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

December 2017

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 global economy is gaining momentum, driven by improving economic activity in developed markets and strong and steady growth in emerging economies.
- Low levels of interest rates and inflation are supporting global economic conditions. The next recession is likely several years away.
- Our 2018 forecast for U.S. real GDP growth is 2.5%. There is potential for upside to this scenario from tax cuts and deregulation.
- Following Canada's strong performance in 2017, the economy is expected to moderate to 2.0%-2.5% in 2018 on the back of a cooling housing market.
- A broad-based improvement in domestic demand and corporate profits will support growth of 2.0%-2.5% in the Eurozone in 2018.
- Brazil and Russia have emerged from recession buoyed, in part, by rising commodity prices. Growth in emerging markets is forecast to expand by 4.9% in 2018, its fastest rate in five years.
- Global equity indices are reaching new highs, supported by upbeat earnings forecasts, but valuations are stretched in some key sectors of the market. Tax cuts will provide a profit boost to U.S. domestically-focused companies including the telecom, financial and retail industries.
- Major global central banks have started normalizing monetary policy. As policy rates rise further in 2018, long-term bonds are increasingly vulnerable to a correction.

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Global macro backdrop remains favourable

Low interest rates and subdued inflation have provided an accommodative backdrop consistent with a long economic cycle. Improving economic conditions are boosting expectations for corporate profit growth and financing conditions are excellent. In most developed economies, the spread between government and corporate bonds is the tightest in more than a decade. U.S. companies are experiencing the lowest cost of funds since the 1950s (Chart 1).

Chart 1

U.S. Corporate BBB Average Yield

Source: Moody's

The resulting positive effect from this global phenomenon has contributed to synchronizing growth across countries. A lower cost of funds and improved profits has set the stage for increased wages and investment, both of which support economic growth and a further rise in profits in a virtuous cycle. The global economy is picking up and the risk of recession remains low.

In the **United States**, real GDP growth rose 2.3% year-on-year in the third quarter. After-tax corporate profits increased by 7.7% year-on-year, which pushed capital spending up 6.0% over the same period. Meanwhile, consumer spending was solid, expanding by 4.1% year-over-year, driven by strong employment, moderate wage growth and record high household net worth.

While the saving rate drifted lower in the past year, hitting 2.9% in November, continued gains in jobs and wages should support consumption at current levels going forward. Business investment and housing are likely to remain robust. In addition to increased profits and favourable financial conditions, tightening capacity utilization will encourage capital spending in 2018. Total industry plant utilization has risen over the last two years and is reaching levels consistent with new investment. We expect business investment to expand by 6.0% in the year ahead.

On the housing front, affordable mortgage rates, rising home prices and the lowest residential vacancy rate in almost two decades will support the construction of new homes. We expect housing starts to increase towards 1.3-1.4 million units in 2018. There is upside to this scenario given pent-up demand from first-time homebuyers in the 20-35 year age group.

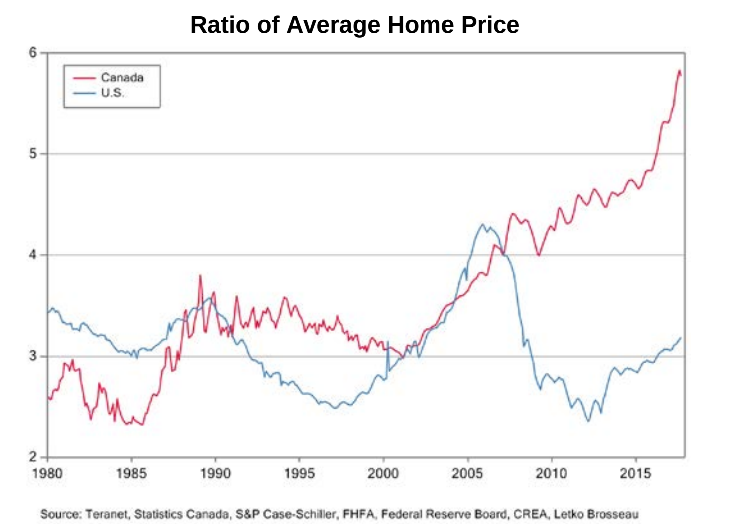
Our base case outlook is for U.S. real GDP to expand by 2.5% in 2018. Growth could pick up to 3.0% given tax cuts and continued deregulation. Uncertainty surrounding global trade policy remains a risk to our outlook, but NAFTA negotiations are likely to take some time and should not significantly impact growth in the year ahead.

Canada is also enjoying favourable economic conditions and low inflation. Real GDP growth was 3.0% year-on-year in the third quarter. While the economy was driven primarily by consumers, future growth is likely to be propelled by capital spending. Corporate profits expanded by 11.5%

year-on-year, an increase that was widespread across industries. Capacity utilization is relatively high at 85%, suggesting a pick-up in spending on plant and equipment.

