Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

June 2013

Summary

- Global economic growth will pick up in 2014 as fiscal tightening in major developed economies recedes.
- Underlying fundamentals for the U.S remain healthy. The private sector is the key force driving the economy.
- Canada will experience below-trend growth over the next two years. Consumer spending, housing and energy-related investment will slow.
- The Eurozone economy remains weak with structural adjustments occurring gradually. An easing of austerity will be supportive of a recovery in economic conditions.
- The DEX Universe bond index return is -1.6% over the past 6 months on the back of a steepening yield curve. Interest rates are in the early stages of normalizing to higher levels. 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.

Financial markets appear to be undergoing an adjustment to economic reality. Bond investors have awoken to the fact that monetary conditions cannot be manipulated by central banks indefinitely and a strengthening economy is not compatible with low interest rates. Since the beginning of the year, 10-year bond yields in the U.S. and Canada have risen by 74 basis points and 65 basis points respectively. Equity indices are broadly higher over the same period as investors' expectations for improving economic conditions in 2014 are sustaining confidence in companies' ability to grow profits. The total return of the MSCI World Index (in Canadian dollars) is 14.6% for the first six months of the year.

We reiterate our baseline forecast for a gradual improvement in economic growth across major developed and developing economies in 2014. Fiscal headwinds will ease in both the U.S. and Europe, allowing for an acceleration of their respective economies next year. In Canada, the domestic market has begun to rebalance away from an overheated housing sector and highly indebted consumer. An in-depth review of the Canadian economy supports our outlook, first published two years ago, that Canadian growth will remain below-trend until consumer excesses have readjusted.

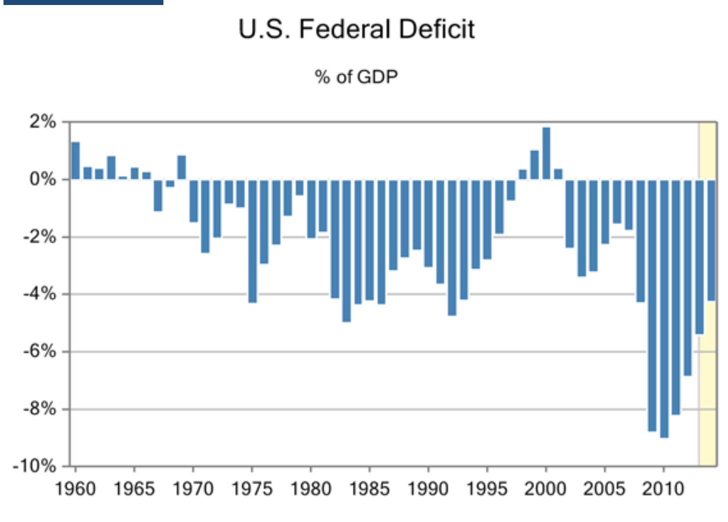
Our investment strategy remains unchanged. We expect interest rates to continue to normalize to higher levels and we are managing our bond portfolios cautiously, with relatively short duration and with careful attention paid to the quality of fixed income investments. Equities should deliver solid returns and outperform both cash and bonds.

U.S. economy to re-accelerate in 2014

Aggregate data for the U.S. indicate subdued economic conditions. During the first quarter, real GDP rose 1.6% year-over-year while in nominal terms, GDP was up 3.3%. Growth continued to be generated by the private sector; consumer spending was up 3.1%, non-residential investment increased 4.7%, while housing surged 17.3%. The U.S. trade deficit narrowed slightly on the back of improving exports and declining energy imports, while government spending declined 1.0% over the past year.

Private sector job creation has accounted for all of the growth in employment. Total employment rose 1.6% year-over-year as of May, with private sector jobs up 1.9% and government employment down 0.3%. The rise in income and payroll taxes at the beginning of the year has slowed disposable income growth to 1.7% but pre-tax compensation rose 3.2% and compensation by private industries increased 3.8%.

Chart 1



Source: Bureau of Economic Analysis, Letko Brosseau. Shaded for forecasts

Other indicators are also pointing toward steady growth. U.S. retail sales are up 3.7% over the past year. On the industrial side, production is up 2.2% and railcar loadings, excluding coal and grains, are up 3.0%. Durable goods orders point toward continued growth, as they are up by 3.1% compared to last year.

