Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

March 2013

Summary

- U.S. slowdown in 2013 is fiscally-induced and not a prelude to recession. Private sector will support return to real GDP growth of 2.5% in 2014.

- Fiscal adjustment in Canada is at an end but correction of consumer imbalances ongoing. Canada expected to see similar growth profile as the U.S.

- Eurozone structural adjustments occurring gradually. Pressure to slow the path to a 3% deficit-to-GDP is building. The region is expected to return to growth in 2014.

- A re-accelerating global economy, increased demand for funds and a global portfolio rebalancing in favour of equities are powerful headwinds for the bond market. Fixed income investments represent a poor risk-reward opportunity.

- Fundamental factors are supporting gains in equity markets. Both in absolute terms and relative to bonds, equity valuations remain attractive.

The economies of the industrial world will shrug off a soft 2013

Global equity markets have begun the year trending towards higher levels. This is in line with the economic reality we are observing. Activity in the U.S. is robust although topline growth will be restrained in 2013 by a combination of higher taxes and mandated cuts in discretionary spending. This adjustment was required and represents a lagged consequence of the excesses in government spending resulting from the Great Recession.

The U.S. will embark on a stronger growth path in 2014 as the private sector, a fundamental force behind the economic recovery, is in sound financial shape. In Canada, 2013 is also expected to be sluggish as the full impact of tighter mortgage restrictions will slow consumer spending. The Eurozone, which front-loaded its austerity program triggering a second recession, is signalling its intention to lengthen the path to a 3% deficit. Under this scenario, a return to growth will occur next year. On balance, the global economy is likely to grow moderately in 2013 and further improve in 2014.

Private sector resurgence underpinning U.S. growth

The U.S. economy re-accelerated as a whole in 2012, with real GDP advancing 2.2% compared with 1.8% in 2011, despite a slowdown in the second half of the year. In nominal terms, GDP expanded 3.5% in the fourth quarter compared with the previous year, propelled by strong growth in housing (16.7%) and non-residential investment (6.8%). Consumer spending increased 3.5%, supported by further gains in labour markets. International trade continued to improve, as exports increased 3.3% while imports were flat. Government expenditures were unchanged.

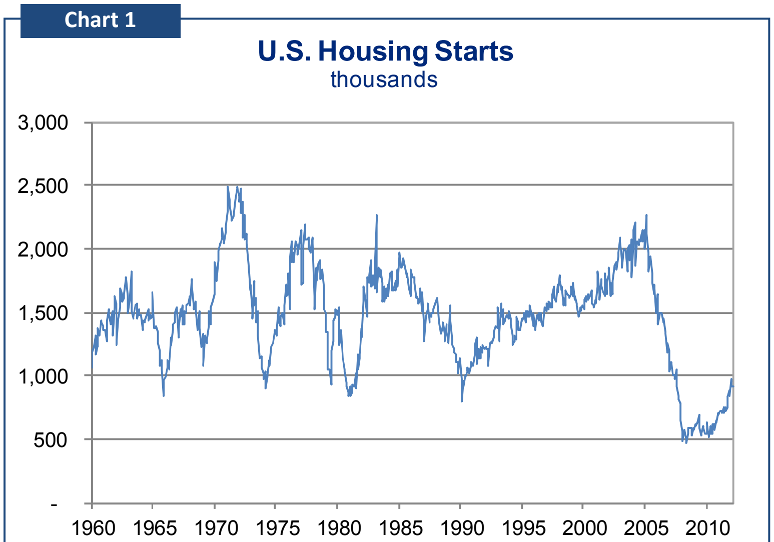
The private sector`s positive momentum has been a key offset to fiscal tightening, creating an average 172,000 jobs per month while government employment fell 8,000 per month over the last year. Hours worked in the private sector were up by 1.8%, in line with employment growth. Another encouraging sign is the ISM employment indicator: the manufacturing survey is at 54.2 while the non-manufacturing survey is now at 53.3, suggesting that both sectors are looking to increase employment. A healthy labour market is an important contributor to rising levels of consumption. Notwithstanding a significant increase in taxes that occurred in January 2013, disposable income (adjusted for non-recurring items) advanced 2.4% above last year's levels. Retail sales are rising at a faster rate, up 4.6% in February.

