Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

Today there is a widespread malaise amongst government policy makers and investors as we are inundated with information, often contradictory, on the state of the world. It is necessary to sort through the muddle and focus on what is important. We would like to share four convictions that drive our current world views and support our portfolio decisions.

First, notwithstanding the many worries, the world economy continues to march on. There remain huge unmet needs in the developing world, which will stimulate consumption in these regions for years to come.

Second, discussions amongst regulators, politicians and corporate executives are about improving their governments and organizations through additional discipline. There is ample consensus in Europe and elsewhere on many issues, i.e. the importance of adhering to fiscal discipline and better regulation for banks. An added positive to these discussions is that the private sector is still considered the main agent through which employment and economic growth will be created. We find it reassuring that economic growth is always a central theme at both national and international levels.

Third, interest rates in the U.S. and Canada are at such low levels that bonds do not offer an attractive risk/reward profile.

Fourth, high quality companies across the world trade at inexpensive valuations. In fact, company dividend yields alone often surpass current yields on fixed income securities.

In this letter, we will review the latest economic developments worldwide and share our views on both fixed income and equity markets.

June 2012

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U.S. Economic Growth Holding Steady

The U.S. economy continues to expand along our expectations. In the first quarter of 2012, real GDP was 2.0% above last year`s level while nominal GDP was 4.0% higher. The sectors that contributed to growth were construction, manufacturing and retail.

U.S. economy progressing along our central growth forecast of 1.5%-2%.

Following five consecutive years of contraction, construction is now growing faster than the economy as a whole. Activity in the residential and non-residential sectors is up 7.0% over the past year to May. Housing may have turned the corner at last; its recovery appears to be supported by several data indicators. Housing starts are up strongly, rising 27% over the past 12 months to 719,000 units, and prices have begun to edge higher. As this is sustained over time, confidence in the housing market will rise and demand will grow. Financing costs continue to fall and commercial banks are open for business. Over the past five quarters, commercial banks have been loosening their credit standards for prime mortgages and have grown their mortgage holdings by 5.9% over the past 12 months. We expect residential construction to be a positive contributor to growth over the next few years.

Manufacturing remains another bright spot. Industrial production in May was 4.5% above the previous year's level and durable goods orders were also ahead 4.3%. Capacity utilization is 79.0%, in line with manufacturing's long-term average. This revival has been sustained by a steady increase in domestic capital investment and strength in consumer demand for durable goods. U.S. firms are also in a good position to continue investing. A survey by ISI of firms whose aggregate sales represent 10% of U.S. GDP indicates that 39% will accelerate their rate of investment over the next twelve months. Capital spending has been sustained by company profitability and economy-wide profits are up 6.5% over the past twelve months.

Housing, manufacturing, and retail sectors positive contributors to growth.

Monthly retail sales have been consistently strong over the past two years. In May, retail sales advanced 5.7% compared with last year. Spending in interest sensitive sectors is also solid. New car sales were up by 11.8% in unit terms (8.9% in dollar terms) and spending on housing-related goods were 6.3% higher. In the past 17 months, growth in consumer spending on goods and services (4.5%) has remained above the growth rate of after-tax incomes (3.4%) and this has been financed by a decline in the saving rate from 5.2% to 3.9%. Looking ahead, we expect that consumer spending will moderate to the level of disposable income growth of around 3%-3.5%.

The recovery in the U.S. labour market is ongoing although job creation slowed during the second quarter. Monthly job gains averaged 97,000 over the past three months, while the private sector created an average of 105,000 jobs. Leading employment indicators still point toward continued improvement: temporary jobs are up 8.5%, hours worked are growing faster than employment (2.3% vs. 1.8%) and the ISI survey signals that 42% of U.S. firms are looking to increase their payrolls. Employment remains on track to advance by around 1.5% this year.

As noted in our last letter, a risk to our growth forecast is an unintended fiscal contraction. The Bush tax cuts and payroll tax cuts expire at year-end 2012; should Washington

politicians fail to reach agreement to extend these measures, a significant tax increase will occur in 2013. For example, the tax rate on dividend income will rise from 15% to 44% and that on capital gains will move from 15% to 24% for individuals in the highest tax brackets. Adding to this, across the board spending cuts are slated to come into force in January 2013. Estimates of the total potential fiscal contraction are in the order of $600 billion, which represents 4% of GDP and 22% of current Federal government revenues. Finally, the Federal government is expected to once again reach its debt ceiling in November or December.

