Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

During the past year, the ongoing global recovery has been punctuated by periods of uncertainty and financial market volatility. Greece's debt refinancing problems and concerns that other weak European economies would suffer the same fate became the catalysts to a 15% decline in the MSCI World equity index between mid-April and early July. A slowdown in certain U.S. economic indicators during the summer months was interpreted as an early warning sign for a double-dip recession. U.S. and Canadian 10-year bond yields fell by around 100 basis points between April and early November. In late autumn, a banking crisis in Ireland led European authorities to put together a financial aid package and prompted renewed concerns over the fiscal health of a few member nations. Bond and equity markets in Europe weakened in November and talk of an eventual dissolution of the Eurozone resurfaced.

Throughout the year, we have reiterated our view that the global economic recovery was durable. Most economies have now expanded for six consecutive quarters and, in the developing world, growth continues at a strong pace. In the U.S., we saw little evidence pointing towards a relapse into recession. Indeed, more recent data indicate stronger activity in the fourth quarter and real U.S. GDP expanding around 3% for 2010. Throughout the year as bond yields continued to decline due to expectations of weakening growth and speculation regarding the impact of the Federal Reserve's Treasury bond purchase program, we cautioned that a rebound in private sector demand for funds would eventually lead to upward pressure on interest rates. Since early November, yields on 10-year government bonds in the U.S. and Canada have risen by 85 and 40 basis points. Our view on Europe has been similarly consistent and will be the main topic addressed in this letter; while many Eurozone countries face challenges in reining in their deficits and public debts, the situation is manageable.

Our investment strategy continues to favour equity investments over bonds and cash.

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A Review of the Global Economy

The likelihood of a double dip recession in the U.S. remains remote.

As we discussed in last quarter's letter, the likelihood of a double dip recession in the U.S. remains remote as most economic indicators continue to point towards a steady recovery. Data for the third quarter indicate that U.S. real GDP expanded by 3.2% on a year-over-year basis. Private sector demand bounced back with sales of consumer durables 5.4% higher while corporations increased their spending on machinery and equipment by 19.1%. Our forecast for real GDP growth in 2010 remains around 3%.

A broad cross-section of economic data, particularly in the industrial sector, is signalling robust activity. As of October, industrial production is up 5.8% and manufacturing orders are up 10% compared with a year ago. This is reflected in the transportation sector, with diesel consumption having increased 7.7% over the past year while rail freight car loads are 7.2% higher. In addition, corporate profits have rebounded strongly from their recession lows and have now surpassed the previous peak reached in 2006. U.S. corporate profits totalled $1.7 trillion in the third quarter, a 27.8% increase over the past year. Profits of the financial sector are up 10.6% while non-financial profits are up 36.2%.

The labour market continues to lag the recovery, although conditions are slowly improving. The latest employment data for December show that total employment is 0.9% above last year's level corresponding to an average 94,000 jobs created per month. Employment in the private sector is slightly better, up 1.3% over the same period.

Our base case forecast for the U.S. economy in 2011 calls for 2% real GDP growth. A more optimistic growth case of 3%-4% is also feasible.

Encouragingly, various leading job indicators are pointing towards sustained growth in employment. First, aggregate hours worked in the private sector are up 2.5% year-over-year, twice the rate of job creation in the private sector. Second, temporary job creation is expanding at a rate of 26,000 per month or 16.1% year-over-year. Third, initial unemployment claims have dropped to levels prevailing around August 2008, indicating less people have been registering for unemployment benefits. Fourth, the Institute for Supply Management (ISM) employment indexes have recently recorded the highest readings since October 2007 for the non-manufacturing sector. Finally, a just published survey of 118 Chief Financial Officers by ISI Group, a U.S.-based economics research firm, indicates that 37% of corporate CFOs plan to increase their hiring in 2011. These combined factors largely explain a robust 7.3% annual increase in retail sales and reinforce our expectations for continued steady growth in private sector payrolls.

Our base case forecast for the U.S. economy in 2011 calls for approximately 2% real GDP growth. This will be supported by employment expanding at a 1%-1.5% pace, continued moderate wage growth and a full extension of the Bush tax cuts. Under this scenario, nominal after-tax incomes will rise by 3%-4% which will be supportive of a similar increase in consumer spending. Furthermore, strong corporate profits and healthy balance sheets should allow for significant increases in corporate investments.

