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Dear Clients of Letko Brosseau

The collapse of share prices preceded by the events of the last weeks in the financial world has been breathtaking and unpleasant. We have seen two of the largest entities serving the U.S. residential mortgage market, one of the largest insurance companies in the world (AIG) and the second major investment dealer fail in less than six months. This was followed by the bankruptcy of one of the largest savings and loan companies in the U.S.

Our world today is based on a money economy and essential to it is an efficient financial system. The banks must work and savers must have confidence that the system will work. Governments and central banks are showing they understand this, as evidenced by their actions in dealing with the problems we face today.

Do central banks have the tools to correct the problems? Yes they do and we are witnessing their use today. First, central banks are providing large amounts of liquidity into the banking system worldwide. This comes in many forms, direct deposits by central banks, acceptance of various forms of collateral for loans including securities not usually taken, and outright purchases of various securities from the banking system. These are tools that work to provide liquidity and may replace deposits that flee one bank in favour of another. Recently, the Federal Reserve said it will double to $900 billion its auctions of cash to banks in the near term. Similar steps are being taken by other central banks.

Governments and central banks are also showing they understand the importance of assuring the safety of depositors' funds. In the U.S., commercial banks that appear unable to survive are being merged into larger institutions with the help of the Federal Deposit Insurance Corporation (FDIC). Deposit insurance has been increased to $250,000 from $100,000.

Europeans have taken another approach, preferring to have governments inject some form and degree of equity into banks as announced in the U.K. on October 9th. In addition, governments in Ireland, Germany and Austria have announced the state will guarantee bank deposits.

We believe central bank authorities are taking correct measures to steady the banking system and this will work. At the moment we are in the midst of this crisis, it may take some time for their efforts to take effect. As these funds are made available, credit markets will stabilize and this will return confidence to equity markets as well.

Today, interest rates on corporate credit have risen to very attractive levels compared to government securities and share prices have fallen to valuations that represent excellent value. Global economic growth will slow in the short term but will not be derailed. There is no shortage of demand in the world and we believe the global economy is working well.

The events of recent weeks and in fact the last year in the financial markets have been distressing. At a time like this we believe it is most important to try to understand what forces are driving these events and how to manage through them. There are two tracks we will follow. First we try to explain what is behind the recent drop in financial markets and second we review what impact these events could have on the economy.

While this saga of troubled financial markets dates back about one year, the month of September was a whirlwind of drama.

- On September 7, Fannie Mae and Freddie Mac were placed under government protection. These two government sponsored entities together held or insured approximately 45% of all residential mortgages outstanding in the United States.

- The following week on September 15, Lehman Brothers filed for bankruptcy making this the largest ever in the U.S. Coincidently, Bank of America announced the acquisition of Merrill Lynch, America's best known brokerage franchise.

- Within days AIG, one the country's largest insurers, was bailed out by the federal government. While this company's insurance businesses which operated worldwide appeared to be sound, credit default insurance written by the company was stressed by the Lehman bankruptcy and related market concerns sending credit spreads sharply higher. This in turn required more capital which could not be raised easily given market conditions.

- On September 25, Washington Mutual, the 6^{th} largest deposit taking entity was shepherded into the hands of J.P. Morgan with the help of the FDIC.

- Within a week Wachovia the nation's 4^{th} largest bank was the subject of a takeover bid by Citigroup with the help of a massive insurance policy provided by the FDIC. Within days Wells Fargo topped the offer.

- Finally after a week of high drama Congress passed a $700 billion program to purchase distressed mortgage assets from the banking system.

It may be difficult to point to any one of these events as they all played a role in setting the stage, we believe the Lehman Brothers failure triggered a freeze in the commercial paper (CP) market which radiated into bond and stock markets. This market for short term borrowings had been under pressure since the sub-prime crisis began in mid-2007. It had shrunk from $2.2 trillion as of June 2007 to $1.8 trillion at the end of August 2008. In the wake of losses on Lehman Brothers, commercial paper spreads rose in this market causing widespread declines in price.