The U.S. economy is undergoing a fiscally-induced slowdown, the effects of which will abate by next year. Notable progress is occurring in the federal government's budget balance (Chart 1). Improving revenues coupled with lower spending has led to a narrowing of the U.S. federal deficit from 6.8% of GDP in Q1 2012 to 4.9% of GDP in Q1 2013.

Looking ahead to 2014, economic activity will continue to be led by the private sector. In our March 2013 economic report, we outlined three medium-term growth drivers for the U.S. economy: housing, corporate capital spending and trade. The housing market is in the early stages of a multi-year recovery. U.S. corporations are expected to generate profits in line with nominal GDP growth or better, which bodes well for continued growth in capital spending. Furthermore, we anticipate growth in investment in the oil, gas and petrochemical sectors. The increase in domestic energy production will lead to an improvement in the trade balance. Meanwhile, as fiscal tightening subsides, the main headwind to growth will diminish in importance.

Our central forecast for U.S. real GDP growth in 2013 is 1.5%-2.0%. By 2014, we expect the U.S. economy to expand 2.5%-3.0%, returning to a growth path more in keeping with its historical average.

Eurozone to ease austerity measures

Economic conditions in Europe appear to be bottoming notwithstanding weak real GDP data recorded across the region during the first quarter of 2013. Real GDP for the European Union contracted by 0.8% year-over-year and a breakdown across countries indicates that an expansion is occurring outside the Eurozone only: Sweden +1.7%; Switzerland +1.1%; U.K +0.6%; Germany -0.3%; France -0.4%; Netherlands -1.7%; Spain -2.0%; Italy -2.4%.

Unemployment, which typically lags a turnaround in economic activity, worsened to 12.2% in April compared with 11.2% recorded the previous year and is a major factor inducing Eurozone governments to favour growth-oriented policies. A look at more timely economic data indicates that rate of contraction in Eurozone activity is easing. As of May, the Purchasing Managers' Index (PMI) for manufacturing improved to 48.7 from March's level of 47.0.

German fiscal retrenchment is complete now that they have attained a zero deficit. Consensus has emerged within the European Union to allow member countries more time to reach their deficit targets. Since government spending represents on average 48% of Eurozone GDP, an easing of austerity will be supportive of a gradual recovery in economic conditions. In addition, structural reforms are ongoing, which should put the Eurozone on a longer-term path to improved competitiveness. Positive early signs of adjustment include the notable improvement in the region's trade surplus and a narrowing of the gap in member countries' unit labour costs.

Economic conditions for the Eurozone will remain challenging in 2013. The main risks remain on the political front; high unemployment and associated social unrest will test authorities' commitment to continued reform. Our baseline forecast is for real GDP to grow in a range of 0% to 1.0% in 2014.

Japan on a bond buying binge

Japan has embarked on an aggressive expansion of its monetary policy. In April, the Bank of Japan implemented a program of financial asset purchases, mainly Japanese government bonds, amounting to 13% of GDP per year. An expectation of this decision has had a strong impact on the country's currency and stock market: since November 2012, the Yen depreciated 19.3% versus the U.S. dollar and the Nikkei rose 46.4% in local currency.

Thus far, few signs of success can be observed in the country's economic data. Real GDP growth during the first quarter was just 0.2%. The Bank of Japan is seeking to increase inflation toward 2% yet the current inflation rate is -0.7%. The trade balance continues to deteriorate, as import growth (+8.9%) has been faster than export growth (+0.7%) over the past year.

Going forward, the trade balance is expected to improve as a weaker yen stimulates demand for Japanese exports. Over the medium term, however, the ultimate consequences of this aggressive monetary expansion are still a question mark.

IMF forecasts improved global growth for 2014

The IMF expects global real GDP to grow by 3.1% in 2013, with subpar growth in the advanced economies (1.2%) counterbalanced by a healthy expansion in emerging markets (5.0%). As at the first quarter of 2013, real GDP expanded 7.7% in China and 4.8% in India. Growth has been varied across developing Asia: the Southeast Asian countries are advancing at a rapid rate, with real GDP growth in Indonesia, Thailand and Malaysia at 6.0%, 5.4% and 4.1% respectively. Meanwhile, Asian developed economies are experiencing slower growth, as real GDP is up 1.5% in South Korea and 1.7% in Taiwan. Difficult conditions in the advanced European countries are affecting the neighbouring economies; real GDP is up 1.6% in Russia, 0.5% in Poland and 1.4% in Turkey. In South America, economic growth is slow in Brazil and Mexico, at 1.9% and 0.8% respectively, while Chile is growing at a 4.1% annual rate.