A more optimistic growth case can also be put forward. Should the U.S. saving rate decrease somewhat from the current 6% level towards 4.5% and/or the trade balance improve marginally, this could push real GDP growth closer to 3%-4%. Longer term, however, we still maintain that the U.S. government will have to take action to reduce its fiscal deficits and

consumers will gradually rebuild savings closer to a long-term average rate of 8%. This will lead to subpar economic growth in the range of 1%-2%.

The Canadian economy continues to progress, particularly on the domestic front. During the third quarter, real GDP was 3.4% higher than the same period last year buoyed by consumer spending which rose by 3.4% and corporate investment which grew by 8.7%. Government spending and residential investment were flat.

Meanwhile, the high level of the Canadian dollar is having an adverse impact on the trade sector. Net exports subtracted 3.2% from real GDP growth and the trade balance in real terms now accounts for -10.2% of GDP, the largest deficit since the 1960s. As we estimate growth for 2011, trade remains an important swing factor. Our key assumptions are: exports and imports grow at the same pace as 2010; a slow and steady increase in jobs; a continued rise in corporate investment and moderate fiscal tightening. Under this scenario, the Canadian economy will grow by 2%-3% in 2011.

Growth in other parts of the world remains robust.

A review of growth prospects in other parts of the world points to continued economic progress and, in some regions, strong recovery. Japan's economy has benefited from a rebound in exports. Real GDP increased by 5% over the past year as exports increased by 21.7% and as corporate investment rose by 6.5%. In other parts of Asia, economic growth is robust. China's real GDP growth over the past year is 9.6%, India's economy has grown by 8.9% and growth rates for other Asian economies range from 4.5% to 7%. Economic expansion in Latin America is similarly vigorous; Brazil's real GDP advanced by 8.8% while Mexico has grown by 5.3% over the past twelve months. Given the strong recovery in the developing world, the IMF's latest economic forecast calls for real global GDP to grow by 4.2% in 2011.

Europe's Challenges

Recovery from recession in Europe has evolved differently from one country to another. Real GDP growth for the Eurozone expanded an aggregate 1.9% over the past twelve months. On one end of the spectrum stands Germany, with its economy growing by 3.9% led by exports that are up 16.8%. On the other end lie Italy, Spain, Ireland and Greece with growth rates below 1% and the latter two not yet having emerged from recession.

It would be mistaken to assume that recent challenges will hasten the dissolution of the European Monetary Union.

In November, Ireland became the second Eurozone country to require a rescue package from the EU and IMF. As was the case last spring, market participants again raised doubts about the long-term outlook for the Eurozone. As we discussed extensively in our June 2010 letter and review again below, it would be mistaken to assume that recent challenges will hasten the dissolution of the common currency union. Furthermore, it is our view that Eurozone members face a situation that is ultimately manageable.

Europe's currency union is the culmination of six decades of effort towards economic integration. Following World War II, Germany, France and Italy began to negotiate a series of treaties to facilitate free movement of goods across borders. By the early 1990's, the signing of the Maastricht Treaty laid the groundwork for the creation of a European Monetary Union

(EMU). Shortly thereafter, all capital controls were lifted within what would eventually become the Eurozone and a fixed currency peg was established among the original 11 (now 16) participating currencies. In 1999, the Euro was created as a purely electronic currency and a single monetary policy overseen by the European Central Bank (ECB) was established. In January 2002 physical coins and bills replaced all national currencies in the Eurozone.

Foreign (i.e. non Euro) ownership of Eurozone debt does not exceed 28% in any single member country.

During this period, common interests combined with strong political will drove the creation of the world's second-largest economic entity whose GDP currently totals $12 trillion, compared to $14.6 trillion for the U.S. The region's economies, financial systems and capital markets are fully integrated. Across the Eurozone, countries hold on average 49% of their own national debt securities; adding in Eurozone cross-border debt holdings, this proportion rises to 72%. Foreign (i.e. non Euro) ownership of Eurozone debt does not exceed 28% in any single member country. A closer look at trade flows shows that 60% of all merchandise transactions by countries of the Eurozone are with fellow members. On the investments side, 56% of the income received or paid out as interest and dividends come from within the region. There is, therefore, a high level of Euros at stake for every country which is a member of the Union.