Buyers of CP are quite diverse but money market mutual funds have played an active role holding over 40%. Money market mutual funds advertise liquidity and security. Losses in Lehman and the marking of holdings to market values made it difficult for funds to redeem units as is customary at par value. The result has been a withdrawal from the CP market in preference for T-Bills and bank deposits where no losses might occur. The consequence was a rapid shift of about $200 billion away from CP, leaving many large companies unable to access this credit as was their custom. Corporations have instead had to turn to their banks and draw on lines of credit. Where such lines have fallen short, bankers have been renegotiating terms and raising rates. This process occurring over a short period of time has been both disruptive and stressful for these markets with spillover effects throughout capital markets.

Following this through the bank community, we believe that this surge has caused bankers to be more cautious in extending credit as they had prior obligations to honour lines of credit that were being quickly drawn down by these prime borrowers. This we believe is partly responsible for comments in the press that banks are unwilling to lend to one another. It is likely that they are simply conserving cash to serve well established commercial clients.

Banks are financing these increased demands through a combination of deposits and where necessary central bank funding. **The Federal Reserve and other central banks have and will provide whatever is required to accommodate these needs and insure that business can continue to function. The recent announcement by the Fed to create a fund to purchase commercial paper is illustrative of this resolve. We therefore believe that distressed conditions in the money markets are temporary.**

In our opinion, central banks are doing exactly what they should be doing to get us through this crisis and their efforts deserve our support. In order to stabilize markets they must saturate the system with liquidity to insure its smooth function.

Their determination to insure depositors are kept whole is evident in the smooth takeover of Washington Mutual, Wachovia, as well as Fortis and Dexia in Europe and now Hypo Real Estate.

Economic Consequences

The second and critically important track to follow and appreciate is what may happen to economic activity. As always it is helpful to understand where we are now and where we have come from. Briefly we begin with 2nd quarter GDP which rose 2.1% in the U.S., 1.4% in Western Europe and 0.8% in Japan. The BRIC block of emerging giants i.e. Brazil, Russia, India, and China experienced growth rates of 6.1%, 7.8%, 7.9% and 10.1% respectively. During the summer industrial production weakened and in August was 1.5-1.7% lower than last year's level in the U.S. and Europe. BRIC industrial production has remained very strong ranging from gains of 4.7% in Russia to 12.8% in China.

Recent employment data reflects weakness in the U.S. September job levels at 145 million were 1 million lower than last September or 0.7 %. The effect on personal disposable income (PDI) has not been calamitous. PDI grew an average of $30 billion per month over the summer after adjusting for the tax stimulus package. This represents an annual growth run rate of $360 billion or 3.3%.

Previous recessions over the last 50 years have experienced unemployment rates ranging between 6-10.8%. At the high end this might result in total job loss of 6 million or 4% of peak employed. Areas of particular weakness in the U.S. are housing and autos. Residential construction peaked at 2.2 million starts in January 2006 and slid to about 900,000 early this year. The result in GDP accounts has already been felt as the dollars spent has now declined from about $830 billion to just over $500 billion. In a country of about 140 million housing units, current levels are close to the minimum required to maintain the housing stock. In addition, inventories of unsold homes appear to be stabilizing.

The auto sector is running at just under a 12.5 million unit annual rate down from 17.5 million at its peak in 2005. Its contribution to GDP is currently about $330 billion down from $400 billion last year. The impact of its decline is already reflected in GDP. Of particular concern has been the poor state of the domestic industry's balance sheet. In recognition that some help is required, Congress has passed a bill that provides for a $50 billion cash infusion over 2 years.

It is important to remember that the U.S. economy is no longer one based on manufacturing. Today less than 10% of total jobs are employed in the manufacturing sector. The large service sector has become the dominant and diverse employer. During the 2nd quarter, services to consumers grew 5.2% over last year and export services rose 16.5%.

Our point is that while further weakness in the economy should be expected, employment at 145 million is close to record levels. Economic weakness in the more cyclical areas of housing and autos has already affected GDP. The relatively low level of the U.S. dollar is driving very strong gains in exports which in total are more than twice the size of the housing and auto sectors combined.

