SUMMARY

- The global economy remains strong and shows no signs of weakness. Global real GDP is forecast to expand 3.9% in 2018 and 2019, up from 3.7% in 2017.
- Consumer spending and business investment are key drivers behind the economic expansion in the United States. We expect U.S. real GDP to grow 2.5-3.0% in 2018 and 2019.
- The Canadian housing market is stabilizing, reducing the risk of a significant correction. We project Canadian economic growth to be 2.0-2.5% in 2018 and about 2.0% in 2019.
- The Eurozone's real GDP is anticipated to expand 2.0-2.5% in 2018 and 2019 as loose monetary conditions and consumer spending continue to support economic activity.
- Notwithstanding weaker conditions in select developing economies, growth in emerging markets is expected to accelerate from 4.9% in 2018 to 5.1% in 2019.
- Economic cycles do not have set lengths. Although the current expansion is in its tenth year – relatively long compared with those in the past – the fundamentals supporting it remain intact.
- While increased trade protectionism presents a risk to our forecast, we do not believe the tariffs introduced to date will have a significant negative impact. USMCA marks a positive resolution to a large source of uncertainty.
- As monetary policy normalizes in tandem with rising inflation, equity markets could experience some volatility. However, this should not be of significant concern to long-term investors given the positive backdrop for global equities.

NO IMPEDIMENTS TO STRONG ECONOMIC GROWTH

Nine years after the Great Recession, the global economy shows no signs of weakness. Concerns that the current cycle may be nearing an end are unwarranted, as data do not substantiate this view. The International Monetary Fund forecasts that global real GDP will expand by 3.9% this year and next, the fastest rate since 2011. Central bank policies remain very stimulative and should not impede the underlying forces of growth.

In the **United States**, real GDP expanded 2.9% year-on-year in the second quarter, led by growth in consumption and business investment.

Consumer spending grew 4.8% in nominal terms in the second quarter compared with a year earlier, its fastest rate in more than three years. U.S. job creation averaged a healthy 185,000 per month during the three months to August and the unemployment rate fell to 3.9%. The increase in consumer spending was aided by higher household disposable income, up 5.3% from the same period a year ago due in part to lower personal taxes.

Business investment also accelerated 8.3% in the second quarter as corporate profits increased 7.7%. Construction spending grew 9.1%, while investments in research & development and new equipment & machinery were both up by approximately 8%.

On the housing front, an average annualized 1.2 million homes were built during the three months to August, a rate broadly consistent with household formation and demographic demand. House prices are in a strong uptrend, up 6% on an annual basis since 2015, while residential vacancy rates are at a two-decade low. These factors helped total residential investment increase 7.2% in the second quarter.

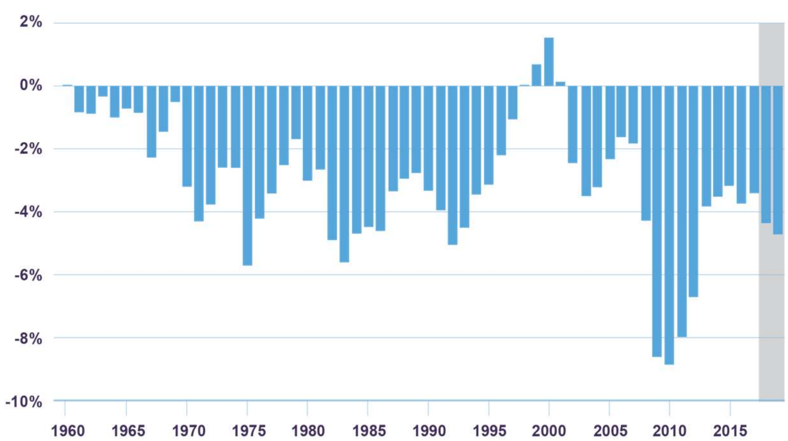
The U.S. government has proposed to raise spending by 5.8% in 2018 and 4.6% in 2019 in its most recent budget. Combined with the Trump Administration's tax cuts, the deficit is expected to increase from 3.5% of GDP in 2017 to 4.7% in 2019 (see Chart 1), injecting stimulus into an already robust economy.

