Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

Just over twelve months ago, questions about the sustainability of Greece's debt load dominated the financial press and investors evaluated the likelihood of a default leading to negative spillover effects on the Eurozone. These events, combined with signs of weakening U.S. growth, were viewed as a threat to the global economic recovery. Bond yields headed towards historically low levels while equity markets declined in spring and early summer of 2010. Today, we note that the same issues once again dominate the headlines and similar – although less pronounced – moves have occurred in both equity and bond markets.

As we have reiterated throughout the past year and review briefly again in this letter, while individual countries at the perimeter, notably Greece, are experiencing difficult economic and fiscal situations, we do not believe that the stability of the Eurozone is under threat. Ultimately, the situation in Europe will induce policymakers to find a solution as it will be in their self-interest to do so. Similarly, we do not foresee a scenario in which political parties in the U.S. remain deadlocked over raising the debt ceiling thereby leading to a default on U.S. debt.

It may be tempting for investors to view Canada's economic and financial market landscape with a certain degree of complacency. After all, the economy and its banks have emerged from the recession in relatively strong shape, Canada's fiscal finances appear to be on a solid footing and the country is rich in resources which will benefit from a secular growth in demand from emerging markets. We would caution against the view that Canada will continue to consistently outperform its foreign counterparts. We expect that the valuations of Canadian and international equities will eventually converge towards similar levels.

Our investment strategy remains unchanged. We expect interest rates to rise from these exceptionally low levels and we continue to manage our bond portfolio cautiously, with relatively short duration and with careful attention paid to the quality of investments. Equities should deliver solid returns and outperform cash and bonds.

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Review of the U.S. Economy

U.S. economic growth continued at a steady pace in the first quarter of 2011. Over the past twelve months, real GDP has expanded by 2.3%, driven by consumer spending (up 2.7%) and company investment in machinery and equipment (up 14.7%). Exports remain an area of particular strength (up 16.7%) and in general the pace of the recovery and its distribution among economic sectors remain in line with our expectations.

U.S. industrial activity remains robust.

Industrial production was up 4.4% in May on a year-over-year basis as activity in the manufacturing sector continues to grow strongly. Other key indicators of the economic recovery continue to show positive results: durable goods orders are up 9.8% and retail sales are up 7.7%. These levels of activity, coupled with steady profits and healthy balance sheets, lead us to believe that company investment in machinery and equipment will continue to be robust and a key support for economic growth.

The increase in both nominal wages and disposable income, up 3.3% and 3.4% respectively, is due to a gradual increase in employment and hours worked. Job creation in the private sector is 1.6% above last year's levels and has averaged 184,000 per month between March and May. However job growth has been dampened by public sector cuts as state governments have been required to reduce payrolls in order to balance their budgets. Total employment is only 0.7% above last year's level and monthly job creation has averaged 160,000 per month over the last three months.

Despite positive developments in the jobs market, the pace of job growth has not been sufficient to meaningfully impact the unemployment rate, which remains above 9%. There appear to be structural issues overhanging the jobs market which suggests that the recovery is unlikely to unfold in a classic cyclical fashion.

Private sector employment creation on the rise…

… but structural issues impede faster job growth.

The first structural difference with past recoveries is the persistent weakness in the residential construction sector. Since December 2007, 1.1 million jobs directly linked to the housing sector have been lost. When taking into account job losses indirectly impacted by the collapse in construction, the total is likely far greater. During the same period, housing starts fell from 1.2 million units under construction to 0.6 million units. Notwithstanding the slow pace of construction, the inventory of empty homes remains high, around 2 million units above its historical average. This inventory overhang has not yet been absorbed as the rate of formation of new households – which typically keeps pace with population growth – has fallen and closely corresponds to the current level of new housing starts. Consequently, we expect residential construction to remain weak for at least the next two years and job creation in this sector is unlikely to improve significantly until then.

The financial sector has also experienced job cuts which may be viewed as structural rather than cyclical. Since December 2007, 627,000 jobs have been shed, many of which were linked to the troubles experienced in the mortgage-servicing sector. With residential investment expected to remain weak and U.S. consumers likely to maintain household debt at a stable level, consumer lending activity will be subdued. We should therefore not expect to see significant growth in related financial sector jobs in the medium term.

Turning to the public sector, employment in state and local governments has fallen by 350,000. State and local governments have an obligation to adjust their revenues and expenses on a yearly basis to ensure a balanced budget. Following a loss of tax revenues during the recession, governments have been compelled to reduce payrolls. While revenues have since risen during the economic recovery, states will no longer receive temporary, recession-induced fiscal transfers from the federal government corresponding to 2.8% of their annual budgets. Further fiscal restraint at the federal level should also contribute to keep a cap on government employment.