As those of you who followed our views would know, we have argued that the U.S. has been a higher risk economy for some time. The combination of above average levels of household and government spending, coupled with a very low personal savings rate has left the economy overextended and ripe for correction. It is finally happening. We do not believe, however, that our earlier forecast for 2008 which called for modest real GDP growth of between 1-2% needs to be changed. At this stage we believe recession-like conditions will be evident in the 3rd and 4th quarters. We continue to believe that over the next few years the U.S. will see sub-par economic growth i.e. 1-3% as compared to the 3-5% enjoyed for many of the last 15 years. This outlook will remain for an extended period until household savings rates return to more typical levels in the area of 4-6%. This may take 1 or 2 years.

We again put forward the view that this economic correction should not affect Europe to the same degree as it has not experienced the same excesses as the U.S. Similarly expanding economies in Asia, the Middle East, South America and Eastern Europe should not experience serious fallout from America's difficulties. The auto sector in Japan is perhaps the most vulnerable to a U.S. slowdown. However Japanese exports of other products to emerging markets should compensate for any such weakness. We remain of the view that the world economy is working very well. Global real GDP in 2009 should continue to grow at a rate of close to 3% as per IMF forecasts.

Financial Markets

Financial markets have been uniformly down this year and were hit particularly hard in September. As of October 8th, U.S. 30-year Treasury bonds have been the best performers up 10.5% year to date in U.S. dollars. Corporate investment grade bonds have fallen 8%. World stock markets as measured by the MSCI Global index has fallen 33.7% in local currency. The S&P 500 has declined 31.2%. The S&P TSX is down 27.3% while European shares have dropped 34%. Emerging markets have fared worse down 40%.

We have been asked frequently whether one should alter asset mix today and reduce equity exposures. Our reply has been that this is not the time to make such a change. While difficult to foresee events such as these, portfolio strategy should attempt to anticipate more difficult times with a structure that can withstand stress.

Our policies over the last few years have considered the elevated risks in the U.S. albeit not focusing precisely on a sub-prime problem. We have stressed high quality credits in our fixed income portfolios avoiding real estate and other asset backed securities of virtually all types. We had eliminated virtually all holdings exposed to auto financings such as GMAC.

In recent years we have taken a generally cautious approach to U.S. exposure. Our emphasis has been on energy where tight global supply conditions and asset values have supported share prices. This remains true today. Other sectors have included telecommunications and cable where stable, growing revenues and profits are underpinned by reasonable valuation and often by attractive dividend yields. While health care, both pharmaceuticals and hospital chains have not delivered good returns recently, these companies have great skills and one can see a world of as yet many unmet needs for health products and services. Valuations also remain very depressed.

The banking area has of course been the most difficult for us this year. Our emphasis however has been on companies that control the top franchises in their various markets. We have preferred banks with broad deposit taking bases that would not be vulnerable in a period of diminished confidence. We have avoided investment banks that operate with enormous leverage and other financial concerns that sold highly levered products such as credit insurance.

We believe that heavy write-downs that were made at the end of 2007 and during the 1st half of 2008 in regards to sub-prime CDOs and other structured finance products will moderate. Holdings of these instruments are much diminished. Furthermore banks have substantially increased loan loss reserves and in some instances such reserves well exceed non performing loans. This gives managements much greater flexibility in providing for additional problems as they arise. Leading banks are trading at 5-6x more normal earnings levels and many offer generous dividend yields.

Over the last two years, we have eliminated deep cyclical holdings in mining and the steel industry as commodity prices rose dramatically. Similarly, we have reduced investment in agricultural supplies as these prices rose. More recently, as oil prices reached peak levels in early summer we reduced various holdings and brought our weights back to earlier targets. Furthermore, we have had opportunity to reduce holdings in a company that has profited from the purchase of credit default insurance on companies such as AIG. Today we are considering high quality new investments in consumer staples and others in areas of the economy that may be expected to turn upwards in the early stages of recovery. All this to say that there is much to do but best done in a thoughtful unhurried manner.

Conclusion

We reiterate the world economy is both working well and offers much opportunity for growth as there remain huge unmet needs around the world. The difficulties in the banking system can and are being addressed with the tools available to government and central banks. Their efforts will be successful in stabilizing markets. Today's equity markets do not reflect reasoned judgment but rather fear and liquidation pressures. Stocks offer excellent value and will return to more reasonable and higher valuations as today's problems are resolved.

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This letter as well as all published Economic and Capital Markets Outlooks are available on our website at www.lba.ca