Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

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The fear of nationalization that plagued the banking industry now appears to have subsided. As explained in our March 10th letter, we were of the opinion that the large trading losses experienced in the fourth quarter by the major U.S. banks probably resulted from deleveraging under adverse market conditions and were unlikely to be repeated in the first quarter of this year. Furthermore, while loan books may continue to deteriorate given that the economy has remained weak, banks have already set aside substantial reserves which will make dealing with further losses more manageable. We were encouraged by the government's initial announcements in February to stabilize the financial system. Subsequent positive reports from the CEOs of Bank of America and Citigroup, among others, indicating profitability from underlying operations was improving appeared to confirm that bank nationalization is neither the desired nor likely outcome.

Uncertainty regarding global economic growth remains, however, and the main question is: how long will the recession last and how painful will the adjustment towards recovery be. In this note, we would like to revisit in more detail the economic forecast published earlier this year. In particular, we address three main issues: the path of adjustments in U.S. consumer spending, U.S. economic scenarios for 2009 – 2011 and further risks to the global economy.

Looking at the economic developments that occurred over the past nine months, the pace of adjustment in U.S. consumer spending has been breathtakingly fast. As we try to quantify the factors that created this and take stock of multiple government interventions that took place in the past months, we come out cautiously optimistic. As explained below, our base case scenario is still for nominal and real GDP to be roughly flat in 2009 and medium-term growth to range from 1%-3%, well below the 3%-5% rate which prevailed between 2001 and 2007. Considering this outlook, and our views on corporate profits and interest rates, we continue to believe that stock market returns will be greater than bond returns over the medium term.

Letko, Brosseau & Associates

1800 McGill College Avenue
Suite 2510
Montreal, Quebec H3A 3J6

Telephone : 514-499-1200
800-307-8557

130 Adelaide Street West
Suite 3200
Toronto, Ontario M5H 3P5

Telephone : 647-426-1987
800-307-8557

U.S. Economy Revisited

Although the U.S. economy only began to contract in the fourth quarter of 2008, shrinking by 0.8% on a year-over-year basis, the National Bureau of Economic Research has determined that December 2007 marks the official beginning of the current recession. The U.S. has experienced 32 recessions since the Civil War, with the average contraction lasting 17 months. More recently, however, downturns have been milder: for the 10 recessions since World War II, the average duration was 10 months.

As of the first quarter 2009, the U.S. has technically been in recession for 15 months and current data do not yet suggest a recovery is underway. To assess a recession, both production and employment must be in a contraction phase. As of February, industrial production is down 12.2% compared to last year's level and has declined for 13 consecutive months while orders for manufactured goods are down by 20% YoY. Employment has also contracted since December 2007, with levels down 3.2% since the peak and a total cumulative loss of 4.4 million jobs. Both these indicators are coincident with the economic cycle and it is fair to say that their direction over the next few months points to continued weakness. By this measure, the current recession is expected to last longer than the worst experienced during the Post-WW II cycle (1981-82 recession which lasted 16 months) but remain shorter than the average recession cycle of the Pre-WW II period (21 months).

There are tentative signs of stabilization in the U.S. economy, albeit at a low level. Retail sales of many goods have held steady over the past four months and even sales of clothing and electronics were up slightly over the course of the past three months, rising by 3.0%. Home starts and sales appear to have leveled off at 550,000 and 5,000,000 respectively. Durable goods orders were $165 billion, also flat over the past three months. In addition, many large sectors of the economy are naturally stable, such as government and health care spending, which represent 21% and 15% of U.S. GDP respectively. In the coming year, government spending will grow even faster, by 10%, given the significant stimulus package enacted.

Looking ahead, the main risk to the U.S. economy remains the path of adjustment in consumer spending, which represents around three-quarters of economic activity. If consumers remain more unwilling to spend or creditors remain reluctant to lend to consumers, the recovery will be pushed further out. It is therefore essential to look deeper into the factors which may impact consumer spending and saving over both the short-term and long-term horizon.

As noted in our previous letters, consumer spending was the main engine of growth for the U.S. economy in the last decade. From 2001 to 2007, personal consumption and residential investment accounted for more than 75% of the growth in GDP. During the same period, consumer spending increased by $2,655 billion while disposable income increased by $2,684 billion. So all additional income earned during this period was spent and consequently, the savings rate moved from 1.8% to 0%.