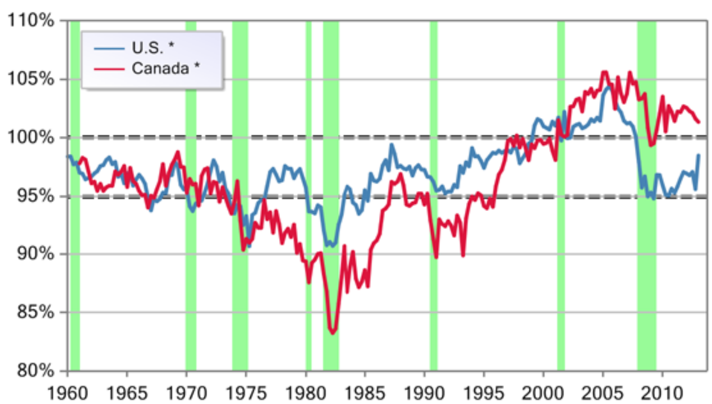
According to the IMF, real GDP for 2014 is forecast to rise to 3.8%, based on an accelerating U.S. economy and a resumption of growth in the Eurozone.

Canada hitting a soft patch

It is well understood that the Canadian economy weathered the 2008-09 financial crisis and recession relatively well. Real GDP grew 3.4% in 2010, 2.5% in 2011 and 2.1% in 2012. It took about one and a half years for the economy to regenerate all the jobs lost during the recession; in contrast the U.S. is still 2.4 million jobs short of its pre-recession job market peak. The banking system avoided large losses on its loan portfolios and subsequent deleveraging and recapitalization which many global banks were forced to undertake in the period immediately following the financial crisis. Credit conditions in Canada therefore remained easy and this together with an environment of low interest rates fuelled a record rise in consumer spending as a share of income, house prices and household indebtedness. We noted these developments in our Economic Report of June 2011 and maintained then that excesses were building in the Canadian economy and medium-term growth was likely to average at below-trend rates.

Chart 2

Consumer Spending as a % of Disposable Income



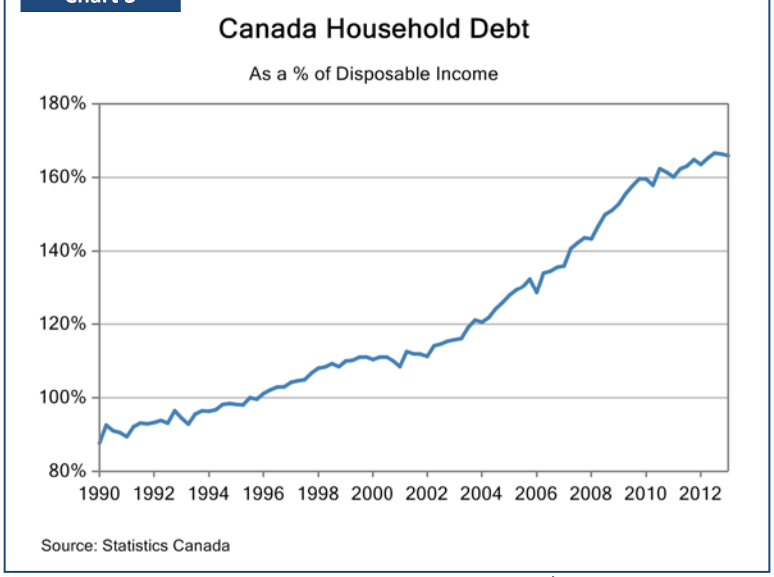
* Spending on goods, services and residential construction
Note: Shaded for periods of recession
Source: Census Bureau, Bureau of Economic Analysis, Statistics Canada, Letko Brosseau

As we update our growth forecast for Canada, three areas warrant attention. First, we note that the economy is rebalancing away from consumers and residential investment. This adjustment is necessary and has been deliberately induced by government policy in response to high consumer debt levels. Second, external trade is unlikely to contribute to growth in the near term as the Canadian dollar remains above its estimated fair value level. Third, resource sector-related investment spending is set to pause following a decade of fast-paced growth. Combined, these factors will represent a headwind to growth for the next two years.

