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.

Contact us

Montreal Head Office

1800 McGill College Avenue
Suite 2510
Montreal, Quebec H3A 3J6
Tel: 514-499-1200
800-307-8557

Toronto Office

145 King Street West
Suite 2101
Toronto, Ontario M5H 1J8
Tel: 647-426-1987
800-307-8557

Calgary Office

Suite 800, 355-4th Avenue S.W.
Calgary, Alberta T2P 0J1
Tel: 587-350-1706
800-307-8557

Research

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Summary

- The global economy grew at its fastest rate in more than five years during 2017 as a synchronized expansion took hold across developed and developing economies. Global real GDP is expected to increase further in 2018, with projected growth of 3.9%.

- Tax cuts and deregulation are adding in stimulus at a time when the U.S. economy is experiencing a healthy expansion. We forecast U.S. real GDP growth of 2.5%-3.0% this year, with potential for upside from fiscal policy.

- Canadian economic growth is expected to moderate to 2.0%-2.5% in 2018, from 3.0% in 2017, as the housing market cools.

- The Eurozone economy is forecast to expand by 2.0%-2.5%, driven by job gains and consumer spending.

- Growth resumed in Brazil and Russia in 2017 after two years of contraction. Emerging market economies are expected to expand 4.9% in 2018.

- Despite a volatile start to the year, the investment landscape continues to favour equities. Earnings are growing and it is still possible to invest in reasonably-valued companies.

- Early signs of a pickup in inflation will put upward pressure on longer-dated bond yields. Long bonds are vulnerable to a significant price correction and should be avoided.

- With the global economy now in a more normal stage of the cycle, new imbalances are beginning to emerge. Low household saving rates, rising corporate debt and trade protectionism are some of the risks we see on the horizon. However, we do not expect these factors to trigger recession in the near term.

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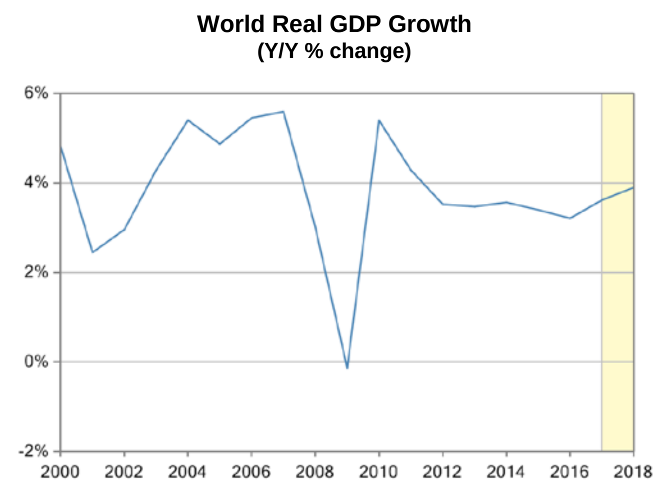
Global growth on an upswing

Global real GDP expanded by 3.7% in 2017, the fastest pace since 2011, on the back of synchronized growth in both developed and developing economies. Growth increased 2.3% across developed economies, compared with 1.7% in 2016. Emerging markets grew 4.7%, up from 4.4%, as Russia and Brazil emerged from recession and China and India remained buoyant.

The macroeconomic backdrop remains broadly positive. Interest rates and inflation are relatively low, household incomes continue to rise with healthy job creation, global manufacturing is in an upswing and business confidence is strong. Global real GDP is expected to expand by 3.9% in 2018.

Chart 1



Source: IMF. Shaded for forecast

In the **United States**, real GDP grew 2.3% in 2017, driven by consumer spending, business investment and housing. Households benefited from solid job gains and steady income growth. During the past 12 months to February, 2.3 million jobs were created and hourly wages rose 2.6%. The unemployment rate declined to 4.1%, the lowest since 2000. A continued increase in the labour force participation of the working age population could prompt further job and income growth.

Lower taxes should boost corporate earnings growth in 2018. We expect profits to reach $1.9 trillion this year, up from $1.7 trillion in 2017, of which $75 billion-$100 billion is due to the tax cut. The combination of strong profit growth, low cost of funds, high capacity utilization across many industries and a positive economic outlook suggests robust capital spending ahead.