We forecast the U.S. economy will expand 2.5-3.0% in 2018 and maintain that level of growth next year.

In **Canada**, real GDP grew 1.9% year-over-year in the second quarter, driven predominantly by personal consumption and business spending. Consumer spending rose 4.0% in nominal terms during the second quarter as disposable income grew 4.4%, assisted by a 2.9% gain in hourly wages.

Business investment expanded 6.8%, driven by construction (up 7.0%), machinery and equipment (6.6%) and R&D (6.6%). Plant and equipment capacity utilization rose to 86% in March, suggesting the increase in capital spending will continue.

Chart 1: U.S. Federal Government Deficit (% of GDP)



Source: U.S. Bureau of Economic Analysis, Congressional Budget Office (CBO), Letko Brosseau. Shaded for forecasts

The housing market is stabilizing following the introduction of stricter mortgage qualification rules on January 1, 2018. Toronto house prices initially suffered steep declines but have since recovered. As of July 31, the city's average price of homes sold (based on MLS listings) was 4.3% higher than a year earlier. Overall Canadian prices were flat, however. Meanwhile, unit sales fell 4%, as mortgage rates rose by a cumulative 70 basis points over the last 12 months. This gradual stabilization of the housing market at a time when the employment picture and the economy as a whole remain healthy reduces the risk of a significant correction.

Canada's trade deficit deteriorated slightly, reaching $49 billion in Q2, up from $43 billion in the same period a year earlier. Exports grew 4.3%, but were outpaced by a 4.9% increase in imports. U.S. tariffs on steel (25%) and aluminum (15%) imports took effect on June 1st, while retaliatory tariffs by Canada were implemented on July 1. While these measures remain in place, the successful renegotiation of NAFTA removes a large source of uncertainty over Canada's investment climate.

We forecast Canadian real GDP to expand 2.0-2.5% in 2018 and about 2.0% in 2019.

Despite a slight tapering of its growth rate, **Europe** is still benefiting from loose monetary policy and significant pent-up demand. Eurozone real GDP expanded 2.1% during the second quarter from a year earlier, down from 2.5% in 2017. Spain grew 2.7%, Portugal 2.3%, Germany 1.9%, France 1.7% and Italy 1.2%. Outside the Eurozone, the United Kingdom expanded 1.3%.

While longer-term growth in Europe is forecast to be lower than in North America due to slower population growth, shorter-term prospects for the Eurozone remain encouraging. The region is still far from exhausting the unfulfilled demand that emerged from the Great Recession and the European sovereign debt crisis. For example, the unemployment rate remains elevated at 8.1%, with levels in Spain, Italy and France particularly high at 15.2%, 9.7% and 9.3% respectively. Continued job creation will provide the backdrop for increased consumer spending and support economic activity for the next several years.

We expect the Eurozone economy to expand by 2.0-2.5% in 2018 and 2019. Due to the uncertainty surrounding Brexit, expected growth for the U.K. is lower, at 1.5% for both 2018 and 2019.

Real GDP in **Japan** grew 1.0% in the second quarter from a year earlier. Consumption grew only 0.4% in nominal terms, but consumer spending should begin to accelerate in the coming quarters. In the three months to July, employment rose 1.8%, while average wages increased 2.3%, the fastest pace in almost 20 years. We expect the Japanese economy to expand 1.0-1.5% in 2018 and 2019.

The outlook for **emerging markets** is mixed. Both India and Mexico's real GDP growth is accelerating, while growth in southeast Asia remains steady. However, Turkey and Argentina are under economic stress, while Brazil and China are seeing mild slowdowns in activity. On balance, however, the region is expected to expand at about twice the rate of the developed world (see Table 1).