Our preferred measure of consumer expenditures includes both personal spending and residential investment as a proxy for spending on housing. Shown as a share of disposable income, this ratio moved from 95% in 1995 to 103% in 2001 before peaking above 106% in 2006. This behaviour was mainly driven by two factors. First, interest rates were low for both mortgages and consumer loans, enticing consumers to borrow for durables and real estate purchases. Second, a large appreciation in the prices of real estate and financial assets occurred. Net worth to disposable income moved from 550% in 2001 to 630% in 2007, even in the absence of savings. So long as consumers "felt" wealthier, they did not seem to mind a low savings rate.

It had been our view that the historically high ratio of total spending to income was unsustainable and consumers would eventually adjust this downward. If done gradually over a period of time, we believed that this would lead to a lower economic growth than the 3%-5% rate enjoyed during the last decade. This ratio initially began to correct in 2007, declining to 104% in mid-2008 as a housing recession led to sharply lower residential investment.

However, following the freezing of the credit market in the fourth quarter of 2008 which was accompanied by sharp declines in equity markets and a curtailment of business activities, consumers began to quickly adjust their spending behaviour. The ratio of total spending to income fell to 98.5% in February 2009 and the savings rate rose concurrently to 4.2%. In past recessions since the Second World War, an adjustment of this magnitude usually occurred over a 2-4 year period. This time, it occurred in just 7 months. Such a dramatic change in consumer behaviour has had a destabilizing effect on the U.S. economy and this has shown up in the form of a 1.6% decline in nominal GDP growth in Q4 compared with the previous quarter.

In order to assess the likely path of this recession, it is important to understand the nature of the adjustment in consumer spending/saving patterns. Consumers can either cut back spending voluntarily as a temporary response to increasing job uncertainty and a desire to reduce debt burdens and increase savings. Or the spending cuts may be involuntary in nature and brought about by a lack of credit or a loss of employment. To assess these developments, we need to look at trends in household balance sheets, employment markets and the impact of an aging population on spending patterns. We also need to assess the various government measures which have been enacted to unblock the dysfunctional sectors of the credit markets.

As noted above, U.S. households expanded mortgage debt as personal spending increased and this was made possible through low interest rates and rising home values. Consequently, at the end of 2007, the households' equity share in their homes was 49%. With home prices down by between 10%-17% (according to different price indicators), owners' equity fell to 43% of home values at the end of 2008. Excluding mortgage-free homes, we estimate that homeowners' equity ranged from 11%-16% at the end of 2008, with around 20% of households owing more than their house is worth. Mortgage delinquencies and defaults have therefore begun to rise, with delinquency rates at 5.1% on prime mortgages and 21.9% on subprime mortgages, compared with 2.6% and 13.3% respectively at end-2006.

The impact of tighter lending standards and the inability of homeowners to borrow further against their houses would suggest that one important support to consumer spending has disappeared. However, the U.S. government announced in March two programs to help homeowners who are either facing difficulties in meeting their mortgage payments or no longer qualify to refinance their mortgages. It is estimated that these programs may help up to 45% of households.

Furthermore, mortgage rates have fallen by over 1.5% to around 4.75% in the last 6 months and this should prompt homeowners to refinance mortgages, lower their interest payments and put more money into their pockets. Early data from the Mortgage Bankers' Association show that refinancing did increase in February and March as the refinancing index moved from 2750 in the 4th quarter to 4450 in the 1st quarter of 2009. We estimate that the potential impact of the government housing program and lower mortgage costs could translate into annual savings of up to $100 billion. While home prices may have further room to fall as the housing market adjusts to still high levels of unsold homes, home affordability indicators are at all time highs and tentative data suggests that first time homebuyers have begun to venture into the housing market.

Another common argument for lower consumer spending this year and next is that consumers will be more prudent and opt to pay down mortgage, credit card and auto debt rather than spend. At year-end 2008, 14% of disposable income was needed to cover debt service payments, compared with 13.1% in 2001 and 11.8% in 1991. For consumers to reduce debt service costs to a level below the one that prevailed in 2001, we assume that: 1) households will use part of their savings to repay credit card and car loan debt and 2) households will take advantage of the historically low mortgage rates and government programs to refinance into lower interest rate mortgages. This would be possible within twelve months if the savings rate remains near current levels of around 4-5%.