Chart 2

Source: Statistics Canada

We forecast U.S. real GDP to expand 2.5%-3.0% in 2018. Growth could surprise to the upside given the high level of consumer confidence, rising household wealth and the likelihood of additional fiscal stimulus and deregulation.

Economic growth in **Canada** accelerated in 2017. Real GDP rose 2.9% in Q4, compared with 2.0% a year earlier. Employment remained strong, with 283,000 jobs added during the 12 months ended February. The nationwide unemployment rate reached its lowest level since comparable data became available in 1976 (Chart 2).

Domestic economic activity was robust. The headline manufacturing PMI stood at 55.6 in February, indicating strong momentum for the industrial sector. New home construction was up 10% and home prices rose 7.5% year-over-year in February. Given that construction activity is now above the fair level justified by household formation, we expect slower yet positive growth in housing.

Despite a weaker currency, the trade deficit increased to C$55 billion in Q4 from C$24 billion a year earlier. Canada has consistently run a trade deficit since the Great Recession of 2008-09. The balance of trade has deteriorated in most major industries, including consumer goods, motor vehicles and machinery. The only exception is the oil and gas industry, where net trade has remained positive and on an improving trend over the past decade. Looking ahead, the uncertainty surrounding NAFTA suggests that trade could continue to be a drag on growth in the short term.

We expect the Canadian economy to expand 2.0%-2.5% in 2018.

Europe continues to improve. Real GDP grew 2.7% in Q4 from a year earlier. For the Euro area as a whole, 2.4 million new jobs were created in the 12 months to September, while the unemployment rate fell to 8.6% in January, down from 9.6% a year ago. Disposable income grew 2.7% year-over-year in Q4, which fuelled a 6.3% increase in car sales and a 3.4% increase in sales of all other consumer goods. All major economies in the region are in an upswing and our 2018 real GDP growth forecast for the Eurozone is 2.0%-2.5%.

The **United Kingdom's** real GDP expanded by 1.4% in the fourth quarter, as continuing lack of clarity on Brexit is damaging business confidence. The British pound has fallen 20% against the euro since mid-2015. Inflation was up 3.0% in January from a year earlier, pressuring the Bank of England to consider raising interest rates. The IMF anticipates that the U.K. economy will grow 1.5% in 2018.

In **Japan**, real GDP expanded by 2.1% year-over-year in the fourth quarter, as businesses ramped up capital spending. The IMF recently increased its 2018 forecast for real GDP growth to 1.2% from 0.7%, in line with our expectations of 1.0%-1.5%.

Among **Emerging Markets**, the BRIC economies performed well last year. Brazil and Russia both returned to growth following two years of contraction. India's real GDP expanded 6.6**%** year-over-year, while China grew 6.9%.

Brazil's recovery was driven by consumer spending and business investment. Capital spending turned positive during Q4, growing 3.7% in real terms, the first annual expansion in 14 consecutive quarters. We anticipate real GDP growth of 1.5%-2.5% during 2018.

Russia's economy advanced 1.5% in real terms during 2017 as exports picked up due to higher energy prices. Inflation is expected to remain muted, real wages are rising and the central bank is likely to continue easing interest rates. The IMF 2018 forecast for real GDP growth is 1.7%.

Overall, emerging market economies are forecast to grow 4.9% in 2018, the highest rate of expansion in five years.

Risks on the horizon

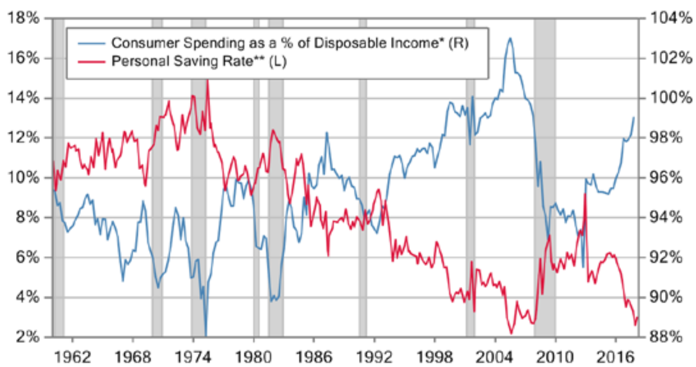
During the past decade, global economic imbalances have been addressed and, for the most part, corrected. U.S. households have reduced debt to 104% of income in 2017, from a peak of 132% in 2007. The U.S. deficit, which reached 9% of GDP in 2010, fell to 3.4% of GDP in 2017. In Europe, banks' leverage has been curtailed significantly. The asset-to-equity ratio across the Euro-area banking system declined to 12.5 times in 2017, compared with 18 times in 2008.