We conclude that job creation in the U.S. will continue to improve at a growth rate of 1.0% – 1.5% per year, in line with 1.2% experienced during 2003–2007. Our economic forecasts take into account that approximately 2 million out of the 8 million jobs lost during the last recession may not be regained over the next 3–5 years. This level of job creation, coupled with low levels of wage inflation, should still generate steady growth in disposable income of 3.0%–4.0% and a similar rate of expansion in consumer expenditures.

We do not believe U.S. government will default on its debt.

Federal government spending is expected to stay relatively flat in 2011. The deficit will increase slightly from 9% of GDP in 2010 towards 10.5% of GDP in 2011. At the current pace of borrowing, the U.S. Federal government will reach its self-imposed debt ceiling in early August. Disagreement between Republican and Democratic leaders regarding how much to increase the debt ceiling and the fiscal path to follow over the next 18 months has led to concern that an accord remains elusive. If both parties cannot agree prior to the debt ceiling deadline, the Federal government will need to drastically reduce its activities and all non-essential activities will stop. In our view, if a shutdown should occur, it would last only a few days as there will be considerable pressure to resolve the issue. We do not believe that the U.S. Treasury will be required to stop servicing the interest payments on Government bonds and bills, an event which would trigger a default. We expect to have more clarity on the path for the government's finances once the 2012 presidential campaign gets underway, as fiscal sustainability will undoubtedly be a major theme of the campaign.

U.S. real GDP forecast to grow at modest rate.

Our forecast for U.S. real GDP growth in 2011 is 2.0%–3.0%. Going forward, we still expect real GDP to shift to a slower growth path of 1.5%–2% as fiscal contraction sets in, although the nature and pace of the reduction will remain a subject of significant debate in the short-term. Progress on the trade balance, either through an improvement in the deficit with China or a reduced dependency on imported oil, has the potential to boost growth by 0.5%–1%.

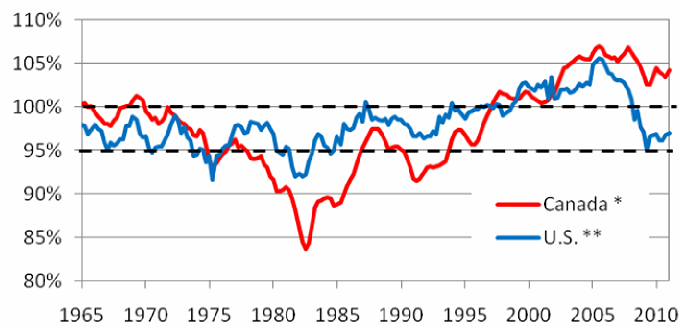
Perspectives on Canada

Canada has emerged from the global recession in strong shape. On a nominal basis, Canadian GDP is 3.5% higher than the peak reached in 2008. Real GDP grew by 3.2% in 2010 and is on track to expand by around 3% in 2011. Total private wages are up 5.7% year-over-year and 134,000 additional jobs have been created in the recovery than were lost during the recession. Industrial production expanded by 5.0% and aggregate corporate profits are up 13.4% over last year.

Canada has emerged from recession in relatively solid shape.

Canada has fared well for several reasons. First and foremost, the banking system avoided the large losses on its loan portfolios and subsequent deleveraging and recapitalization which many global banks were required to undertake in the aftermath of the financial crisis. Additionally, the shutdown of the shadow banking system made up of GMAC, Ford Credit, Fannie Mae, Freddie Mac and private mortgage issuers, which at the height of the crisis could neither sell debt packages on the securitization market nor finance the holdings of such financial assets also played a major part in the severe constraint on credit in the U.S. economy. In Canada the shadow banking system played a relatively minor role in the credit distribution channel and the banks emerged from the crisis in relatively solid shape. Easy access to debt financing at low interest rates allowed consumers and corporations to quickly ramp up spending and investment.

Chart 1
Consumer Spending as a % of Disposable income



* Spending on goods, services and residential construction
** Spending on goods, services, interest payments, transfer payments and residential construction
Source: Census Bureau, Bureau of Economic Analysis, Statistics Canada

But today, Canadian consumers spend at high rate, have accumulated a lot of debt and their home values are at

Today, consumer spending on goods, services and housing in proportion to disposable income remains significantly higher than in the U.S. (Chart 1). Canadians spend 105% of their after-tax income, close to the peak level of 107% reached in 2007, while Americans have reduced their spending rate from 105% to 96%, a level more in line with their historical average.

Canadians have also benefitted from rising home values. Unlike the situation in the U.S. and several European countries, residential real estate in Canada did not experience a sharp correction in prices following the recession. From 2000–2007, housing prices increased 70% in Canada while U.S. prices jumped 104%, both markets rising at rates much faster than the growth in disposable income per household. In contrast, from 2008–2010, national home prices in the U.S. declined 30% while in Canada prices continued to rise by 19%. As a result, house prices in Canada are at record high levels relative to median household income (Chart 2). U.S. consumer wealth was adversely affected by a decline in both real estate values and financial portfolios. The ratio of net worth to disposable income declined from 6.4 to 5.0 in the U.S. while in Canada the decline was negligible, from 6.4 to 6.1. Thus, the robust Canadian housing market has helped to sustain a high consumer spending rate.