The Turkish lira and Argentinian peso depreciated 37.3% and 54.1% respectively against the U.S. dollar during the year ended Sept. 30, 2018, as capital started to flee both countries. Inflation spiked to 17.9% in Turkey and 34.4% in Argentina in August. The central bank of Turkey moved to raise its key rate by 625 basis points to 24% in September, while Argentina's central bank raised its key rate by 1,500 basis points to 60% in August, both of which will dampen economic activity and potentially lead to recessionary conditions in the coming quarters.

Elsewhere, growth slowed slightly in Brazil and China. Real GDP rose only 1.0% in Brazil during the second quarter, in part due to a trucking strike that disrupted the country's supply chains. Another negative factor was the uncertain outcome of the upcoming general election. The Brazilian economy is nonetheless expected to expand 1.0-1.5% in 2018 and 2.0% in 2019.

In China, real GDP grew 6.7% in Q2, but this masked a slowdown in certain cyclical economic indicators. Commodity consumption for production was down significantly on a year-on-year basis to July: aluminum -29.5%, iron ore -22.7%, copper -16.1% and cement -7.7%. Meanwhile, annual car sales totaled 25 million units in August, unchanged from the prior year.

Table 1: Global Real GDP Growth

	2017	2018	2019
U.S. *	2.3%	2.5 – 3.0%	2.5 – 3.0%
Canada *	3.0%	2.0 – 2.5%	2.0%
Eurozone *	2.4%	2.0 – 2.5%	2.0 – 2.5%
U.K.	1.7%	1.5%	1.5%
Japan *	1.7%	1.0 - 1.5%	1.0 – 1.5%
Developed	2.4%	2.4%	2.4%
China *	6.9%	6.5%	6.5%
India	6.7%	7.3%	7.5%
Brazil *	1.0%	1.0 – 1.5%	2.0%
Russia	1.5%	1.7%	1.5%
Mexico	2.0%	2.3%	2.7%
Emerging	4.7%	4.9%	5.1%
World	3.7%	3.9%	3.9%

Source: International Monetary Fund, Letko Brosseau

* 2018-19 forecasts for these countries by Letko Brosseau. All others from the IMF

There were encouraging signs of robust growth in other sectors. Combined revenues of all listed companies rose 12.6% during the second quarter and, despite the ongoing trade dispute with the U.S., exports increased 10.9% over the same period. We believe China's real GDP growth will stabilize at around 6.5% over the next two years.

Growth in other emerging markets is generally accelerating. In India, the economy expanded 8.2% during the second quarter. The IMF forecasts real GDP to rise 7.3% in 2018 and 7.5% in 2019. Meanwhile, Mexico's economy grew 2.6%, with growth expected to reach 2.3% in 2018 and 2.7% in 2019.

Overall, emerging markets' real GDP is forecast to increase from 4.9% in 2018 to 5.1% in 2019.

THE CURRENT CYCLE STILL HAS LEGS

The current business cycle is long by historical standards. This has given rise to concerns that we must be on the cusp of a slowdown. Economic cycles, however, do not have a predetermined length. They are driven by a complex mechanism of credit growth, inflation and the buildup of imbalances.

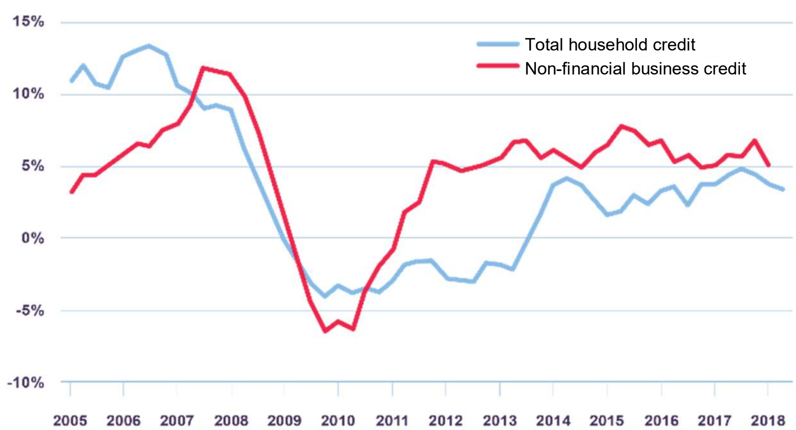
Cycles typically end when credit growth decelerates sharply, either because inflation restricts monetary policy or when imbalances become significant enough to make the economy vulnerable to shocks. While we remain attentive to developments that indicate the current expansion is at risk, we do not see signs of an impending recession.

