Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

December 2013

Summary

- Major global economic imbalances are on the way to being resolved. The world economy should see a synchronized expansion in 2014, the first since 2007.
- Activity in the U.S. could surprise to upside if there is a marked rebound in cyclically-sensitive sectors.
- The Canadian economy is transitioning away from consumer spending and housing investment. Growth is expected to be modest at 1.5%-2.0%.
- Europe should return to positive albeit slow growth as a result of less fiscal tightening across the region.
- Yields remain vulnerable to upward pressure and long-term bonds are still at extreme valuations. We are maintaining a short duration in our bond portfolios and are underweight bonds within balanced mandates.
- Equity markets are being supported by fundamental factors. Given the favourable backdrop for earnings growth, reasonable valuations and solid dividend yields, we continue to expect a higher return from owning stocks compared with bonds and cash.

Global equity markets rose an impressive 35.4% in 2013, with indices in the U.S., Germany and the U.K. at or above their prior peaks. Concerns have surfaced that stocks may be reaching excessive levels, particularly given the sluggish economic recovery to date. Increasing asset prices do not represent a risk in itself so long as the rise is justified by underlying fundamentals. The key questions, then, are whether valuations have reached extreme levels and whether profit growth can be sustained.

It must be emphasized that the structural adjustments and fiscal and monetary policy interventions arising from the financial crisis were exceptional responses to an extraordinary event. We are nearing the end of this adjustment period as global economic imbalances have been, or are on their way to being, corrected. Our forecast for 2014 calls for an increase in economic activity worldwide and this should provide a supportive backdrop for corporate earnings.

While equity prices have risen more rapidly than corporate profits thus leading to an expansion in market multiples, equity valuations today are broadly in line with long-term historical averages and far from extreme levels associated with prior market bubbles. In contrast, the correction in long-term bond prices has longer to run as interest rates rise to levels more consistent with a growing economy. Equities should continue to outperform both cash and bond investments over the medium-term.

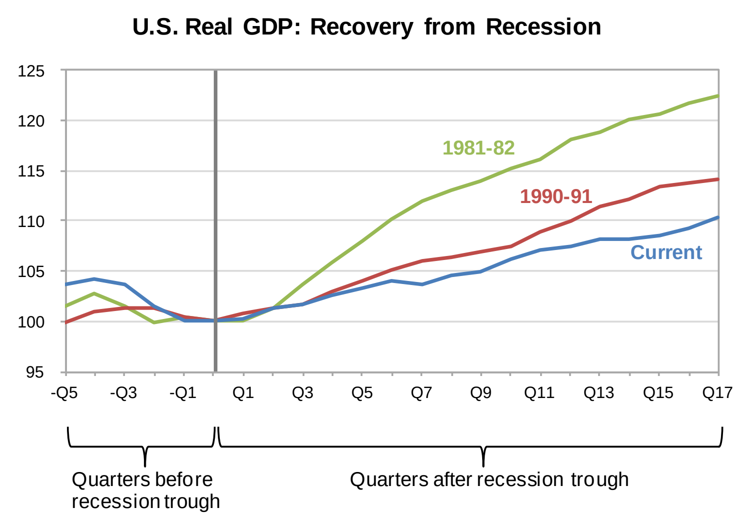
LETKO BROSSEAU

An increasingly consumption-driven U.S. economy

The recovery from the deepest recession in the U.S. since the 1930s has been atypical. Given the scale of financial crisis, the need to correct government imbalances and the deleveraging of the private sector, the economy has proceeded at a more moderate pace than rebounds from past recessions. Real growth from 2010-13 averaged 2.2% compared with 5.4% in the 3 years following the 1981-82 downturn and 3.5% for the 1990-91 recession (Chart 1). We believe that structural adjustments are nearing an end and U.S. growth may surprise to the upside in 2014.

Significant headway has been made on reining in unsustainable fiscal deficits. The U.S. federal deficit has declined from a peak of 9.3% of GDP in Q2 2009 to 5.0% of GDP in Q3 2013. The Congressional Budget Office forecasts that the deficit will decline to 3.6% of GDP in 2014 and to about 3% of GDP thereafter from improving revenue collection.