The global economy is now firmly in an upswing. U.S. GDP is expected to record its best nominal growth in 2018 since the Great Recession. This has led to higher stock prices and an upward trend in interest rates. With general optimism on the rise, we note that the ingredients are in place for a buildup of new excesses. Low household saving rates, rising corporate debt and trade protectionism are some of the factors that may trigger instability and ultimately recession. We believe a closer look at these risks is warranted.

The U.S. saving rate has declined to a 3-month average of 3.0%, near the lows prevailing before the 2008/09 recession. In addition, our measure of the consumer spending rate, which includes spending on new home construction, has risen from around 95% of disposable income to 99% during the past 3 years (Chart 3). Levels above 100% typically indicate that household finances are stretched.

Chart 3

Measures of U.S. Household Finances



* Spending on goods, services and residential construction
**3-month moving average
Source: Census Bureau, BEA, LBA; shaded for periods of recession

While the low saving rate is a concern, the medium-term outlook for U.S. consumer spending is still positive. Household wealth is reaching new highs on the back of rising home values and higher stock prices. New jobs are being created at a steady rate and wage growth is beginning to accelerate. As a result, we believe current consumption levels can be financed by incomes, without the need to dip further into savings.

Another area of risk is rising corporate-sector leverage. The ratio of debt-to-EBITDA (earnings before interest, taxes, depreciation and amortization) of U.S. non-financial corporations reached 4.3 times in Q3. While still below the peak of 5.1 times reached just before the tech bubble burst, corporate indebtedness has nonetheless risen steadily over the past decade, fuelled by ultra-low interest rates. It is worth noting that interest rates and credit spreads remain near all-time lows. As both rates and spreads normalize in the coming years, interest burdens will increase and highly leveraged companies in particular may struggle to refinance.

The U.S. government is also projected to increase borrowing in order to finance tax cuts and to cover future infrastructure spending. The deficit is expected to rise from $665 billion in 2017 to about $1 trillion in 2019, or about 5% of GDP. The stimulus is coming at a time when labour markets are tight and industrial production is robust. This will push up interest rates which, in turn, will put pressure on households and businesses. In the shorter term, however, the additional fiscal stimulus is likely to boost growth, which will partially offset the impact of rising rates.

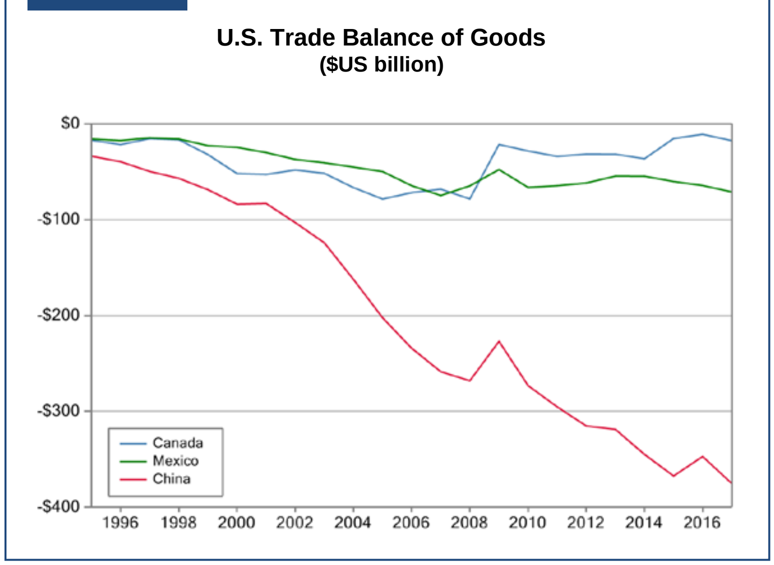
The emergence of these risks suggests we are entering the mature phase of the business cycle, although we are not yet close to recession. Indeed, recessions typically occur when the central bank attempts to rein in inflation and temper growth by raising interest rates sufficiently to tighten credit. This ultimately leads to a dampening of demand. It is our view that the economic cycle still has further room to run.