Looking at the employment situation, the pace of job losses continues to be high as more than 600,000 jobs were lost in January, February and March and the unemployment rate has risen to 8.5%. We assume that a further 1.5 million jobs will be lost in the next year bringing the unemployment rate close to 10%. This development is consistent with growth in disposable income of around 2%, principally as a result of higher government transfer payments and lower taxes. Although below income growth experienced in recent years, it still represents approximately $200 billion of additional spending power available to consumers.

In addition to the U.S. government's plan for mortgages, the Federal Reserve is also working aggressively to ease other credit conditions for households. To that end, the Federal Reserve created the Term Asset-Backed Securities Loan Facility (TALF). This facility will be used to restart the securitization process for new loans and will target credit card receivables, car loans, student loans and small business loans. Although started only recently, we think this program will help significantly given its size of up to $1 trillion once fully operational. This compares to household debt outstanding which, excluding mortgages, was $2.6 trillion at year-end.

Finally, some economic forecasters have pointed to the changing demographic profile of the U.S. population as a main reason that economic growth is unlikely to return to trend levels experienced in the last decade. The baby boom generation was born in the 20 years following the end of WW II and with age ranges from 45-63; this group is now approaching retirement. It is often argued that this demographic group, which accounts for the largest slice of the U.S. population at 28%, will increase their savings rate during their last years of paid work particularly as their net worth took a large hit over the course of the past 18 months.

In the short term, it is difficult to forecast how demographics will influence the economic recovery but it will likely play a more important longer-term role. During the next ten years, the expected growth in the population aged 20 to 65 will be 0.5% annually, compared to a growth rate of 1.2% in the past decade. Also, spending patterns may change as retirees typically consume fewer durable goods but more leisure and health related services.

When we developed our U.S. economic scenario for 2009 earlier this year, we worked through a set of assumptions on labour markets, incomes and savings rates as the main variables driving the U.S. economy. Reviewing the factors above, our base case scenario assumes that government attempts to stimulate will work and that the worst of the consumer spending adjustment has occurred. In this case, we use a savings rate of 5%, an unemployment level of around 10% and disposable income growth of 2%. Additionally, households will have greater spending power due to lower oil prices ($160 billion) and lower mortgage payments ($25 billion). Under these assumptions, nominal GDP will be stagnant in 2009. Real GDP growth should be similar given little if any inflation. Going forward beyond 2009, the U.S. will likely experience slow growth as the government scales back its presence and the private sector regains its footing and starts to grow again.

A more pessimistic scenario assumes a sharper consumer spending adjustment as either credit remains tight or consumers voluntarily change their behaviour, implying an increase in the savings rate to 8%. This scenario is more consistent with a nominal GDP contraction of 2% to 3% in 2009 and suggests a sharper rebound in 2010 and beyond.

Prospects for Global Growth

Slower U.S. consumer spending will have a large impact on global economies. U.S. GDP totals $14.3 trillion representing about 30% of global GDP. Accordingly, U.S. personal consumption and residential investment account for 22% of world GDP. Between 2007 and mid-2008, most of the adjustment in U.S. household spending occurred through lower residential investment which had little impact on the rest of the world. As personal consumption, especially for durable goods such as autos started to contract in the U.S., this began to show up as a cutback in imports from foreign countries.

During the three months to January, U.S. imports excluding petroleum were down 11.2% compared to the same period last year. This has created ripple effects throughout the supply chain of exporting countries, mostly located in Asia but also in Europe, and we have seen economic growth in these countries contract. Our base case scenario is a gradual upturn in the U.S. followed by a period of more moderate economic growth. Exporters of capital goods, such as Japan, Korea and Germany, will see a very slow recovery due to excess worldwide industrial capacity. Exporters of consumer goods and commodities should follow the path of the U.S. economy, although recovery will also hinge on levels of local demand. The IMF forecasts world output to expand by 2.2% in 2009, with emerging markets growing by 5.1%. It should be noted that this forecast was published in November 2008 and does not factor in the extensive global fiscal stimulus and monetary easing which has occurred since then.