Chart 1



As the drag from fiscal policy abates, consumer spending should be supportive of stronger growth. The outlook for consumer spending is key as it accounts for about 70% of economic activity. The most important driver of consumption is income and the main driver of income is employment. We expect that about 2.2 million new jobs will be created in 2014 which should boost overall incomes by $100 billion. Wage increases in an environment of 7.0% unemployment are typically difficult to achieve. However, we note that one-half of total personal income is earned by individuals with a university degree although this group represents a little more than one-third of the workforce. The unemployment rate for this part of the working population is a mere 3.4% suggesting that they are in a stronger position to negotiate better salary increases. We therefore expect that total wages will increase by about 2.3% in 2014, slightly above the average rate of 2.0% during 2010-2012, which would add another $150 billion to overall income. Together with other sources of income, the additional $250 billion from employment and wages will help disposable income grow by an estimated 3.0% in 2014.

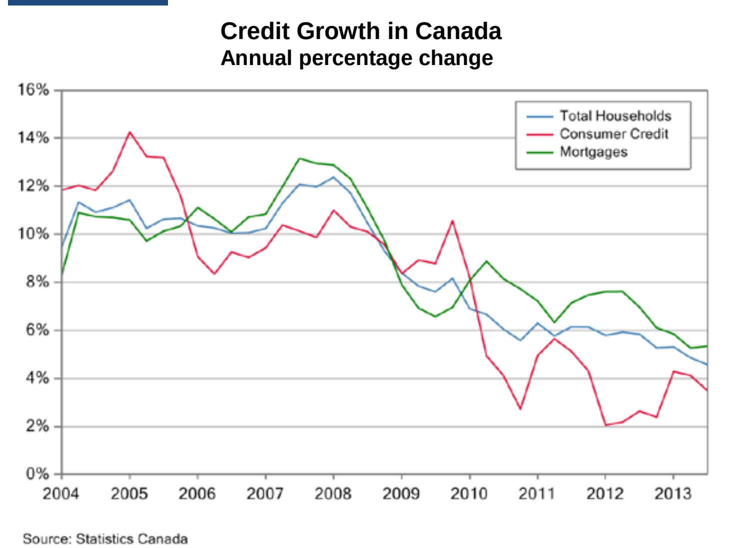
We reviewed the deleveraging trend of U.S. households in the September issue of our *Economic and Capital Markets Outlook* and concluded that household finances are in a more balanced position. In addition to the growth in disposable incomes, a significant increase in household net worth has occurred due to recovering home values and rising equity markets. This has fuelled gains in consumer confidence. We therefore expect that consumer spending may rise more quickly than disposable income growth and be boosted by both an increased demand for and a greater availability of credit. Debt service ratios for consumers remain at historical lows and while mortgage lending contracted by 0.8% year-on-year, personal credit including car, student and credit card loans was up 6.3%. In sum, consumer spending is forecast to rise 3.7% on an annual basis.

The U.S. economy may get a further lift due to pent-up demand from cyclically-sensitive sectors: housing, cars and capital spending. Housing starts are running at 1 million per year, about 30% below the normal level required to sustain household formation and the replacement of the capital stock. The average age of the car fleet has risen to about 11.4 years as a combination of high unemployment and tight credit conditions discouraged Americans from purchasing a new car in recent years. With a turnaround in both the jobs market and credit growth underway, even a modest decline in the fleet's average age to 10.8 years would trigger a boost to car sales from 15 million to nearly 20 million. On the capital spending front, American firms have amassed $1.6 trillion in cash on their balance sheets. As the economy continues to recover, investment opportunities will arise, opening the door for increased capital spending.

Fiscal tightening, tough credit conditions and household deleveraging have hindered economic growth in past years. As these factors have eased, we foresee that growth will increase from 1.5% in 2013 to 2.5%-3.0% in 2014. Under a scenario where housing, autos and capital spending are buoyed by a return to more normal conditions, growth could reach 3.0-3.5% in the medium-term.

The Canadian economy is rebalancing

Chart 2



Economic growth in Canada remains tempered by a shift away from consumer spending and residential investment. Household indebtedness is still elevated at 167% of disposable income but credit growth has been in a downtrend (Chart 2) and disposable income growth remains solid at 4.0% year-on-year. A gradual slowdown in mortgage and consumer credit and an accompanying deceleration in housing-related spending is precisely what the economy needs to rebalance in the medium-term.

Investment spending in the mining and energy sectors declined to an estimated $79 billion in 2013 from $81.4 billion the prior year. A combination of low commodity prices and an unfavourably large gap between the price of heavy Canadian oil and that of West Texas Intermediate (WTI) oil led to delays in key mining and energy projects. However, companies are signalling a pick-up in capital spending plans for 2014. For example, Suncor, the biggest Canadian integrated energy producer, is forecasting capital spending of $7.8 billion, a 16% increase from 2013.

