Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

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A convergence of events during the summer months had a significant impact on stock and bond prices across the world. Various global economic data raised concerns of slowing activity. The political brinksmanship over raising the debt ceiling in the U.S. led to the S&P downgrade of U.S. Treasuries. As Greek tax revenues fell short of forecast, renewed angst regarding Greece's solvency emerged and spilled over to other members of the Eurozone. These events undermined investor confidence and led to a decline in the MSCI World Index of 16% between April and September. Over the past three months, the interest rate differential between a 10-year bond from Italy and Spain compared to Germany rose to an historical high as fears of contagion persisted. At the same time, long-term bond yields in Canada and the U.S. fell to levels below those seen in 2008-09. The European financial sector also began to experience a tightening in funding sources as U.S. money market funds and other investors reduced holdings of European stocks and commercial bank paper in particular.

We believe the financial and economic risk priced into European equities is now excessive and unwarranted. We are further convinced that the outlook for Europe and the common currency union is more encouraging than is currently appreciated by the market. The recent developments in the price of shares and bonds have moved against our positioning. However, equities remain attractively priced and bonds have become very expensive. In our view stocks currently represent a much better risk/reward profile than bonds.

September 2011

Global economy slowing, but growing

U.S. economic growth moderated in the second quarter to 1.6% over last year. The run-up in the price of oil penalized real growth. A read of the nominal data showed reasonable performance with personal consumption up 4.8%, investment in machinery and equipment 9.3% ahead and export of goods up 17%. Government, not surprisingly was a drag, up only 1.1% over last year.

No signs of double-dip recession in U.S.

Some broad-based economic indicators in the U.S. show signs of a slowing, albeit growing economy. Industrial production is up 3.4% over the past twelve months, with production growth holding steady at those levels for the first half of this year. Manufacturing activity is expected to remain healthy in the second half as new orders of durable goods are strong, up 10.2% over the past year to July. ISM indexes as of September also point toward continued growth, averaging 52, although this measure has been in a downtrend since the beginning of the year. Inventory levels are in line with sales; as of July the inventory to sales ratio is close to the average level during the past economic expansion. Indicators from the transportation industry have weakened. Railroad car loadings are flat compared to last year while diesel consumption is down 0.4% for the same period. Meanwhile, retail sales have been quite buoyant, showing an average annual gain during the last 3 months of 7.9%.

Private sector jobs growth steady.

Job creation has been sluggish as all levels of government are reducing the size of their workforce leaving the private sector the sole engine of employment. Over the past three months to September, an average of 117,000 private sector jobs per month was created. If this pace is maintained, disposable income should grow in a range of 3.0% to 3.5%, which would enable consumption to grow at a similar level. This is a key assumption used in our U.S. GDP forecast for 2011 and 2012 and explains why we think the U.S. will follow a slow growth path rather than falling back to recession.

Given the lack of consensus regarding the medium term outlook for the federal budget, we assume that there will be little fiscal austerity in the U.S. until after the next presidential election. Consequently, the U.S. will record an 8%-10% deficit-to-GDP in 2011 and 2012 and arguably remain the only major industrialized economy to delay enacting budget balancing measures. In building our real GDP forecast for the U.S. using the above assumptions, we expect growth in the range of 1.5% to 2.0% in 2011 and around 1.5% in 2012. This remains in line with our long-term average growth forecast.

In Canada, the high level of the Canadian dollar is having an adverse impact on the economy. Excluding the trade sector, real GDP growth in the second quarter would have been 4.2% instead of 2.2% over the past year. Domestic economic indicators are holding up; employment has grown by 1.3% over the last year and aggregate wages are up 4.8%. Consumer spending increased 4.4% while retail sales have grown by 3.9%. The current pace of residential housing starts is around 195,000 on an annual basis.

We expect Canadian real GDP to expand by 2.0% to 2.5% in 2011 and growth in the region of 2% for 2012. This forecast is predicated on job growth of around 1% being maintained and the household saving rate remaining close to current levels of 4.1%. We further assume that investments will grow slightly faster than nominal GDP, while government spending will grow more slowly than nominal GDP as fiscal deficits are progressively reduced.

Over the past year, the Euro area as a whole has seen its real GDP grow by 1.6%, although considerable dispersion exists among member countries. Germany grew by 2.8% while the Netherlands, Belgium and Austria expanded 1.5%, 2.5% and 4.1% respectively. France has seen its GDP expand by 1.6% while Spain and Italy are experiencing very low levels of GDP growth at 0.7% and 0.8% respectively. The three countries that are currently receiving help from the IMF and the European Commission, namely Ireland, Portugal and Greece, have seen their economies struggle. Real GDP was essentially flat (up 0.1%) in Ireland while Portugal and Greece are in recession (-0.9% and -7.3% respectively). More recent data on industrial production and unemployment rates demonstrate a similar picture. Europe appears to be on track for sub-par growth in the region of 0.5%-1.5% in 2012. However, the current turmoil in financial markets and pressures on the region's financial system have adversely affected business and consumer confidence, raising the risks that the region could experience a shallow recession.