Housing is expected to cool as affordability is increasingly becoming an issue. The ratio of home prices to disposable income reached 5.8x, up from 5.3x at the end of 2016 (Chart 2). This compares with 3.2x for U.S. households. Meanwhile, household debt to disposable income climbed to a new high of 175% despite a solid increase in personal incomes, which were up 3.7% year-on-year in Q3.

Chart 2



As the Canadian economy gradually pivots away from housing we forecast that real GDP will moderate to 2.0%-2.5% in 2018.

Growth in **Europe** is accelerating. Real GDP increased 2.6% year-on-year in Q3 as Spain expanded by 3.1%, Germany 2.8%, Portugal 2.5%, France 2.3% and Italy 1.7%. A combination of higher employment and moderate wage growth led to a 2.8% year-on-year rise in disposable income in Q2, which supported a solid pick-up in consumer spending. Housing (+7.0%) and business investment (+5.2%) were also strong contributors to economic growth.

Looking ahead, significant pent-up demand should support growth in the region for years to come. Despite impressive gains in the jobs front, the unemployment rate is still relatively elevated at 8.8%. Credit growth turned positive in France and Germany, but is still contracting in Spain, Italy and Portugal. Further normalization in both areas should provide an additional boost to economic activity.

We forecast real GDP growth in the Eurozone to increase to 2.0%-2.5% in 2018.

In contrast, prospects for growth in the **United Kingdom** are soft due to the overhang of uncertainty related to Brexit. The pound has depreciated 21% against the U.S. dollar from its peak in mid-2014 and this has fuelled inflation. The consumer price index was up 3.2% in November, one of the highest levels amongst developed markets.

The U.K.'s protracted negotiations on its exit from the European Union has hurt business confidence and dampened economic activity. Real GDP expanded by 1.7% in Q3, down from 1.8% in 2016 and 2.3% in 2015. Brexit talks are likely to take time, which will continue to hamper confidence in the medium term. The IMF forecasts that growth in 2018 will stabilize at current levels (+1.5%).

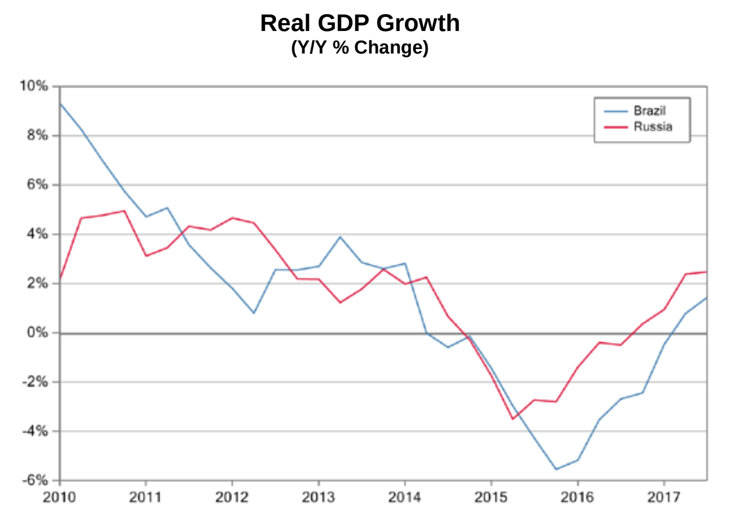
Real GDP growth in **Japan** expanded by 2.1% year-on-year in Q3, up from 0.9% in 2016. Corporate profits jumped 5.5% year-over-year in Q3 and this led to a rise in business investment. Capital spending increased 5.2% against a year ago in Q3.

We believe the IMF's 2018 forecast of 0.7% real GDP growth understates the momentum in Japan's economy. Our forecast calls for growth in the range of 1.0%-1.5%.

Growth in **Emerging Markets** is strengthening. Chinese real GDP grew 6.8% year-on-year in Q3 and India was up 6.3%. The economies of Brazil and Russia have troughed and are projected to continue to improve.

Brazil emerged from its worst recession on record in Q1 2017. Since then, growth has been steadily firming. In Q3, real GDP was up 1.4% year-on-year, driven by a 2.2% increase in consumer spending. With a record low central bank policy rate of 7%, rising real wages, improving credit conditions and a gradual recovery in the labour market underway, the economy is primed for a consumption-fueled expansion. In Russia, real GDP growth turned positive in Q4 2016 and continued to accelerate in 2017 on the back of an oil price rebound (Chart 3).

Chart 3



Growth in emerging markets is expected to expand by 4.9% in 2018, its fastest pace in five years. Given a broad-based upswing in developed economies, we forecast that global real GDP will rise by 3.7% in 2018.