On the trade front, the drag on economic activity caused by the strong Canadian dollar has begun to ease as the currency has moved from parity to $0.94 against the U.S. dollar. The Canadian dollar remains above its estimated fair value of around $0.88, but the recent depreciation has had a positive impact on competitiveness and trade. As a result, for the first time since late 2011/early 2012, the manufacturing sector is no longer contracting.

While we believe that Canada will benefit from increased economic activity south of the border, we forecast that the growth of the Canadian economy will remain lower than in the U.S. Our baseline real GDP growth forecast for 2014 is 1.5%-2.0%.

Gradual progress in Europe

Positive developments on the trade front, easing fiscal austerity and generally improved consumer and business confidence have helped the Eurozone economy to recover from a recession that has lasted since 2011. Growth is now positive in most countries although consumption and investment remain weak. As we assess the growth drivers of the European economy, we note that in the long-term, growth prospects are lower than for the U.S. in part due to a poorer demographic profile. However, two factors are likely to provide a boost for the European economy in the medium term.

First, structural reforms typically bear fruit over longer periods. As the implementation of these reforms in various European countries is ongoing, increased labour productivity and greater flexibility for corporations will only translate into better economic activity over time. Second, the currently elevated unemployment rate of 12.1% is suppressing demand for goods. As the unemployment rate returns to more normal levels, pent-up demand will translate into actual demand setting the stage for a rebound in consumer spending. The auto industry is one such example. During the decade preceding the 2008-09 financial crisis, annual car sales averaged 15 million units. Since then, annual sales have averaged 13 million units. This has created pent-up demand equivalent to almost one full year of car sales.

While these two factors should support economic growth over the medium term, the deleveraging of the European banking sector remains a major near-term headwind. Many European banks have made significant progress in shoring up their balance sheets with key financial players such as BNP Paribas and ING Groep already compliant with Basel III regulatory capital ratios. However, the lack of standardization with respect to the reporting of impaired assets has led to uncertainty regarding the health of some banks.

The ECB is launching a bank-by-bank asset quality review in 2014 to streamline the recognition of non-performing loans and this is expected to oblige weaker banks to raise further capital. In the meantime, however, better capitalized banks are lending only to borrowers meeting strict credit standards. The cautious stance adopted by the banking industry is preventing credit from flowing to small and medium-sized businesses and lower quality borrowers. Although the ECB's review process is delaying the pick-up in credit that will help spur economic activity, it is laying the foundation for a better structured, more uniform and healthier banking system over the long run, which we view very favourably.

Europe is expected to be in a transition year as growth in 2014 will remain in a subdued range of 0%-1.0% while banks continue to deleverage. Increased credit availability, an improvement in the unemployment rate and a pick-up in consumer spending will be positive drivers from 2015-onwards. Political risk remains a concern given high levels of unemployment in certain countries.

Reacceleration of global growth in 2014

The reacceleration of global growth in 2014 will be driven primarily by improved conditions in developed markets. While growth expectations for emerging markets have been tempered by the destabilizing effects of capital outflows, economic activity in most countries is set to pick up. The IMF forecasts that global real GDP will grow at 3.6% in 2014, the first year during which all major economies will record positive growth since 2007 (Table 1).