Industrial activity is visibly growing. Industrial production increased 2.5% above last year's level. Durable goods orders are up 3.9% and the ISM new orders index is at 51.4, consistent with continued expansion. Other indicators, such as railcar loadings (excluding grain and coal) and diesel demand, are up 4.2% and 2.1% respectively.

Fundamental growth drivers: housing, capital spending and trade

As we build our forecast for 2013 and 2014, we highlight three key growth drivers: residential investment, corporate capital expenditures and external trade. The recovery in the *housing sector* is well underway and is in the early stages of a multi-year expansion driven by positive fundamental forces. Household formation, which stagnated following the recession as poor labour markets forced individuals to find roommates or return to their parents' home, has begun to return to more normal levels. In 2012, an average 1.4 million new households were created, compared to an average of 410,000 during 2009-2010. In contrast, housing starts for February were 917,000 (Chart 1), indicating that the demographic push will be a positive force underpinning construction activity for an extended period.

Chart 1



Source: U.S. Census Bureau

Furthermore, the housing supply-demand balance is adjusting and a reduction in inventory has pushed prices higher. The inventory of existing and new homes for sale is now down to 2.1 million compared to about 4.5 million at the housing market`s peak in 2006 and 3 million homes as late as September 2011. Housing affordability remains compelling as the interest rate on a 30-year fixed rate mortgage is 3.6% and debt service costs are now at their lowest level since 1983. Apartment vacancy rates are in decline while rent inflation, at 2.7%, is now running ahead of consumer price inflation. Given the positive structural backdrop, we expect housing investment to grow by 15% per annum this year and next.

Several factors suggest that *capital spending* will remain robust in the medium-term. A general support to corporate investment has been the strong recovery in profit margins and earnings since the recession: profit margins are near peak levels and S&P 500 operating earnings are up 16.9% annualized. Profits are expected to grow in line with nominal GDP or better over the next 5 years.

The discovery and exploitation of colossal shale oil and gas reserves has led to an increase in investment in wells and related infrastructure. U.S. onshore oil and gas production will continue to grow, thereby requiring a rising amount of investment to increase production levels. A cheaper source of domestic energy could engender a ramp-up in the manufacturing sector, with the petrochemical industry in particular incentivized to boost investment.

An increase in onshore oil production in the U.S. will also have an important spillover on the *trade balance*. Under varying scenarios for oil prices and production, we estimate that the trade deficit in the oil sector will shrink by $25 billion - $50 billion per year over the next few years. If the U.S. also manages to improve its deficit position with China, trade could add meaningfully to growth.

Fiscal tightening will induce temporary slowdown, not recession …

The cumulative effect of higher taxes and a cut in discretionary government spending will restrain U.S. growth in 2013, but this headwind will decline in importance in 2014. Disposable income in the U.S. grew by an average $400 billion per year during 2011-2012. The direct impact of higher taxes kicking in on January 1st, implemented as part of the fiscal cliff negotiations, is $150 billion.

Since disposable income growth is the most important determinant of consumer spending, our forecast builds in a fiscally-induced slowdown in consumption in 2013, although its magnitude is likely to be partially mitigated by a lower saving rate. By next year, the impact will wear off, allowing for stronger gains in consumer spending. Mandated cuts in discretionary outlays – the sequester – will cut federal spending by $50 billion this year but this will be offset by a gradual increase in spending at the state and local level, as the latter is seeing a rise in tax receipts.