Credit conditions are favourable

Monetary policy remains loose and credit growth is solid in the U.S. Total household credit increased 3.5% year-over-year in the second quarter, while non-financial corporate credit rose 5.2% (see Chart 2). Surveys also suggest there is upbeat sentiment among loan officers, which should support continued lending activity.

Inflation remains muted, although it is slowly picking up. The core personal consumption expenditure deflator, the U.S. Federal Reserve's preferred measure of underlying inflation, rose 1.9% in August from 1.6% a year earlier. As the cycle matures, inflation will likely accelerate further. This will push interest rates higher and tighten credit conditions, thereby restricting economic growth.

Chart 2: Lending to the U.S. Private Sector (Y/Y Change)



Source: Federal Reserve Bank of New York, U.S. Federal Reserve Board

We are not there yet. The Fed is still in the early stages of normalizing policy and credit remains available. With the effective Fed Funds rate at 2.18%, short-term rates adjusted for underlying inflation are only 28bps, a level that is extremely attractive to borrowers. Credit conditions in most developed economies are similarly positive.

Turning to the developing world, China's central bank has embarked on a policy of quantitative easing, which will provide domestic financial institutions with cheap funding to encourage lending and to buy corporate bonds. On balance, global credit conditions remain healthy and show no signs of contraction.

No substantive imbalances ahead

The Great Recession of 2008-2009 was precipitated by a major buildup of financial excesses in non-bank credit that left the global economy vulnerable to shocks. Following Lehman Brothers' bankruptcy, it took several years of household balance sheet adjustment, government deficit reduction and bank deleveraging to put the global economy on its current structurally sound footing.

As we are slowly entering the mature phase of the economic cycle, we are becoming sensitive to the build-up of new imbalances. We are keeping a close eye on U.S. non-banking credit and capital flows to and from emerging markets, where risks can flare up and cause destabilization.

It was the non-bank credit channel that froze following Lehman's collapse, intensifying the credit crunch and amplifying the ensuing recession. Growth in private non-bank credit only resumed in 2013. Today, the market for private debt, leveraged loans and collateralized loan obligations is once again steadily expanding, driven by investors' thirst for yield.

It is not yet clear whether this development could sow the seeds for future instability. Annual growth in private non-bank credit is still less than half the $3.6 trillion reached in 2007. Moreover, total private non-bank credit outstanding at the end of 2017 was only 1.5% higher than 10 years earlier. Over the same period, nominal GDP expanded by a cumulative 34.8%.

A more pressing concern for investors has centered on the potential for difficulties in Turkey and Argentina to spread to other emerging markets. We remain of the view that while domestic issues may be impacting a narrow group of countries, developing economies generally remain in a structurally sound position.

In past editions of the *Economic and Capital Markets Outlook* (September 2013 and December 2015), we explained how the Fed's normalization of monetary policy was stimulating a repatriation of funds into developed markets. Consistent with our past analyses, we continue to believe that reserves in most major developing countries provide a backstop to the adjustments triggered by these flows of capital. Foreign exchange reserves in emerging markets totaled $7 trillion at the end of 2017, compared with $1 trillion during the Asian financial crisis two decades ago.

With no signs of a credit crunch and no indication of significant imbalances, the main threat to our economic forecast is increased trade protectionism. Negative spillovers of a trade war include dislocations in global trade, a climate of uncertainty for business investment and/or an acceleration in inflation.