Table 1 – World Growth Forecast

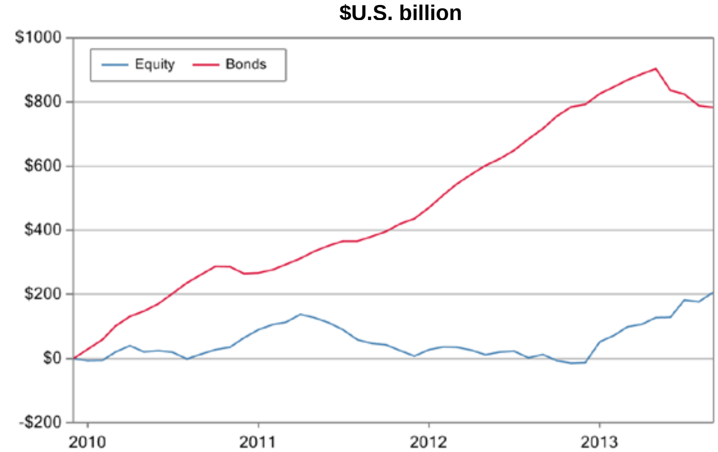
	2012 Nominal GDP (US$ bn)**	2012 Share of world GDP (%) ***	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
U.S. *	$15,685	19%	3.4%	2.7%	1.8%	-0.3%	-2.8%	2.5%	1.8%	2.8%	1.5%	2.5%
Canada *	$1,819	2%	3.2%	2.6%	2.0%	1.2%	-2.7%	3.4%	2.5%	1.7%	1.5%	1.7%
Japan	$5,964	6%	1.3%	1.7%	2.2%	-1.0%	-5.5%	4.7%	-0.6%	2.0%	2.0%	1.2%
U.K.	$2,441	3%	3.2%	2.8%	3.4%	-0.8%	-5.2%	1.7%	1.1%	0.2%	1.4%	1.9%
Eurozone *	$12,198	14%	1.7%	3.2%	3.0%	0.4%	-4.4%	2.0%	1.5%	-0.6%	-0.4%	0.5%
Germany	$3,401	4%	0.8%	3.9%	3.4%	0.8%	-5.1%	3.9%	3.4%	0.9%	0.5%	1.4%
France	$2,609	3%	1.8%	2.5%	2.3%	-0.1%	-3.1%	1.7%	2.0%	0.0%	0.2%	1.0%
Spain	$1,352	2%	3.6%	4.1%	3.5%	0.9%	-3.8%	-0.2%	0.1%	-1.6%	-1.3%	0.2%
Italy	$2,014	2%	0.9%	2.2%	1.7%	-1.2%	-5.5%	1.7%	0.4%	-2.4%	-1.8%	0.7%
China	$8,227	15%	11.3%	12.7%	14.2%	9.6%	9.2%	10.4%	9.3%	7.7%	7.6%	7.3%
India	$1,825	6%	9.3%	9.3%	9.8%	3.4%	8.5%	10.5%	6.3%	3.2%	3.8%	5.1%
Brazil	$2,396	3%	3.2%	4.0%	6.1%	5.2%	-0.3%	7.5%	2.7%	0.9%	2.5%	2.5%
Russia	$2,022	3%	6.4%	8.2%	8.5%	5.2%	-7.8%	4.5%	4.3%	3.4%	1.5%	3.0%
Mexico	$1,177	2%	3.2%	5.0%	3.1%	1.2%	-4.5%	5.1%	4.0%	3.6%	1.2%	3.0%
World	$71,707	100%	4.7%	5.3%	5.3%	2.7%	-0.4%	5.2%	3.9%	3.2%	2.9%	3.6%

** Forecasts for the U.S., Canada and the Eurozone are from LBA, all others are from the IMF*
*** Based on 2012 exchange rates*
**** Based on purchasing-power-parity (PPP) exchange rates*
Source: IMF, LBA, October 2013

Equities in fair value range

Major equity indices around the world have recorded double-digit total returns in 2013 (expressed in CA$): S&P 500 +41.5%; S&P TSX +13.0%; FTSE-100 +28.6%; DAX +40.0%; CAC-40 +34.1%; Nikkei +39.7. As equity prices have increased faster than corporate profits, valuations have moved from inexpensive territory to a level more consistent with fair value. Using a conservative estimate in which earnings grow in line with U.S. nominal GDP, the S&P 500 Index trades at 16 times 2014 earnings. Using an average of analysts' earnings estimates on a company-by-company basis as published by S&P Dow Jones Indices, the S&P 500 Index trades at 14.6 times 2014

Chart 3



Source: Investment Company Institute

earnings. Both metrics are in line with the historical average price-to-earnings ratio of 14.4 times trailing earnings and are far from "bubble"-type levels of 25-30 times.