… setting the stage for re-acceleration

Our central forecast for U.S. real GDP growth in 2013 is around 1.5% but improving confidence may result in a better outcome. By 2014, we expect the U.S. economy to expand 2.5%, returning to a growth path more in keeping with its historical average.

In Canada, fiscal excesses addressed but consumer adjustment ongoing

The Canadian economy weakened in 2012 through a combined effect of a slowdown in trade and consumer spending, particularly in the latter half of the year. Real GDP was up 1.8% in 2012 compared with 2.6% the prior year. During the fourth quarter, consumer spending expanded 2.6% year-over-year in nominal terms, non-residential investment was up 5.4% and residential investment advanced 5.9%. Government spending advanced by 2.1% while the trade deficit widened; exports were down 4.5% as imports declined 0.3%.

As we build our forecast for 2013 and 2014, we envision a slower rate of consumer spending. This is partly driven by the tighter mortgage rules that were implemented last summer, which are already having an impact on housing-related consumption. These rules are likely to slow consumer credit growth and have a negative impact on house prices and residential investment.

In conjunction, we expect employment growth to moderate along with the economy in 2013 and 2014, following the creation of 310,000 new jobs (+1.8%) in 2012. The Federal government laid out a steady spending growth path in its recently tabled 2013/14 budget. Fiscal retrenchment at the federal level is largely complete while the provinces are on track to stay the course on deficit cutting. Capital spending will slow as we do not expect a return to the double-digit growth seen from mid-2010 to mid-2012 given weaker commodity prices and trade will deteriorate further.

In sum, we expect Canada to experience similar real GDP growth as the U.S., around 1.5% for 2013. In 2014, given improved prospects for the U.S., growth in Canada should re-accelerate by an additional 0.5%-1%.

Europe: activity flat but sentiment improving

While international investors tolerated U.S. deficits in the range of 8%-10% of GDP from 2008-12, Eurozone countries were unable to avoid frontloading harsh fiscal cuts in a joint effort to restore confidence and credibility. These cuts had a large impact, given that government spending represents 50% of Eurozone GDP, compared with 40% for the U.S. and Canada. As a result, it was the only major developed economy to fall into a double-dip recession. Real GDP in the Eurozone was –0.4% in 2012 versus 1.4% in 2011. During the fourth quarter, only Germany advanced slightly as real GDP was up 0.4% year-over-year, while contractions occurred in all other major countries: France –0.3%; the Netherlands –0.9%; Spain –1.9% and Italy –2.7%. Outside the Eurozone, the U.K. eked out a slight expansion of 0.3%, while Sweden and Switzerland advanced 1.5% and 1.2% respectively.

Coincident economic indicators across the Eurozone do not show a meaningful improvement in economic activity, credit or jobs. The Purchasing Managers' Index (PMI) survey, a leading indicator of industrial activity, points to continued sluggishness. Both the manufacturing and non-manufacturing Eurozone PMI for March are around 47, indicating a small contraction in economic conditions. To get a more timely reading on activity, an informal survey of around a dozen European companies was undertaken by our analysts. The findings are similar, as few companies see a turnaround in current sales and production levels in their European operations.