Criteria for eligibility to enter and remain within EMU were set in the stability and growth pact which required tight fiscal discipline among member countries. For example, annual government deficits and aggregate public debt were not to exceed 3% and 60% of GDP respectively. In practice adherence to these limits was often breached and sanctions for such deviations were never applied. Consequently, once the 2008 financial and economic crisis hit, many countries were already carrying high debt levels which were further exacerbated by a recession-induced rise in fiscal deficits. The worst offenders in 2009 were Greece and Ireland, with budget deficits of 15.4% and 14.4% of GDP and debt levels projected to reach 150% and 107% of GDP respectively by the end of 2011. However, these countries currently account for a negligible share of Eurozone GDP: Greece accounts for 2.5% and Ireland's share is 1.7%.

Eurozone funds are sufficient to bail out Greece, Ireland and Portugal… but not Spain and Italy.

Following the stand-alone deal negotiated for Greece's rescue in May, two separate Eurozone funds, topped up by IMF money for a total of €750 billion, were created to provide timely financing to a country experiencing difficulties raising funds in capital markets. These special lending facilities involve all 16 Eurozone members borrowing – on a proportional not equal basis – directly or indirectly via the offer of guarantees in debt markets. A country's access to this funding would be conditional on enacting measures to bring budget deficits in line and reducing public debt levels.

In practice, however, the funds available to assist countries in difficulty are less than €750 billion. Each country requiring access to financing from the lending facilities means one less country able to contribute its proportional share. For example, Greece and Ireland have received financial assistance and are therefore not contributing to the funding pool. This has not had a meaningful impact since their combined proportional representation within the Eurozone funding pool is 3.1%. Should contagion persist and credit markets refuse financing to other large Eurozone countries such as Portugal, Spain and Italy, the funding pool would progressively shrink. It is therefore important both to quantify the problem and review the likelihood of these larger countries being shut out of debt markets.

We assume that the backing of the Eurozone's triple-A rated countries (Germany, France, the Netherlands, Austria, Finland and Luxembourg) is the most secure and hence these countries are least likely to require access to financing. According to our calculations, the arrangements for Greece and Ireland will jointly account for 1.3% of the combined GDP of the 6 triple-A rated countries, assuming the facilities are fully utilized and the debt markets remain closed for both countries until 2013. Following these two deals, the triple-A countries will still have €255 billion in bilateral loans and guarantees on offer, representing 4.5% of their combined 2011 GDP. This is sufficient to cover the requirements of Portugal, should they be shut out of debt markets. However, if either Italy or Spain were to request financial assistance, the remaining pool of funds would not be able to finance all their deficits and upcoming maturities from 2011 until 2013.

We believe that neither Italy nor Spain should encounter financing difficulties although capital markets have more recently demanded much higher yields on their outstanding debt securities. In Italy, 10-year bond yields are currently 4.4% and Spanish bonds of similar maturity are 5.5%. German bonds, generally considered the highest quality within the Eurozone, currently yield 2.80%. These levels are still far from seriously crimping Italy and Spain's financial outlook.

Italy represents 17% of Eurozone GDP and is the region's third largest economy, with nominal GDP totalling €1.5 trillion. Italy has operated with high public sector debt levels for many years. The debt-to-GDP ratio, which first breached 115% in 1993, has since fluctuated between 115% and 130% and is expected to reach around 120% in 2011. On the positive side, Italy has a below-average fiscal deficit of 5% of GDP for 2010, falling to 4.3% in 2011. The government has enacted an austerity plan which is expected to reduce the fiscal deficit even further to less than 3% by 2012. Although the Italian state is highly indebted, 60% of public debt is held internally and 90% is held within the Eurozone. In addition, private sector debt levels are low; household debt represents 37% of GDP while nonfinancial corporate sector debt is 74% of GDP.

We believe that neither Italy nor Spain should encounter financing difficulties.