Investor confidence in Europe has been undermined…

Economic growth in emerging markets has thus far remained solid, although more recent data suggest manufacturing activity may be slowing somewhat. Prices of major commodities have fallen sharply: for example, copper is down 28% year-to-date and some large metals producers have warned that customers are asking for delays in orders. During the past twelve months ended June 2011, real GDP increased by 9.5% in China, compared with 10.3% in 2010. The purchasing managers' index (PMI) for China has declined from 53.9 in December 2010 to 51.2 in September 2011. Most countries in Latin America experienced growth in a range of 3.5% to 5.0%, similar to the growth seen in South East Asia. In Eastern Europe, Turkey saw its GDP expand by 8.8% while Russia grew by 3.5%. According to the latest IMF economic forecast, published in September 2011, real GDP should expand by 6.4% and 6.1% across emerging economies in 2011 and 2012 respectively. This will allow the world's real GDP to grow by 3.0% and 3.2% in 2011 and 2012.

The case for Europe

Market participants have continued to question Greece's debt repayment capacity and over the summer months sovereign debt concerns spread throughout the Eurozone resulting in a sell-off in equities. European banks stocks, in particular, have declined in aggregate by 30% year-to-date due to investor worries about this sector's exposure to sovereign debt and amid signs that some funding sources have begun to dry up. A chorus of economists is now forecasting that Europe will slip into recession on the back of fiscal austerity and consumer and business retrenchment.

…but outlook for Eurozone more positive than appreciated by markets.

While the balance of risks has risen since earlier this year, we continue to believe that past and current actions of European politicians demonstrate the will and the courage to act to support the Eurozone. Furthermore, the current environment facing European banks is unlikely to create a severe credit crunch similar to that following the bankruptcy of Lehman

Aggregate Eurozone fundamentals are solid.

Brothers as the European Central Bank (ECB) is ensuring that financing remains available. While aggregate growth for the region has slowed alongside other industrial countries, it is premature to conclude that a recession is imminent or will occur in 2012. Furthermore, we do not believe that current financial and economic stresses presage a breakup of the Eurozone.

There are several reasons why we continue to be invested in companies domiciled in the Eurozone. As a whole, the Eurozone is a well-balanced economy. European consumers maintain a very conservative and high saving rate averaging 15% and exhibit a long-term pattern of spending on goods, services and housing that is well within a sustainable average of 95% of disposable income. Greece, Ireland, Portugal and Spain did experience a period of over-consumption fuelled by a boom in the property market, but all periphery countries with the exception of Greece have now adjusted to a spending rate of 90%-95% of income.

Consumer spending rate in a sustainable range;

saving rate is high;

Regarding trade, the Eurozone as a whole has maintained a positive trade balance for the past decade, staying in a tight range of 0% to 2% of GDP. The current account has also remained generally in balance, ranging from -1.0% to 1.0% of GDP. The aggregate data mask the fact that some countries (Spain, Greece and Portugal) habitually ran large deficits, while others (German and the Netherlands) ran large surpluses. This gap has been shrinking and the adjustment is likely to continue; over the past three years, trade deficits have been reduced in Greece, Portugal and Spain while trade surpluses have eroded in both Netherlands and Germany. Productive capacity is close to fully employed in the surplus countries, as can be illustrated by the low unemployment rate of 4.4% and 6.1% respectively for the Netherlands and Germany. Furthermore, the Euro is arguably inexpensive compared with the Canadian dollar and roughly in parity with the U.S. dollar. To determine the relative value of the Euro, we build fair value models based on consumer price (CPI) parities. Our valuation measures, which are long term in nature, indicate that the Euro is valued at a 10% discount against the Canadian dollar, a level within its historical ranges.

trade sector in balance;

Government is the most contentious sector, as much of the Eurozone's turmoil of the past 18 months has centered on the sustainability of current debt levels and the capacity of sovereign European governments to repay in full their outstanding bonds. While large budget deficits occurred in 2008-2009, Eurozone governments have since taken action to reduce expenditures, even in the face of a challenging macroeconomic environment. With the exception of Greece and Ireland, the Eurozone is targeting deficits of 3% of GDP by 2013, an enormous fiscal adjustment to a more acceptable level in a fairly compressed amount of time. The U.S. has made no such commitment.

governments tackling deficits.

Aggregate debt levels for the region are in line with other major industrial nations and we are confident that most countries will be able to improve their debt metrics from their own internally generated tax revenues. Gross and net government debt to GDP for the Eurozone as a whole stands at 96% and 60% respectively, compared with the U.S. (101%, 75%), the U.K. (89%, 62%) and Canada (86%, 34%). Greece (157%, 125%) remains an outlier while Italy (129% and 101%) is in a more favourable position, having maintained a high yet stable debt-to-GDP ratio for over two decades largely by running primary fiscal surpluses.

Greece continues to face enormous challenges. At this point, we cannot say how or if Greece will pay back its outstanding debts. There are solutions to Greece's problems which do not involve default on its obligations. Most would involve a greater degree of fiscal integration. In the interim, Eurozone governments and the IMF have accepted to help Greece finance its deficits and refinance its upcoming maturities, conditional on Greece following guidelines on its deficit and debt reduction programs through the sale of government owned assets.