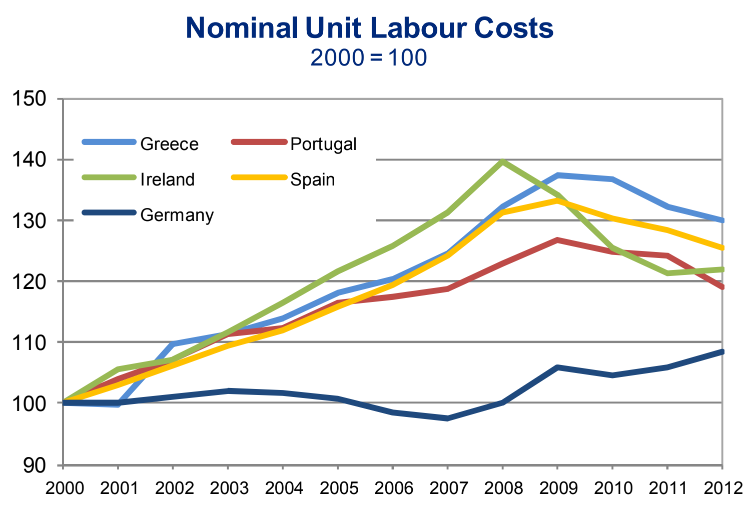
Improvements are more visible in the financial markets. From June 2012 to March 2013, total returns on major stock markets in the Eurozone are between 15% - 25%, with the exception of Italy (10%). In addition, spreads of peripheral country bonds compared to Germany have significantly improved compared with their mid-2012 peak: 10-year spreads for Italy are down from 460 bps to 280 bps and for Spain down from 640 bps to 380 bps (yields are at 4.6% and 4.9% respectively). Eurozone surveys of investor confidence and surveys of economic conditions show a marked improvement compared to the second half of 2012.

Eurozone fiscal progress undeniable, but is it sustainable?

Sustained investor confidence in the Eurozone rests on two key questions: does “austerity fatigue” risk derailing continued progress on addressing (1) key structural reforms in business and labour markets and (2) the region`s deficit and debt imbalances.

We are of the view that Europe will move forward with structural reforms. Indeed, countries including Spain, Portugal, France and Italy have made some headway in loosening barriers to do business and increasing labour force flexibility. We also see a rebalancing of trade flows; countries formerly generating large current account deficits are now improving their trade balances. More recently, wage inflation in Germany is running at higher levels than elsewhere and the gap in unit labour costs has narrowed in the periphery`s favour (Chart 2).

Chart 2



Source: Eurostat

Our central forecast for Eurozone growth rests on the as-yet-to-be-determined path of fiscal tightening. During the past year, most member countries reduced their deficits substantially, quite an achievement in a recessionary environment. On average, the 5 largest economies of the Eurozone (Germany, France, Italy, Spain, and the Netherlands) cut their deficits by a further 1.1% in 2012. With a budget balance of only –0.2% of GDP in 2012, retrenchment in Germany is largely done. The amount of fiscal contraction to be targeted for 2013 for other Eurozone members is unclear. Several countries, notably France and Italy, are openly lobbying for a lengthier path to reaching the target deficit objective of 3.0% or less, not least to allow structural reforms to start bearing fruit. As we assess our forecast for Europe in 2013 and 2014, the likelihood that fiscal consolidation will slow considerably has increased. Therefore, Eurozone real GDP should gradually improve and move back toward a growth rate of 1.0%-1.5% in 2014.

Japanese government turns activist

Japan experienced a tsunami-related reconstruction boom in 2012, with real GDP growth reaching 2.0% vs. –0.6% in 2011. Earlier this year, Japan`s newly elected government announced a three-pronged approach to overhaul the economy: ultra-easy monetary policy with an explicit 2% inflation target, short-term fiscal stimulus and a medium-term growth policy. The IMF estimates that if the combined measures are implemented, economic growth could be boosted by at least 1%. Currently, it forecasts Japanese real GDP growth at 1.2% in 2013 and 0.7% in 2014.

While short-term growth prospects may have improved as the yen has depreciated by 10% against the U.S. dollar since the start of the year, it is too soon to call for a secular turnaround in the

Japanese economy. The country faces structural challenges in the form of a rapidly aging population and an unhealthy debt load. As a result, we remain cautious with respect to its longer-term growth prospects.

Emerging markets primed for re-acceleration

Economic growth across the developing world decelerated in 2012, with real GDP up 5.1% compared with 6.3% in 2011. Real GDP expanded 7.8% in China and 4.5% in India. Growth in developing Southeast Asian countries remained strong, in a range of 5%-7%, whereas the more mature economies of South Korea and Taiwan were noticeably weaker, 2.0% and 1.3% respectively.