Consumer spending and residential investment as a share of income peaked in 2007 at 107% and is arguably in the process of an adjustment back to more sustainable levels (Chart 2). In an effort to let the air out of a potential nation-wide housing bubble, in June 2012 the Federal Government reduced the amortization period for insured home mortgages from 30 years to 25 years. This measure, which followed a series of tighter credit standards, had a direct impact on housing affordability: a borrower's monthly payments jumped 12.5% under the shorter amortization period.

Immediately following this policy change, the housing market began to slow. Existing home sales are down 5.5% from July 2012. Home price inflation has decelerated to an annual rate of 2.0%, compared with 4.6% in July 2012. Housing starts have also contracted, down 18.4% over the past year to a May level of 186,000. We expect that the Canadian housing market will remain weak as interest rates climb and further erode housing affordability. Furthermore, banks and the Canadian Mortgage Housing Corporation (CMHC) are unlikely to loosen their credit standards in the medium term, as household debt levels remain elevated (Chart 3).

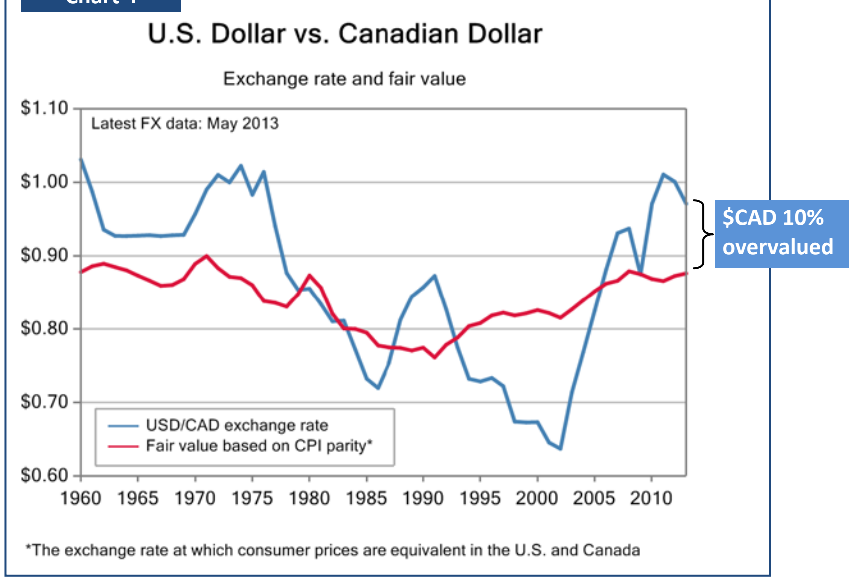
Chart 3



We estimate that weaker residential investment and capital expenditures will translate to a sluggish jobs market. As of May, total employment rose 1.4% year-over-year while private sector employment was up 1.1%. Removing the contribution from the construction sector, private sector jobs rose just 0.2% over the past 6 months. Looking ahead, we expect employment growth in Canada to slow to 0.5% to 1.0% per year. Consequently, we estimate a growth rate of 2.5% to 3.0% for disposable incomes and a similar if not lower expansion in nominal consumer spending.

The trade sector, traditionally a contributor to economic growth in Canada, has swung from a record surplus of 5.7% of GDP in 2001 to a current deficit of 2.0% of GDP. The trade balance's deterioration is concentrated in four main sectors: forestry, natural gas and natural gas liquids, durable goods manufacturing (cars, car parts, electronics) and consumer goods. In the latter two sectors, the strong currency has led to steady erosion in competitiveness and a relocation of production outside Canada. This situation is likely to persist as long as the Canadian dollar continues to trade above its long term parity, which we estimate to be around $0.87 USD per 1 CAD (Chart 4).

Chart 4



However, a decline of the Canadian dollar towards its fair value level could stimulate exports and provide upside to growth in the medium term.

