LetkoBrosseau

ECONOMIC AND CAPITAL MARKETS OUTLOOK

JANUARY 2019

- The stock market decline of about 15% since September appears triggered by overly pessimistic views of the economic cycle and worries of political miscalculation particularly with regards to trade issues. The long bull market run made stocks vulnerable to correction, but **economic indicators do not justify recessionary concerns.**
- The **global economy is growing**. Global real GDP is forecast to expand 3.7% in 2019, consistent with 2017-2018 levels.
- **Solid jobs growth and rising incomes in the U.S.** continue to underpin consumer spending. We expect U.S. real GDP to expand 2.0-2.5% in 2019.
- **Canada and Europe's economies are moderating from a quicker pace.** Neither region is at risk of a contraction.
- Prospects for **emerging market countries remain positive.** These regions are forecast to grow 4.7% in 2019, more than twice the rate of the developed world.
- The **U.S.-China trade dispute** remains a source of uncertainty. While a deterioration of negotiations **is the main risk to our forecast**, we believe a **community of interests encourages compromise.**
- **Equities remain our favorite asset class**. We expect a higher return from owning stocks compared to bonds and cash in the medium-term as macroeconomic concerns recede.

Equity markets closed the year on a volatile note. Prospects for a U.S.–China trade war and rising central bank policy rates raised doubts about global growth.

Our reading of economic data reinforces our view that the global economy is fundamentally sound and the medium-term outlook for equities remains positive.

As we look forward to the New Year, we take this opportunity to address the most pressing questions and concerns you have shared with us.

Are stock and bond markets telling us a recession is imminent?

The headlines are filled with references to equity market sell-offs foreshadowing recession. Another often-quoted indicator is that when long-term yields fall below short-term rates – when the yield curve is said to invert – an economic contraction soon follows. In fact, neither are infallible predictors of recession.

The S&P 500 Index declined by 10% in January 2018 from its prior peak and again by 14% at year-end. This speaks to investors' sensitivity to short-term macroeconomic concerns, not their forecasting ability. The U.S. stock market has declined by 10% or more at least six times between 2010 and 2016. During this period, real global economic growth averaged 3.9% and growth in developed markets averaged 1.9%. Despite the pullbacks, the U.S. stock market is up a cumulative 99% over the last eight years.

The equity market's longer-term rise has been driven by a powerful expansion in corporate profits, the key driver of share prices. Looking ahead, we expect profits to grow by mid-single digits over the medium term, in line with the nominal growth rate of the economy.

The spread between the 10-year bond yield and the 3-month Treasury bill rate (the Federal Reserve's best measure of the yield curve) has continued to narrow. While the spread is still positive at 50 basis points, investors are concerned that the yield curve is signalling the end of the economic expansion.

Recessions are typically preceded by yield curve inversions. However, as shown in Chart 1, recessions do not always follow from yield curve flattening or inversions. In certain cases, like in the mid-1960s and mid-1990s, a recession occurred more than five years after the curve reached the current level. Moreover, in the 1960s case, the recession occurred more than three years after the curve inverted.

It is critical to understand the context behind the flattening of the yield curve. In the current environment, long bond yields have been artificially suppressed by the Fed's bond-purchasing program (quantitative easing) and low inflation. As the Fed reduces its balance sheet and as inflation slowly picks up, long-term yields should be pressured upward.

The U.S. is in one of the longest cycles in modern history. Are we close to the end?