Economic and financial market impacts of these government activities are notably unpredictable. We assume that regardless of the election results, the risk that policy inaction will lead to a U.S. recession in 2013 should be a sufficient incentive for politicians to negotiate some solution. Our base case scenario is therefore for a slow increase in tax rates over the next five years instead of an immediate hike at the end of 2012.

"Fiscal cliff" remains a question mark.

Reviewing our forecast for the U.S. economy, we continue to expect real GDP to grow by 1.5% to 2.0% in 2012. However a number of factors could make for a better outcome. These include an improved trade balance influenced by currently lower oil prices and reduced energy imports, further strength in housing and continued gains in investment.

Europe: A Work in Progress

The strains in Europe's financial markets have hit consumer and business confidence in the region. It is therefore no surprise that the Eurozone's real GDP growth has weakened. At the end of the first quarter, the Eurozone economy was flat compared with the prior year as domestic demand contracted, while the real trade balance improved. Germany, France, Austria and Belgium are still experiencing positive growth while other Eurozone members' economies are contracting. Germany is outperforming its neighbours, with real GDP up by 1.2% in the past year. Outside the Eurozone, the U.K. is in recession, as real GDP has now contracted for four of the past six quarters, although the economy is virtually flat (-0.1%) over the last year.

Europe to experience mild recession this year.

Recent economic indicators for the Eurozone point to weakness. Retail sales are down 1.6% across the region. The unemployment rate has increased by 1.1% over the past twelve months and now stands at 11.1%; Germany is the exception as its unemployment rate has improved from 6.0% to 5.6%. Industrial production has fallen 1.9% and Purchasing Managers Indexes (PMIs), for both manufacturing and non-manufacturing sectors, are at their lowest levels since 2009. Increased risk aversion of banks, firms and households has led to lower private sector demand for funds. Loans to households and the non-financial sector are now contracting at a pace of -0.5% and -0.7% respectively over the past twelve months. We expect that the Eurozone's economy will experience a mild recession this year. Even as current indicators point to a poor economic climate, the absence of large economic imbalances in the Eurozone, coupled with a high savings rate and a Central Bank working hard to prevent a large scale credit crunch, should preclude the European economy from going into a deep recession.

The malaise afflicting the Eurozone is a direct consequence of a crisis of confidence in the region's ability to stabilize its banking system and sovereign debt markets. The most visible indicator of this negative sentiment is the disparity in 10-year government bond yields: Germany is able to borrow at 1.6% while Italy and Spain need to pay 5.8% and 6.3% respectively.

The European Central Bank (ECB), national governments and European institutions are well aware of the need to restore confidence in the region's banking system in order to prevent a large scale credit crunch or deposit flight. This is why two successive rounds of stress tests of European bank balance sheets were conducted in 2010 and 2011. In addition, the ECB has embarked on long-term liquidity creation measures to fund the banking system in unlimited amounts. Recently, European governments have agreed to recapitalize Spanish banks through a €100 billion line of credit, the first such package made available. Importantly, at the end of June, a commitment was made to create a pan European bank regulator by the end of 2012. This regulator will be able to recapitalize banks directly, while using funds made available through the EFSF and the ESM. The Spanish banking recapitalization will be managed by this new entity. There are also discussions underway to move ahead with a Eurozone-wide system of deposit insurance.

Europe beginning to focus on growth-oriented measures.

While the main focus over the past two years has been on austerity programs to reduce government deficits, talk has also begun to turn towards finding ways to stimulate growth in the region. A recent announcement to this effect was an increase in the capital of the European Investment Bank (EIB), an institution which provides long-term loans for large capital investment projects. The increase would allow the EIB to expand its balance sheet from €400 billion to €460 billion. In addition, at the end of June, further stimulative measures worth €60 billion were announced, bringing the total stimulus to €120 billion. This represents 1.3% of nominal GDP and will be disbursed over a few years, potentially boosting Eurozone GDP by 0.3% to 0.5% annually over each of the next three years.