Spain's GDP is €1 trillion or 11.5% of the Eurozone. Spain was formerly one of the most fiscally responsible countries in Europe. It reduced its debt-to-GDP levels from a peak of 75% in the mid-1990's to a low of 42% in 2007. Its fiscal problems were severely exacerbated during the recession as the domestic economy was badly hit by a housing downturn. Residential investment fell by more than 50% and the national unemployment rate increased from 8% to 21% during the past three years. In response, Spain has been one of the most aggressive countries in implementing austerity measures, which should bring its deficit of 9.3% of GDP in 2010 to less than 3% of GDP by 2013. By then, Spain should be able to stabilize its debt-to-GDP ratio to around 80%. In addition, Spain has shown a willingness to sell state-owned assets to reduce its debt load. For example, the Spanish government will sell half its stake in national airports and around one-third of its ownership of the state lottery. Although many announced measures are yet to be implemented, the decisions taken to date point in the right direction.

We continue to think that a breakup of the Eurozone is unlikely. We are convinced that European leaders will explore every solution that is within their power to maintain the currency union, which was slowly and carefully built over the past sixty years.

Investment Strategy: Bonds

Interest rates will continue to rise from current low levels.

Bond yields began to rise during the last quarter, reversing much of the decline experienced between April and September. Prior to the Fed's announcement on November 3 that it may purchase up to $600 billion of additional U.S. government debt securities over the following eight months, bond yields had declined to 1% for 5-year Treasuries and to 2.57% for 10-year Treasuries. Rates in Canada were also affected, as they reached 2.05% and 2.87% for the same maturities. In the face of growing evidence of a sustained economic recovery, concerns of a double dip recession have receded and 5 and 10 year yields are up roughly 80 basis points in the U.S. and 40 basis points in Canada since early November.

In addition to the announced $600 billion government bond purchase, the Federal Reserve will also reinvest proceeds totalling $150 billion from maturing mortgage securities into U.S. Treasuries. The Fed's balance sheet, which expanded from $900 billion prior to the 2008-09 credit crisis to a current $2.3 trillion, will increase to $3 trillion in June 2011 if its asset purchase program is completed. The Fed has cited current low inflation and excessively high unemployment as justifications for additional monetary stimulus. It should be noted that the amount of bonds expected to be purchased will roughly equal the cumulative U.S. fiscal deficit over the next eight months. Therefore, the Fed is likely attempting to mitigate a rise in interest rates – a so-called "crowding out" effect – if private sector demand for credit gains traction over the next few quarters.

We believe the economic impact of the Fed's actions is far from clear and serious questions remain as to how excessive liquidity will eventually be withdrawn from the financial system. An improving economy, persistent large fiscal deficits and a gradual return of private sector borrowing argue that interest rates will continue to rise from current low levels. We are therefore maintaining a relatively short duration in our bond portfolios, in addition to investing a lower proportion of funds in bonds compared to our portfolio targets.

Investment Strategy: Equities

We expect total returns from equities in the range of 6%-15% per annum over the next 5 years.