Greece has undertaken concrete action to bring its finances in line, although the steep contraction in its economy has been greater than forecast making further austerity difficult to implement. Market speculation on Greece's potential failure and the contagion effects on Portugal, Ireland and more recently Spain and Italy have led to pressure on the still fragile financial system. The current stressed situation in both bank funding markets and sovereign debt markets could, if prolonged, put the Eurozone economy at risk. A contraction could come from two sources: an inability to access the sovereign bond market which creates pressure on government spending or an inability of banks to fund themselves thus leading to a credit crunch, which then would impact consumer and business spending.

Risk that continued financial stress could spill over to wider economy…

The Eurozone is tackling the issue of liquidity for its sovereign debt through the European Financial Stability Facility (EFSF). This facility has extended funds to three countries: Greece, Ireland and Portugal. Negotiations are underway to widen the size and or scope of this fund. In addition, the ECB through its Securities Markets Program (SMP) has intervened in the markets to buy sovereign bonds when liquidity has dried up. The ECB is also hard at work to ensure that banks have ample access to financing. There are increasing signs that the market is imposing tighter funding conditions for European banks. Currently, the spread between the overnight interbank market and the risk free rate in the Eurozone is at 0.80%, higher than similar spreads in the U.S. and U.K. (0.30% and 0.40% respectively) and above the average for 2010 and the first half of 2011 (0.31% and 0.25% respectively). Funding through bank deposits remains relatively steady with the exception of the Greek banking system, which is experiencing deposit flight. The ECB has provided the liquidity necessary to enable European banks, including Greek banks, to finance their assets.

We do not see evidence of a credit crunch taking hold in Europe. Loans to the non-financial sector for the Eurozone as a whole are up 2.5% over the past 12 months to July. Looking at the five countries under the most stress (Greece, Ireland, Portugal, Spain and Italy), their outstanding loans to the non-financial sector are down in aggregate by 3.1% over the past twelve months. We consider the ECB measures to be effective and expect them to continue going forward. Consequently, we do not expect the Eurozone to suffer from a crippling credit crunch as was seen in the U.S. immediately following the collapse of Lehman Brothers.

… but ECB maintaining smooth functioning of monetary system.

European governments and institutions have undertaken a multitude of actions to ensure the smooth functioning of their monetary union. We do not doubt the political commitment to the Eurozone; almost all major political parties in the region are behind the support mechanisms. Citizens of Eurozone countries also seem aligned with this view as most surveys show support for a stronger economic and financial integration within the Eurozone. We view the Eurozone as a viable economic entity with a fairly valued currency. Notwithstanding the severe market stress occurring currently, we believe that there is the desire, the will and the tools available to survive. We anticipate slow economic gains as governments unwind stimulative fiscal policies but recession should be avoided as the consumer has adjusted its spending pattern to a more sustainable level and corporations are operating with healthy balance sheets and remain flush with cash.

Given this backdrop, we believe European share prices currently discount far more financial and economic risk than is warranted. Adjusting for the Canadian dollar, broad indices in Europe trade at levels that prevailed at the bottom of the market in early 2009 while the S&P TSX and S&P 500 are up 60% and 35% respectively. Meanwhile, European corporate profits are about 70% above their level at end-2009 and have experienced a rebound similar to that recorded in North America. Our top 30 European holdings are currently trading at a price-to-earnings multiple of 8.1 and pay an average dividend yield of 5.3%. This represents a 35% valuation discount to Canadian equities while offering a dividend yield that is nearly double. These are very attractive levels on an absolute and relative basis, even more so considering the very low level of interest rates.

European share prices discount more risk than is warranted.

Capital Markets

Bond yields in both Canada and the U.S. are now below any point during the 2008-09 crisis and are at historically low levels. In Canada, 10-year and 30-year government bonds yield 2.15% and 2.75% respectively. Similar maturities in the U.S. are now at 1.85% and 2.90%.

The U.S. Federal Reserve has implemented new ways of loosening monetary policy. First, at its August meeting, the Fed announced that it would maintain the overnight rate at the current level, between 0% and 0.25% until mid-2013. At its September meeting, the Fed decided to extend the average maturity of its bond portfolio from 6.25 years to 8.3 years over the following 9 months. It will achieve this through selling $400 billion of short term bonds while buying $400 billion of longer term bonds. The Fed therefore continues to be very active in the secondary markets for bonds and is going to great lengths to prevent interest rates from normalizing at higher levels.

In Canada, we consider that current economic conditions are favourable and therefore do not expect any rate cuts. Considering the Fed's engagement for stable short term rates, this will limit the increases that the Bank of Canada will enact over the next two years. In our scenarios, we expect overnight rates to increase by 0.5% to 1.0% over this interval. Considering current rates, we doubt that a further down-leg in yields is likely and that the risk reward of holding Canadian bonds is poor. Consequently, we are carefully managing our exposure to bonds and the duration of our bond portfolios.

Risk/reward for bonds is poor.

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