External imbalance improving.

Progress continues to be made in the region's trade and current account balances. For the Eurozone as a whole, the current account is 0.1% of GDP, a slight surplus and a 0.7% of GDP improvement compared to last year. Countries with persistently high current account deficits have seen these deficits shrink over the past five years: Spain moved from -10.3% of GDP to -3.3% of GDP, Portugal from -12.3% of GDP to -5.4% of GDP while Greece moved from -15.3% of GDP to -9.6% of GDP. Simultaneously, Germany has seen its large surplus decline from 7.4% to 5.7%. A narrowing of the current account gaps across European countries is positive as it reduces the requirements for cross border financing and fosters more stable financial markets. As we expect wage inflation to be stronger in Germany than elsewhere, this positive development should be maintained.

European policymakers are very much committed to the Euro but do require time to implement structural reforms. In the interim, the ECB and other European institutions are marshaling efforts towards addressing liquidity problems. Additional support will be provided should it be required. A majority of Europe's citizens view the European Union favorably and are strongly behind the Euro. The political processes to strengthen the monetary union are

underway. As we look out over the next two years, we expect the Eurozone's fiscal deficit to decline to around 2% of GDP. Net debt to GDP should stabilize at around 67% and the current account balance will likely be in equilibrium. From that point, Europe should be on a more stable path and able to grow at its potential rate of 1.5% to 2.0%.

Global Economy on Moderate Growth Path

Economic growth in Canada has been steady over the past year as real GDP advanced by 1.8%. Canada's expansion is led by increases in personal spending and residential investment, which have been underpinned by healthy increases in employment. Over the past three months, job creation averaged 49,000 jobs per month, a very strong result. Over the past year, employment has risen by 1.2% and the unemployment rate is now 7.3%. Aggregate wages increased by 3.3% over the same period. For 2012, we expect real GDP in Canada to average around 2.0%.

IMF forecasts global economy to grow 3.5% in 2012.

Around the world, real GDP is up 2.7% year-over-year in Japan as the economy continues to rebound from the effects of last year's devastating earthquake. In the developing world, the pace of economic growth has slowed although most countries are still expanding at rates well above the developed world. China's real GDP expanded by 8.1% in the past twelve months while India's GDP is up by 5.3%. In Latin America, growth in Brazil slowed sharply to 0.8% over the past twelve months while other countries in the region are growing at annual rates of 4% to 6%. A similar pace of growth is being experienced in Eastern Europe, as Russia, Turkey and Poland are growing at 4.9%, 5.2% and 3.5% respectively. The IMF's global growth forecast for 2012 is 3.5%, driven by growth in the developing world.

Bond Market Bubble?

Bond yields in Canada are at the lowest level in history, dating back to 1872. Over the last 15 months, the price of the Government of Canada 4% bond due 2041 rose from $105 to $135, a gain of 29%. What has driven bonds to such spectacular moves over such a short time and what could potentially trigger the bursting of this bond bubble?

First, sluggish economic growth has led to a drop in loan demand over the last five years. In the U.S., funds raised – i.e. loans and share issuance – by the non-financial sector dropped from 14.7% of GDP in 2007 to 10.1% over the last year as private sector borrowing turned towards the repayment of debt. This type of activity has often been associated with falling rates.

Second, the fear of a sovereign debt default in Europe as well as concerns for the viability of the Euro and even of the European Union have driven investors, small and large, in search of safe havens such as U.S. Treasuries or Canadian and German government bonds.

Third, the Federal Reserve has expanded the size of its balance sheet through direct purchases of U.S. Treasuries. In 2007, the Fed held $741 billion of U.S. government bonds, which represented 5.3% of GDP. As of March 2012, the Fed held $1,661 billion in Treasuries

Yields driven to all-time lows by:

and an additional $933 billion in U.S. agency debt, representing 16.8% of current GDP. The Fed's significant intervention undoubtedly helped to lower interest rates.