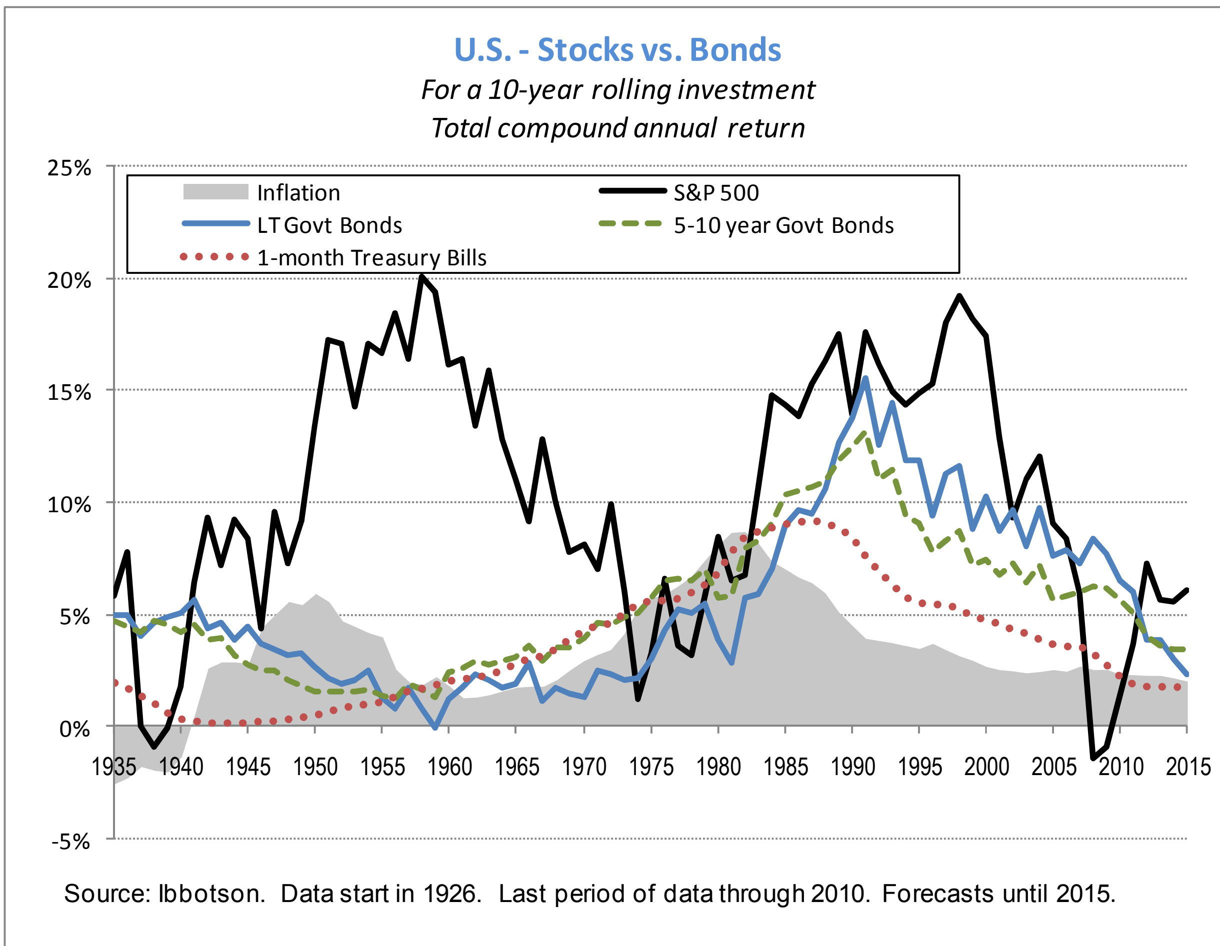
Most major equity markets around the world recorded a positive year in 2010. Total returns on stocks converted to Canadian dollars were: 17.6% for the S&P TSX, 9.4% for the S&P 500 and 6.2% for the MSCI World Index.

It is often said that equities deliver better returns than bonds or cash over the long term. Looking at U.S. data from 1926 to 2010, equities outperformed other asset classes during most periods, often by a substantial margin. Over the last 84 years, the S&P 500 generated an average annual return of 9.8% compared to long-term U.S. government bond and cash returns of 5.4% and 3.6%. During periods when equities underperformed, such as World War II, the Arab oil embargo and the early 1980s recession, the underperformance was relatively short-lived and stock returns eventually improved.

This past decade was characterized by two significant equity market corrections and a downtrend in interest rates. We note in the chart below that this led to higher 10-year average returns from long-term bonds versus stocks between 2007 and 2010, although stocks outperformed bonds on an annual basis in 2009 and 2010. We think this is unlikely to repeat itself over the next few years.

In building our forecasts for asset classes over the next 5 years, we assume weak returns from bonds in the face of rising interest rates and healthy total returns on equities given modest corporate profit growth, current levels of dividend yields and P/E multiples ranging from 12x to 16x. Under differing scenarios of earnings growth and valuation, we expect total returns from equities in the range of 6%-15% per annum, easily outperforming bonds and cash investments.

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



Source: Ibbotson. Data start in 1926. Last period of data through 2010. Forecasts until 2015.

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