Fixed Income Market

During the past three months, the U.S. yield curve shifted up from the historical lows reached at the end of 2008. A more dramatic development has been the increasingly aggressive actions taken by the Federal Reserve. Short-term interest rates were driven to near zero in December 2008 and recently the Fed announced its plan to buy government bonds in order to prevent an increase in longer term interest rates. Such a strategy known as "quantitative easing" was also adopted by the Bank of England and marks the first time since World War II that the Federal Reserve has made direct purchases of U.S. government debt.

The Fed is also buying significant amounts of mortgage-backed securities to effectively control the spread between mortgage rates and thirty year government bonds. We have seen similar announcements across the world as central banks get more involved in fixed income markets.

In this environment, we continue to be prudent yet opportunistic in the management of bond portfolios. The average duration of our portfolios is shorter than the benchmark and we continue to take advantage of the large spreads offered on fixed income securities of high quality issuers, mostly provincial governments but also a few corporations. One factor we continue to monitor closely is inflation. For the near term, inflation is most likely to stay at subdued levels given the high level of slack capacity that exists in North America and across the world. Longer term, given the large amount of monetary stimulus in progress, inflation is a likely threat. Central Banks and governments will need to be disciplined when removing their stimulative policies once growth restarts.

The Equity Markets

The annual rate of U.S. corporate profits peaked at $1.7 trillion in Q3 2006. Profits generated in Q4 2008 were estimated at $1.3 trillion, a drop of 26% from the peak. Most of this decline occurred during the second half of 2008. The sharp contraction of economic activity had an immediate negative impact on profits as firms did not have time to adjust their cost structure to lower demand levels. Businesses have since begun to make these adjustments and the rate of decline in corporate profits is likely to moderate.

Turning specifically to S&P 500 operating profits, these fell 27% from $84.56 per share in 2007 to $61.85 per share in 2008. Particularly hard hit were financials which represented 27% of total profits and fell into an overall loss position. We expect a considerable recovery from these companies as major mark to market effects end and trading losses are neutralized or reversed. Energy producers will experience significant declines given lower oil prices as will other materials producers such as the chemical industry. Overall we expect aggregate S&P 500 profits to be very weak in the early part of the year but improve throughout 2009 and return to the same level as 2008 for the year as a whole. The following year should begin to see more uniform improvement from these depressed levels and we would expect to see operating earnings rise at least 10% in 2010 to about $70 or better. This suggests the S&P 500 is currently priced at a P/E multiple of 13.8x 2009 estimates and 12.3x 2010 levels.

Over the next 5 years we believe earnings should continue their recovery and a long term profit outlook of $96-105 would not be unrealistic. At a valuation range of between 12-16x earnings, the S&P 500 might be expected to trade between 1150 and 1550. Given the current dividend yield of 3.3%, these ranges represent a total return potential of 9% to 16% or an average expected return of 12.5% for the broad averages.

Conclusion

Although it may be too soon to conclude that economic activity has bottomed in the U.S., some indicators point towards more stable conditions. Various factors which have disrupted the credit markets have and continue to be aggressively attacked by the U.S. and other governments. Borrowing rates have been lowered, mortgages restructured, and plentiful new capital provided under the TALF program to banks and near banks. In addition, old fashioned spending for infrastructure and other targeted programs add up to massive stimulus which will be available this year and next.

Consumer behaviour is critical as to how the economy may perform in the months and years ahead. To date the increase in savings has occurred quickly but has adjusted to a reasonable level. Consumers have become more cautious but do not appear to have been overly traumatized. Should their response continue to generate a personal savings rate in the 4-5% range the economy should steady and return to a growth path albeit at rates that will be lower than those of the last 15 years. A higher savings rate cannot be dismissed and this would result in a prolonged period of sluggish activity in the U.S. As we transition through this difficult period we are impressed with how both consumers and the government have responded and as a result we lean towards a scenario that calls for stabilizing forces to prevail and modest growth to return later this year and next.

Given the severe decline in share prices over the last year and the contraction in corporate profits, equity prices have adjusted to valuation levels which are quite reasonable. We therefore favour stocks over bonds and endeavour to move portfolios to their targeted equity levels. We favour high quality companies operating in more stable economic sectors that offer current yield and are available at reasonable valuations.

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