On the employment front, the contrast between the recoveries is significant. Unlike the aforementioned structural issues facing the U.S. market, Canada lost 428,000 jobs during the recession and has since created 562,000. As a consequence, government revenues have been much steadier while in the U.S. tax receipts remain 11% below the 2007 level.

The question which arises is whether Canada's economic and financial backdrop will continue to remain far more favourable than the U.S. and other developed countries. We believe there are reasons which warrant some caution.

The consequence of accommodative monetary policy and easy credit conditions has been a rise in private sector indebtedness. Total Canadian household debt (which comprises mortgages and consumer credit such as auto loans, credit card debt and lines of credit) now amounts to $1.53 trillion or a record 149% of disposable income. In contrast, U.S. consumers have been paying down debt and household debt now stands at $12.9 trillion or 112% of disposable income**.** As interest rates rise to levels more in line with an expanding economy, the consumer spending rate is likely to gradually adjust downwards towards its long term average of 95% of disposable income. Two factors are likely to play an important role in this normalization process, namely consumer credit and the housing market.

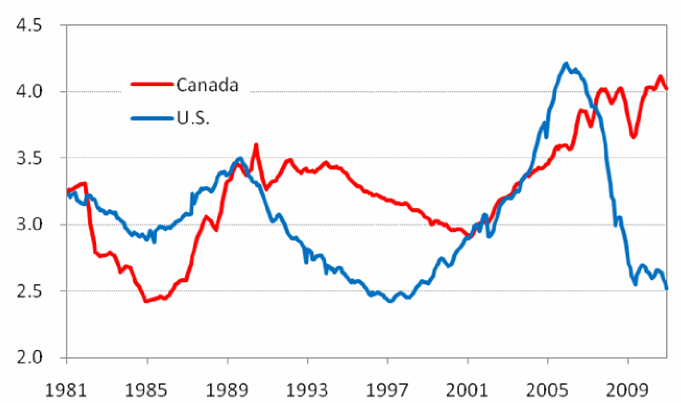
As interest rates rise...

The balance of consumer credit outstanding is now 25% higher today in Canada than at year end 2007, while it is 3.7% lower in the U.S. As the Bank of Canada tightens monetary conditions and interest rates begin to rise, we should see a slowdown in consumer credit. Moreover, consumption will also be impacted as households spend more in line with the income they generate and a portion of the spending is diverted towards increased interest rate payments.

… we expect Canadian consumer spending rate to trend

Turning to the housing market, the appreciation in Canadian real estate has lifted values to 4 times the level of disposable income, a historical high and well above the long-term average of 3.2 (Chart 2). In comparison, the ratio of U.S. home values to household disposable income fell from 3.8 in 2007 to 2.5 in 2011, a level consistent with its historical mean.

Chart 2
Ratio of Average Home Price to Household Income



Source: Teranet, Statistics Canada, S&P Case-Schiller, FHFA, Federal Reserve Board, CREA, Letko Brosseau.

… and housing prices to cool off.

A rising interest rate environment typically leads to a slowdown in residential construction and a cooling off in housing prices. For a 1% increase in interest rates, we estimate that the negative impact on real GDP would be between 0.4% and 1%. We believe that home values are unlikely to continue to grow at a much faster pace than household income and this ratio will adjust towards its mean over the course of the next several years. We do not, however, foresee a U.S.-style housing collapse, given the conservative credit culture of Canadian mortgage underwriting, the strong capitalization of the Canadian banking system and the legal requirement by borrowers to assume full liability on their mortgage debt.

Canada forecast to grow in line with peers in developed world.

While Canada remains structurally sound, one cannot ignore the historically high level of consumer spending, the high level of consumer indebtedness and rapidly appreciating housing market. Moreover, just as in most of the developed world, fiscal tightening will detract from economic growth. An adjustment in consumer and government spending behaviour will occur over the next few years and is factored into our forecast for the economy. Therefore, we expect growth in Canada to average around 2% over the medium term, in line with our forecast for much of the developed world.

Update on Greece

Economic growth has remained steady in the Eurozone. Real GDP is up by 2.4% over the past twelve months, however the growth profile varies widely from country to country. The economic expansion in Northern Europe is robust, with Germany leading the group with 4.8% growth and the Netherlands, Austria and Finland growing at rates above 3%. In France, real GDP has increased by 2.2%, while growth is notably slower in Italy and Spain at 1.0% and 0.8% respectively. The economies of Portugal, Ireland and Greece, all which have received financial support from the EU and IMF, are contracting at rates of –0.7%, –0.8% and –4.8% respectively.