Eastern Europe was affected by the European recession, as real GDP growth moderated to 3.4% in Russia, 2.4% in Poland and 3.0% in Turkey. Brazil`s economy recorded a sluggish 1.5% rate of growth over the past twelve months, while Mexico and Chile advanced 3.8% and 5.0%. The IMF expects emerging markets to expand 5.5% in 2013 and 5.9% in 2014.

Globally, given continued healthy growth in emerging markets, the IMF forecasts world economic output to rise 3.5% in 2013, a slight pick-up above the 3.2% rate recorded in 2012. The IMF also expects a reacceleration to 4.1% real GDP growth in 2014.

Interest rate manipulation: closer to the end than the beginning

Our views on fixed income markets have been unwavering: we consider the level of interest rates in the developed world to be the result of an exceptional policy response to exceptional circumstances, hence bond yields are unsustainably low. As explained in our December 2012 *Economics and Capital Markets Outlook* (available for download on www.lba.ca), the U.S. Federal Reserve appears prepared to experiment with higher inflation in favour of spurring faster domestic growth. We may, however, be closer to an end to this post-crisis era of interest rate manipulation.

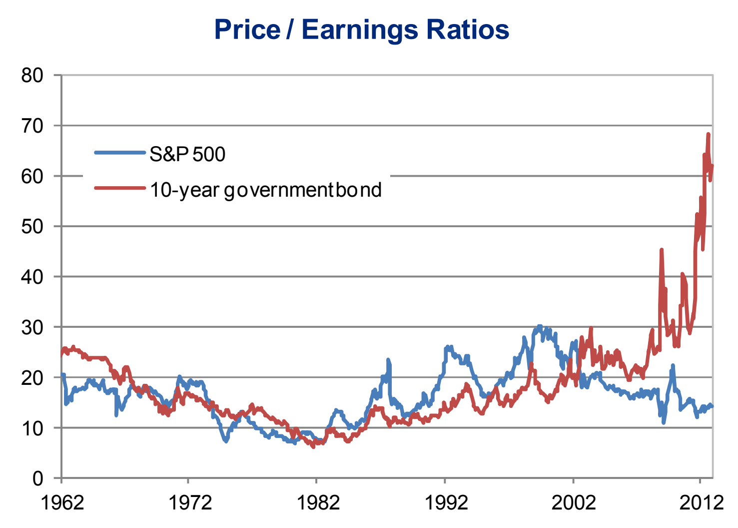
Private demand for funds is increasing and will likely continue on the back of a strong housing market and some firms' desire to re-leverage solid balance sheets to capitalize on low rates. The Fed has also begun to talk of an exit strategy, suggesting that the debate is tilting towards an evaluation of the proper moment to soak up excess liquidity rather than inject more liquidity into financial markets. If U.S. growth picks up as we expect – and perhaps surprises to the upside – pressure on interest rates to normalize higher will be intense. Investors who remain exposed to long-term bonds risk suffering enormous capital losses. This is especially true for pension plan sponsors who have pursued an asset-liability matching strategy in the belief that their long bond portfolios will be insulated from interest rate changes (please refer to our special report on this topic entitled "A Historic Moment – the Bubble in Mandated Assets").

While Canadian government long-term bond yields have drifted upwards by 15 bps during the last quarter, they remain well below levels attained both during the 2008-09 recession and comparable U.S. yields. The benchmark 30-year Federal bond yield is a paltry 2.5%, compared to 3.10% in the U.S. Even adjusting for Canada's more favourable fiscal backdrop, the current yield gap versus the U.S. is wide. If Canadian yields were to simply rise toward current U.S. levels, holders of these bonds would suffer a capital loss of 11%. Furthermore, if the spread between the 2-year yield and 30-year yield on the U.S. Treasury curve was to be applied to the Canadian curve, the 30-year yield would rise by 139 basis points to 3.94%, generating a 22% capital loss.