Reasonable stock valuations vs. animal spirits

Global financial markets were up strongly during 2017. Over the past twelve months, the total return (in C$) for the S&P 500 was +13.8%, S&P TSX +9.1%, DAX +24.0%, FTSE-100 +14.3%, the Nikkei +17.0% and the MSCI Emerging Markets Index +28.1%.

While the stock market's performance was underpinned by improving economic activity and profit growth, valuations in some key sectors are becoming stretched. In the U.S., a small number of stocks, known collectively as the "FANGs" or "FAAMGs" (Facebook, Apple, Amazon, Netflix, Google and Microsoft) have dominated the S&P 500 Index's return. These 6 stocks – among the U.S. index's 500 companies – represent 13% of the market's value and accounted for 23.4% of its total return during the past year (as of October 31, 2017).

With the possible exception of Apple, the FANG/FAAMG stocks are trading at expensive valuations somewhat reminiscent of the 1997-2000 tech bubble. Amazon, for example, is priced at 192x estimated 2018 earnings. So-called 'animal spirits' are also driving the demand for Bitcoin, a digital currency that has seen its value rise by 18 times since the beginning of the year.

Despite such examples of market excess, it is still possible to invest in a diversified portfolio of companies at attractive valuations with good prospects for appreciation. Our equity portfolio trades at a very reasonable 13x forward earnings and offers a 3% dividend yield. In addition, our holdings in the U.S. include domestically-focused companies in the telecommunications, financial and retail industries, where valuations are in line with historical averages and tax cuts are likely to provide a substantial boost to profits.

We believe that developing a sound understanding of companies and, importantly, investing when they trade at a discount to their fair intrinsic value, remains the surest way to capture value over longer horizons.

Bond buyers beware: inflation pressures subdued but building

Major global central banks have begun to normalize monetary policy in recognition of improving economic conditions. In December, the U.S. Federal Reserve raised the Fed funds rate for the fifth time since 2015 to a range of 1.25%-1.50% and is widely expected to hike rates further in 2018. The Bank of Canada is expected to follow suit in the New Year, following two rate hikes in 2017. In Europe, the ECB announced that starting January 1st it would reduce the pace of its monthly asset purchase program from €60bn to €30bn until the end of September 2018.

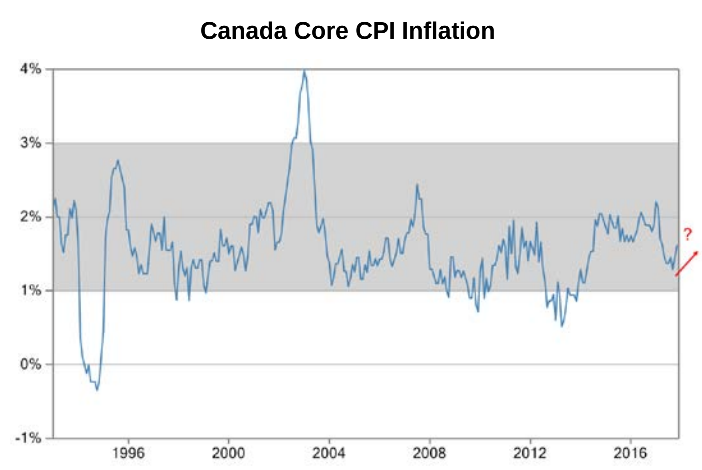
Given the long lags between policy tightening and its impact on economic conditions, global central banks are embarking on a gradual withdrawal of liquidity from the financial system despite subdued inflation readings. The Fed's preferred measure of inflation – the personal consumption expenditure deflator excluding food and energy – is currently 1.5%. The consumer price index excluding food and energy pegs inflation at 1.6% in Canada (Chart 4) and 0.9% in the Eurozone.

As short rates have risen in the absence of clear evidence of inflation, the yield curve in both Canada and the U.S. has flattened. The spread between the 2- and 30-year Canadian government bond yield narrowed from 1.6% at the beginning of the year to only 0.6% at year-end. The 10-year bond yield ended the year at 2.0% in Canada and 2.4% in the U.S.

Strong jobs growth, wage gains, tighter industrial capacity and rising commodity prices are sowing the seeds for a pick-up in inflation in 2018. As central banks continue to tighten policy, yields will be pressured upwards across the entire yield curve. In this context, long-term bonds, which are more sensitive to fluctuations in interest rates, are increasingly vulnerable to a correction.

We continue to hold bonds with a very short duration and favour stocks over bonds within balanced mandates.

Chart 4



Source: Statistics Canada
Note: The Bank of Canada aims to keep inflation at the 2% midpoint of an inflation-control target range of 1-3%

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