Sovereign debt issues are complex but are being addressed.

In Greece, the €110 billion facility arranged by the EU and IMF in May 2010 was meant to cover the government's borrowing requirements until mid-2013. The bailout funds were to be disbursed periodically and conditional on Greece embarking on a stringent fiscal adjustment.

Progress on austerity measures has been made with the government implementing higher taxes on both consumption and income as well as reducing civil service salaries and pension benefits. These measures, however, were largely responsible for the sharp recession in the country. The larger than expected shortfall in government revenues has meant that the path of adjustment for Greek public finances may take longer than originally anticipated. As it appears that Greece will remain shut out from borrowing in international markets in 2013, it has turned once again to the EU and IMF to come to an agreement for assistance beyond the expiry of its bailout fund.

We are not convinced that Greece's current difficulties imply a default on its debt. This solution would unleash chaos in the local banking system, which are important holders of government debt, as well as forcing an even more painful adjustment on the Greek people. Furthermore, a default would mean that Eurozone governments and the European Central Bank, also holders of Greek debt, would bear the losses which we currently estimate at €65 billion or 0.7% of the region's GDP. While first-order financial impact of a Greek default appears manageable for the E.U. (ex-Greece) financial system and the public to bear, the contagion effects on other member countries are difficult to predict. Both the ECB and Eurozone governments are reluctant to be seen to be taking any losses on Greece and, ultimately, share a common interest to preserve the integrity of the political and economic union they embarked upon more than 60 years ago.

Although the details of negotiations are ongoing, it appears that the European Union and the ECB have taken the decision to extend loans to Greece and support its banking system. The maturity of the loans from the €110 billion package was extended from 4.5 years to 7.5 years. European institutions are likely to add additional staff on the ground to help improve efforts in tax collections while requiring Greece to continue to improve its fiscal situation. Greece also looks set to sell some state-owned assets, thereby raising an additional €50 billion. We assume that these measures, if successful, will stabilize Greek debt levels at 150% to 160% of GDP, which may still prevent a return to financial markets and warrant dependency on the EU and IMF for several more years.

Investment Strategy: Bonds

Interest rates in the U.S. and Canada have trended downwards over the past three months, moving back towards the lows last reached in October 2010 and December 2008. Canadian government bond yields for five-year and ten-year maturities fell around 35 basis points and were 2.33% and 3.11% respectively at end-June. Shorter-term yields also moved lower as fixed income markets have reduced their expectations for interest rate hikes from the Bank of Canada. Two-year yields have fallen from 1.9% to 1.56% over the last quarter.

U.S. government yields under 10-year maturities are between 60 – 110 basis points below the Canadian yield curve. The Federal Reserve has maintained policy rates near 0% for the last two and a half years. On the basis of expectations derived from the yield curve, fixed income investors currently do not foresee more than one quarter point increase over the next two years. In the U.S., two-year, five-year and 10-year government yields are 0.46%, 1.73% and 3.17% respectively.

Bond portfolio defensively positioned for rising rates.

We reiterate our view that yields are very low in absolute terms and not an appealing investment. Economic growth continues to progress and employment is on an improving trend. In addition, private credit expansion continues at a steady pace and government financing requirements, while forecast to decline, will continue to be above historical averages. We foresee a rise in interest rates and bond returns for the medium term will be meagre. Consequently, our portfolios remain below their target weight in bonds and duration is kept short.

Investment Strategy: Equities

Global equity markets as represented by the MSCI World Index were essentially flat during the past quarter but still well above levels from a year ago. Over the last twelve months to June, the total return on equities (calculated in Canadian dollars) are: MSCI World Index

+19%, S&P 500 +19%, S&P/TSX +21%, DAX +33% (excluding dividends), CAC-40 +29%, FTSE +22%, Nikkei +6%.

Based on current year earnings, most major stock markets trade between 9.5 and 14.5 times. The 100-year average P/E ratio for the S&P 500 is 14.4 times; this suggests that valuation levels are still within a reasonable range.

Stocks should outperform cash and bonds over medium-term.

U.S. public pension plan and retail investors' allocations to equities have risen since the financial crisis but have not yet returned to their prior peaks. In contrast, U.S. and U.K. private pension plans' allocation to equities have remained near 2009 levels, indicating a shift into other asset classes as stock markets have rebounded. In the U.S. in particular, equity allocations of private pension plans are at 35%, their lowest level in the last 60 years. Even a modest reallocation towards the historical mean could imply an expansion in earnings multiples through a renewed leg upwards in equity prices.

In conclusion, under differing scenarios of earnings growth and valuation over a 5-year period, we expect total returns from equities in the range of 6%-13% per annum, easily outperforming bonds and cash investments.

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