Valuations clearly favour stocks over bonds

Global equity markets have begun the year in an uptrend and U.S. indexes in particular are approaching 2007 pre-crisis peaks. Year-to-date returns in Canadian dollars are: MSCI World +10.2%; S&P 500 +12.9%; S&P TSX +3.3%; DAX +3.0%; CAC-40 +3.3%; FTSE +5.1% and Nikkei +11.8%.

Chart 3

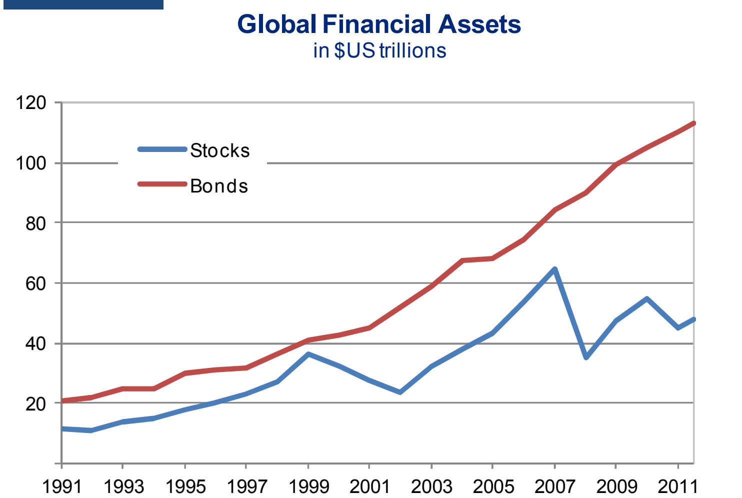


Notwithstanding the significant rise in the markets, most stock indexes in developed economies trade between 12-14 times 2013 earnings, well within a historical fair value range of 14-16 times. In comparison to bonds, equity valuations are compelling. The bond “price-to-earnings” ratio is computed as the 10-year government yield divided by its price. Just as a stock’s P/E ratio measures the multiple attached to the earnings stream of a company belonging to its shareholders, a bond’s P/E values the interest payment stream to bondholders. A long-term view of the price-earnings ratio of the stock market versus 10-year bonds in the U.S. illustrates the extreme and unprecedented gap between the two: in absolute and relative terms, equities offer superior value (Chart 3). A similar conclusion is reached for Canada and Europe.

Moreover, there is some evidence to suggest that global investors are still underweight equities and a rebalancing in favour of stocks looms, providing a support to prices for an extended period. Chart 4 shows a proxy measure for the value of global financial assets. Currently, a wide gap exists between the worldwide pools of capital invested in bonds relative to equities. From end-2007 to mid-2012 (most recent data available) the capital invested in bonds has risen by $26 trillion while equity capital declined by $16 trillion.

Central banks have been significant buyers of fixed income securities, purchasing $3.5 trillion of their government’s debt during the 5-year period, but this alone does not explain the size of the gap. Rather, the main reason is the combined effect of record debt issuance and the willingness of retail and institutional investors to bid up the price of bonds at ever increasing valuations. An analysis of pension plan asset allocations supports this trend: Towers Watson’s Global Pension Assets Study illustrates that at end-2007, global pension funds were invested 55% in equities and 28% in bonds while at the end of 2012, the allocation to stocks fell to 47% and that of bonds rose to 33%. As the

Chart 4



Global equity market capitalization and debt securities outstanding at market value
Sources: BIS, Bloomberg, Barclays, Letko Brosseau

global economy re-accelerates, the demand for funds increases, interest rates rise and inflict negative returns on fixed income assets, we think that global investors will increasingly reallocate away from bonds into equities.

Reasonable valuations, healthy dividend yields, a continued expansion in company profits and a potentially powerful tailwind in the form of a global rebalancing away from bonds are persuasive reasons to favour equities over cash and bond investments in the current market cycle.

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

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