Finally, the trend to "de-risk" pension funds from further declines in interest rates by matching the maturity of its assets with that of the plan's long-dated pension liabilities has been an important support to the bond market. As interest rates fall, lower discount rates are applied to pension plans' future liabilities, leading to an increase in the present value of those liabilities and forcing plan sponsors to increase their annual contributions. Numerous pension plans have responded by adding long-term bonds to their asset allocation in what is commonly known as asset-liability matching. Because the value of long-term bonds moves in the same direction as the discounted liabilities, this strategy reduces the volatility of the pension funds' funding gap and of the resulting contribution requirements.

low loan demand, Fed intervention, safe haven flows, and asset-liability matching among pension funds.

We believe all of these factors have jointly driven interest rates in the U.S. and Canada to record low levels. What could deflate this balloon? We put forth the following as a possible scenario.

Notwithstanding our central forecast for U.S. economic growth of 1.5%-2.0%, there are several economic pressures that could combine and lead to a more optimistic outcome. An additional 1% pickup in U.S. GDP, equivalent to $160 billion, could arise from a more robust improvement in the net trade account possibly via less imported energy. Better housing activity, further gains in domestic manufacturing investments, oil drilling and non-residential construction are areas that are now improving and could accelerate. Ten year Treasuries yielding 1.6% while real GDP grows at 2.5%-3.0% topped by inflation of at least 1% would be unusual and would challenge bond buyers. Furthermore, better conditions in the U.S. might have a constructive impact on Europe's efforts to put in place the elements necessary to calm fears of failure and reduce pressures to move capital to a safe haven.

But a pickup in U.S. growth, continued progress in Europe and changes in pension regulation may trigger bond revolt.

Changes in U.S. regulation should reduce the obligation of plan sponsors to make additional contributions. Recent passage of the Highway Bill came with an amendment affecting pension plans: plan sponsors will now be allowed to calculate liabilities using a discount rate based on a combination of a longer-term moving average of bond yields instead of a 2-year average. The effect will be to increase the discount rate substantially and therefore to reduce the present value of future pension liabilities. Given that most funds in the U.S. are suffering from a solvency deficit, the changes in legislation will allow companies to cut their cash contributions to their pension funds over the next few years, potentially reducing the demand for long-term bonds.

While it is difficult to measure precisely the impact these changes may have on the demand for long-term bonds, we believe these combined developments may prove significant. Needless to say we remain very cautious in regards to bonds and we maintain a low exposure while also keeping our duration short.

Stocks Offer Better Value and Potential Upside

Stock markets have continued to move in the opposite direction to bond markets. Stock prices around the world have declined since the end of the first quarter and the MSCI World Index (in Canadian dollars) is now 3.2% below the level at end-March 2012 and 0.4% above the prior year. Over the past year, the S&P 500 has outperformed virtually all other markets: 11.4% compared with -10.3% for the S&P TSX, -19.9% for DAX, -22.6% for CAC-40, 0.9% for FTSE and -0.1% for Nikkei.

The dividend yields of Canadian, U.S. and European companies are comfortably above 10-year government bond yields and price-to-earnings multiples are in attractive territory. The P/E ratio based on forecast 2012 profits is 12.8 for the S&P 500, 12.6 for the S&P TSX, and 10.3 for the Bloomberg Euro 500. We believe European equities in particular have priced in an excessively negative economic scenario and trade at unusually depressed valuations, close to the lows experienced in 2009. We find it interesting that while anecdotal evidence suggests that many retail and institutional investors have sold exposure to European equities, in the past few weeks several Canadian companies have decided to buy their European-based peers. A few such examples include: Couche-Tard making an offer for Statoil's Scandinavian-based convenience stores; Fairfax Financial buying Brit Insurance Limited; CGI Group buying Anglo-Dutch IT services firm Logica; CAE acquiring UK's Oxford Aviation Academy; Molson Coors taking over Eastern European brewer StarBev; Quebec's engineering firm Genivar bidding for British WSP.

Equities expected to deliver superior returns vs. bonds and cash.

We have maintained a significant exposure to large capitalization companies with worldwide operations that are well positioned to benefit from sustained growth in consumption amongst emerging market economies, regardless of their headquarter location. Our portfolios are well diversified across many economic sectors and geographies and consist of carefully selected stocks that trade at sound valuation multiples. The weighted average P/E ratio of our top 100 holdings is 10.8 and the average dividend yield is 3.5%. We are confident that our equity portfolios will offer better returns than both cash and bonds over the medium term.

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

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