Trade conflict unlikely to exert meaningful impact on growth

The United States Mexico Canada Agreement (USMCA) announced on September 30 preserves the main features of free trade across the North American market. USMCA does not mark a significant departure from NAFTA and is a positive outcome for the three countries' economies.

Trade negotiations between the U.S. and its other trading partners remain a work in progress. The U.S. recently imposed a 10% tariff on $200 billion of Chinese imports, in addition to the 25% tariff that was enacted earlier this year on $50 billion worth of Chinese goods. China, which had retaliated dollar for dollar to the first round of tariffs, decided to respond with levies of 5% or 10% on $60 billion of U.S. imports.

Further escalation of tensions could start to impact economic activity in all countries involved. However, as we maintained throughout the NAFTA process, there exists a powerful community of interests in favour of a positive resolution to the current impasse. All parties have considerable incentive to avoid disrupting global trade flows. This applies particularly to the Chinese, whose biggest export market is the U.S.

While the state of negotiations is changing rapidly, we estimate that current tariffs, including the duties on Chinese imports into the U.S. and those on steel and aluminum, affect less than 3% of global trade and 0.5% of global GDP. Absent further escalation, these measures should have minimal impact on our global growth forecast.

ASSET ALLOCATION DECISION: CONTINUE TO FAVOUR EQUITIES

U.S. equities reached a new high in September, outperforming the rest of the world on a year-to-date basis. The S&P 500 Index achieved a 14.1% return (in Canadian-dollar terms) during the first nine months of 2018, compared with 1.4% for the S&P/TSX Composite Index, 0.6% for Britain's FTSE-100 Index and 6% for the Nikkei. The DAX was down 5.3%, while the MSCI Emerging Markets Index fell 4.8%.

Despite the short-term negative performance in European and emerging market stocks, medium-term equity total returns remain impressive. Over the last five years, the DAX was up a cumulative 54%, FTSE-100 42%, Nikkei 99% and MSCI Emerging Markets 53%. In North America, the S&P 500 gained 141% and the S&P/TSX 46%.

The stock market's strong performance was driven by a significant rise in corporate profits. Valuations thus remain far from bubble-like territories. At quarter-end, the S&P 500 traded at 16.3 times 2019 earnings, the S&P/TSX 13.7, the DAX 11.9, the Nikkei 15.1 and MSCI Emerging Markets 10.7. In contrast, our global equity portfolio trades at an attractive – and less expensive – level of 11 times 2019 earnings, while the P/E ratio for the Letko Brosseau Emerging Market Fund stands at 9.4 times.

We do not exclude the potential for equity market volatility as the Fed continues on its path of normalizing interest rates. This should not, however, be of significant concern to long-term investors. A review of past rate hike cycles shows that, following an initial rate increase by the Fed, equity markets typically remain strong for several years.

Generally, they only significantly contract when the risks of an impending recession materialize. Chart 3 shows the progression of the S&P 500 Index following the first rate increase by the Fed nearly two years ago. We contrast this against the market outcomes during the last eight interest rate cycles dating back to 1972. We believe the medium-term outlook for equity markets remains favourable.

Chart 3: Progression of S&P 500 Following Initial Interest Rate Hike

Source: Letko Brosseau, U.S. Federal Reserve

Prospects for fixed income instruments remain poor. The Fed anticipates raising rates 3 to 4 times during the next year as it forecasts labour markets to remain tight and inflation to pick up. If the spread between short and long rates remains unchanged, long-term U.S. Treasury yields will rise from 3% to 4%, creating losses for bondholders of around 20%. Under a scenario in which interest rate spreads return to their historical average, however, 30-year yields would reach 4.5% and losses would approximate 30%. This dynamic is similar for all developed markets, including Canada.

We continue to favour carefully selected equities over bonds within balanced mandates. Our fixed income portfolios are defensively positioned, with high credit quality, low duration and no exposure to long-term instruments.

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