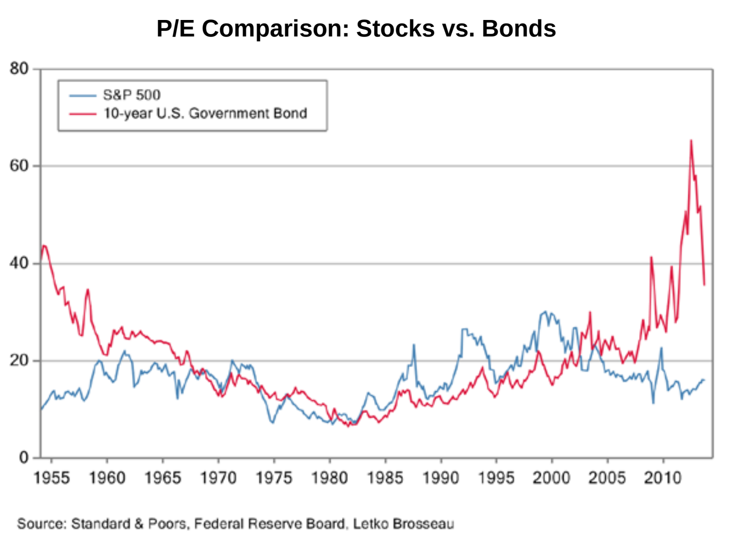
We therefore remain positive on prospects for equity markets as a result of reasonable valuations and a favourable backdrop for earnings growth. We also note that a wide gap still exists between the global pools of capital invested in bonds relative to stocks and we expect that investors will continue to shift out of the former asset class. The proportion of total assets invested in stocks has risen from 30% to 35% over the last two years, but it remains lower than its average of the past 20 years (39%). Looking at the cumulative flows into U.S. mutual funds and ETFs since 2009, a significant amount was invested in bonds. While flows into equities have picked up more recently, there is scope for further rebalancing (Chart 3).

In an environment where overall index price-to-earnings multiples are still reasonable but some companies have seen their valuations reach expensive levels, price discipline and careful stock selection are paramount.

Bonds: where the true risks lie

We have stressed in recent years that low long-term interest rates resulted from several key factors: subdued growth in developed economies, flight to safety flows into U.S., Canadian and German bond markets, unprecedented U.S. Federal Reserve purchases of U.S. Treasuries and liability-driven investment strategies of pension funds. Currently, three out of four factors are at an inflection point. As noted above, growth is set to improve and structural progress in the world economy is lowering the need for safe haven funds. Furthermore, the Federal Reserve has declared a scaling back of its bond purchases. Yields remain vulnerable to upward pressure as these important supports recede and long-term bonds are still at extreme valuations suggesting that substantial risk remains (Chart 4).

Chart 4



A reduction in the Federal Reserve's purchases of bonds raises the question of who will provide the required funding for the economy given the magnitude of the liquidity that has been supplied to markets. Since 2009, which marked the beginning of its bond buying program, the Fed's balance sheet has ballooned to $4 trillion. It has accumulated 38% of the entire stock of U.S. Treasury bonds with a maturity greater than 4 years and has been an important support to the mortgage market, accounting for about a quarter of the stock of agency mortgage bonds. In 2013 alone, $540 billion of U.S. Treasury bonds and $480 billion of mortgage-backed securities were purchased.

Stronger U.S. growth will lead to an increase in the demand for funds in the economy. Assuming, as outlined above, that cyclically-sensitive sectors get a boost from pent-up demand, the economy would require an additional $200 billion in funding. Should the Fed stop purchasing mortgage-backed securities, they would remove $480 billion in housing-related financing. Therefore, an estimated $680 billion would have to be raised from the private sector on an annual basis.

Banks are likely to be significant providers of these funds. Most American banks have now reached their Basel III capital ratios and the U.S. banking system as a whole is not very levered, at about 9 times assets to equity versus about 13 times in Europe. Surveys of loan officers point to an increased willingness to accelerate lending. Even assuming that the entire $680 billion in financing needs was funded through lending rather than savings, only a moderate 7% rise in bank credit would be required. We conclude that banks are in a position to supply both growing demand for credit and compensate for the Fed's withdrawal of liquidity to the mortgage market.

Banks, however, are unlikely to fund public financing needs suggesting that sovereign yields will be under pressure. The government's total financing requirement for 2014 is estimated to be around $700 billion. This entire amount will now have to be funded by financial markets. Complicating the picture is the rebalancing out of bonds currently underway (Chart 3). As the Fed scales back its purchases while private sector demand for U.S. Treasuries abates, higher yields are likely to ensue.

We remain extremely prudent in our bond purchases by focusing on high quality issuers and by keeping a low duration in our portfolios. We continue to believe that a portfolio of carefully selected stocks will outperform cash and bonds over the medium term and as a result, we are maintaining our underweighting of bonds within balanced mandates.

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

To obtain a copy of previous issues of our Economic and Capital Markets Outlook, please visit ***www.lba.ca***