A nearer-term risk to contend with is the spillover effects of trade protectionism. The U.S. has announced measures to curtail imports, including the renegotiation NAFTA and the introduction of tariffs on imported steel and aluminum. Negotiations are also underway with respect to the potential introduction of tariffs on certain Chinese goods.

These protectionist measures are being introduced in part for political reasons. The U.S. administration is promoting tariffs on certain industries as a way to bring jobs back to the U.S., notwithstanding that the economy is already near full employment. Another objective is to reduce the total trade deficit, which stood at $572 billion or 3% of GDP in 2017.

The U.S. trade deficit is structural rather than cyclical in nature: it enjoys a net surplus in services but a large deficit in goods. U.S merchandise imports have far exceeded exports since the 1970s. Tearing up NAFTA would do little to change this dynamic. The U.S. deficit with Canada is $15 billion and its $70 billion deficit with Mexico is relatively minor when compared with the $375 billion deficit with China (Chart 4). While NAFTA remains at risk, we believe the three countries will eventually work out an agreement.

Chart 4



We also believe a compromise will eventually be reached with China as the harmful consequences of protectionism are well understood. Trade irritants in the form of inequality of tariffs and a chronically weak currency need to be addressed now that China is a major global player. For example, China imposes a 25% tariff on imported vehicles from the U.S. while the comparable American tariff is 2.5%. The U.S. is China's biggest market for its goods, and it is therefore in its interests to work out terms that restore more balance to the relationship. The U.S., for its part, has also benefited from greater trade integration. U.S. exports have increased by an average 5.7% per year over the past 25 years, well ahead of the 4.5% annual growth rate in U.S. nominal GDP during the period. Meanwhile, U.S. consumers have enjoyed cheap foreign goods while, in exchange, the country has provided global liquidity in U.S. dollars, the world's reserve currency.

Given the high degree of uncertainty surrounding protectionism and its ramifications, we continue to monitor developments on the trade front. At this stage, however, we do not believe the measures already announced will significantly impact our global growth forecast. The willingness of the different countries to negotiate is encouraging and should prevent an escalation of tensions.

Stock selection more important than ever

The S&P 500 Index was up 28% from year-end 2016 to its peak at end-January 2018. Following this rapid rise, valuations were pushed into rich territory and it is perhaps not surprising that stock markets have since experienced a partial pull-back. Notwithstanding the volatility during the quarter, the S&P 500 is still up 18% between end-December 2016 and end-March 2018 and all major markets remain in positive territory during this time period.

The pickup in global economic growth is creating strong demand for various goods and services. Corporate earnings, the fundamental driver of future equity returns, are expected to increase significantly in 2018. Earnings for companies in the MSCI World Index are forecast to rise 20.9% this year. Valuations across markets remain reasonable: the MSCI World Index P/E ratio based on estimated 2018 earnings is 15.5x.

While the ingredients are in place for a buildup of future economic imbalances, the current environment continues to favour equities. By focusing on fundamental analysis of companies and paying reasonable prices, we aim to select stocks that will provide attractive returns while avoiding significant risk.

Inflation worries increase long bond risk

Despite a positive employment and wage picture in both the U.S. and Canada, interest rates have remained stubbornly low since the beginning of the year. The yield on the 30-year Canada bond at end-March was 2.2%, broadly unchanged from Q4.

Tight labour markets and early signs of wage pressures suggest that inflation is on the rise. This will put significant downward pressure on bond prices, especially those with longer maturities. The downside risk is even greater if additional trade restrictions are implemented, as this will make imported goods more expensive, heightening the threat of inflation.

Overall, we continue to favour capital preservation among fixed-income investments and remain confident that a portfolio of carefully selected stocks will outperform both cash and bonds over the medium term.

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