The third and final factor which will contribute to subdued growth in Canada is a slowdown in capital spending, particularly in the resource sector. Accounting for one-fifth of total private sector investment, resource-related capital spending has expanded at nearly twice the annualized rate of growth of total investment (11.5% compared with 6.2%) for the past decade. This trend is unlikely to be sustained as resource prices have been flat to lower over the past 3 to 4 years. A February 2013 Statistics Canada survey which aggregates responses from 28,000 private and public corporations on their investment intentions indicates that investment in the resource sector is likely to contract by 2.5% in 2013. We therefore estimate that total capital spending will slow from a 7.2% annual growth rate in 2012 to 1.7%-2.0% over the next two years.

Although Canada is facing headwinds from the three factors outlined above, we do not expect pronounced weakness or recession. Personal disposable income is expected to expand at a reasonable rate and fiscal balances are in healthy shape and will not act as a drag on growth. Our baseline forecast for Canadian real GDP growth in 2013 and 2014 is around 1.5%. A pickup in exports on the back of a weaker dollar may result in a better outcome.

Stock selection remains paramount

Despite our muted forecast for Canada, we are confident that our portfolios are exposed to a cross-section of quality Canadian companies which will deliver solid returns even in a low growth environment.

One example is the Canadian banking sector, which has come under the spotlight recently. Investors worry that bank balance sheet exposure to an overheated domestic housing market and a highly indebted Canadian consumer may impact the industry's medium-term profit growth. We are of the view that these risks are manageable.

First, given our base case scenario for positive but sluggish job growth and a slowing housing sector, a U.S.-like housing crisis is not imminent. Banks in Canada have full recourse against a borrower who defaults on a mortgage loan; unlike in the United States, the Canadian borrower must pay his debts. Second, over half of a Canadian bank's housing exposure is backed by credit insurance, primarily through the CMHC, a government-guaranteed institution. For the remaining uninsured mortgage book, the average loan to value ratio is 53%. Therefore, we estimate that house prices would have to drop by at least 35% before banks began to suffer significant losses. Third, direct bank exposure to condominium developers is modest (C$4 billion) when compared to industry capital (C$175 billion) and annual pre-provisioning profits (C$55 billion). Finally, the banking industry's aggregate capital base has increased 30% over last 5 years and is at or above Basel 3 requirements.

We favour Canadian banks with significant earnings contribution from faster growing international markets as we build into our forecast slowing domestic asset growth in Canada. We further build in an assumption that banks will act conservatively to increase provisions for potential credit losses. Canadian banks currently trade at a 10 times price-earnings multiple and offer dividend yields in the range of 4%-5%, a valuation level that we find attractive. We expect our Canadian bank holdings to grow net income by 5% per year which, combined with current dividend yields, should provide investors with healthy total returns over a medium-term horizon.

Investment conclusion: we favour equities over bonds

Despite a downtrend in equity prices during the month of June, the past year has seen strong stock market returns around the world. In North America, the S&P 500 expressed in Canadian dollars increased by 24.4% and the S&P/TSX Composite rose 7.9%. In Europe, the FTSE 100 is up 15.8%, the DAX is up 31.4% while the CAC-40 is up 29.1%. Elsewhere, the Nikkei is up 28.6% while the MSCI Emerging Markets Index is up 6.5%. Most major stock indices continue to trade at reasonable valuations. Using estimates for 2013 earnings, both the S&P 500 and the S&P TSX trade around 14 times earnings. In Europe, the FTSE 100, DAX and CAC-40 trade around 12 times earnings. Elsewhere, the Nikkei 225 trades at around 17.3 times earnings while the MSCI Emerging Market Index trades at 10.1 times earnings. In all major developed countries with the exception of the United States, dividend yields are higher than current yields on 10-year government bonds.

Notwithstanding our forecast for below-trend growth in Canada, long-term interest rates still do not reflect economic fundamentals. The 10-year government yield which ended the second quarter at 2.44% is still below nominal GDP growth and barely affords protection against the central bank's 2% inflation target. Moreover, as investors increasingly shift from fixed income assets into equities, the upward pressure on rates will persist. Consequently, we are maintaining a very short duration in our bond portfolio and are underweight bonds within balanced portfolio mandates, given the low expected returns on this asset class over the next two years. We believe that a portfolio of carefully selected stocks will outperform cash and bonds over the medium term.

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

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