB(minus)-rated company issued a 7-year bond at 4.28%. Providing one of the highest yields available amongst Canadian investment grade corporate bonds, this offering met with strong investor demand. An investor placing $100 in this bond and holding it to maturity would earn 4.28% per annum.

While this may appear attractive, consider an alternative investment yielding the same return with a lower risk profile. Capital Power currently pays a 6% dividend yield that is well covered by stable cash flows, most of which are backed by long-term contracts. By investing $58 in Capital Power shares and balancing this risk by placing $42 in high quality provincial 3-year bonds yielding 1.95% (rolling them over at maturity), the investor also obtains an annual return of 4.28%.

Why would an investor choose this second option? Because if one has a favourable view of the company's prospects this same return is achieved with less risk and offers upside potential. First, it eliminates the interest rate risk given the short duration of the provincial bonds. Second, it lowers the credit risk as more than 40% of the portfolio's capital has been protected in government bonds. In the event of bankruptcy, the investor in Capital Power's bonds will have no such protection. In the more probable scenario where the company continues to increase profits, only the equity holder will benefit from an appreciation in the stock price over the period.

This example illustrates why we continue to favour carefully selected equities over bonds within balanced mandates while avoiding all exposure to long-term fixed income instruments.

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