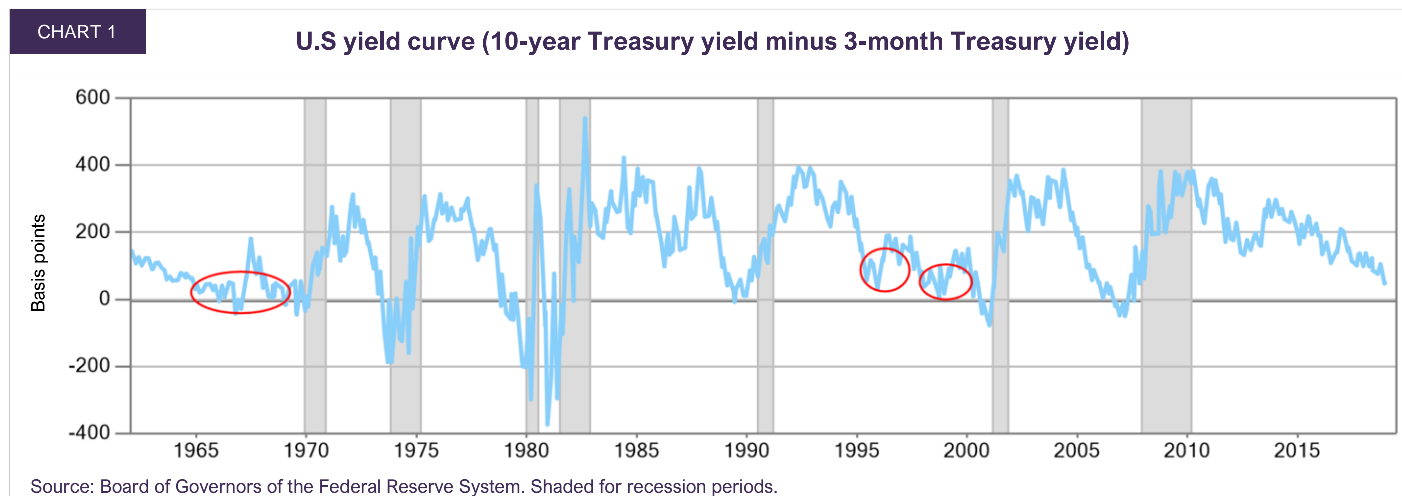
As detailed in the September 2018 edition of our *Economic and Capital Markets Outlook*, there is no predetermined length between recessions. Business cycles are driven by a complex mechanism of credit growth, inflation and the accumulation of imbalances.

Generally, the end of a cycle coincides with a sharp deceleration of credit growth induced by tight monetary policy – a standard response to above target-inflation – or an economic shock stemming from an imbalance.

The current cycle is long, but not exceptionally so. The United States is in its 10th year of expansion, while Australia is in its 29th. Though impressive, neither statistic is relevant in determining where each economy stands in the business cycle.

CHART 1

U.S yield curve (10-year Treasury yield minus 3-month Treasury yield)



Source: Board of Governors of the Federal Reserve System. Shaded for recession periods.

We continue to monitor credit growth, inflation, the outlook for monetary policy and general economic activity. We are also keeping a careful watch for imbalances that could undermine stability.

At present, U.S. credit data signal an expansionary environment for borrowers. Surveys of U.S. bank loan officers, a leading indicator of lending activity, show positive sentiment. Meanwhile, total household credit grew 4.3% year-over-year in the third quarter, and non-financial corporate credit expanded 6.7%.

The core personal consumption expenditure deflator, the U.S. Federal Reserve's preferred measure of underlying inflation, increased 1.9% YoY in November. While tight labour markets suggest inflationary pressures are building, they have not yet materialized.

In the last quarter of 2018, the Fed reiterated that monetary policy is normalizing. At 2.4%, the effective Fed Funds rate is still below neutral and monetary policy remains accommodative.

The U.S. expansion has solid underpinnings (Table 1). Third quarter real GDP grew 3.0% compared with a year earlier. The economy saw growth in three key cyclical areas: consumption, housing and business investment.

TABLE 1

Contribution to U.S. real GDP growth

	2015	2016	2017	2018E	2019E
Consumption	2.0%	1.9%	1.8%	1.8%	1.6%
Investment	0.3%	0.2%	0.8%	1.2%	0.7%
Net Exports	-0.7%	-0.3%	-0.2%	-0.6%	-0.3%
Government	0.4%	0.2%	0.0%	0.4%	0.3%
Real GDP	2.0%	1.9%	2.5%	2.8%	2.3%

Source: Bureau of Economic Analysis
E = Letko Brosseau estimate

Consumer spending increased 5.2% year-over-year in nominal terms, supported by solid job creation and disposable income growth. In the last three months of 2018, the U.S. economy added an average of 254,000 jobs per month and the unemployment rate stood at 3.9% in December. During this time, household disposable income was up 5.0% relative to the same period last year. Household net worth increased to a record $109 trillion.

Labour market dynamics and rising household formation continue to exert a fundamental demand for housing. Residential investment grew 6.2% year-on-year in the third quarter and construction of new homes averaged 1.2 million on an annualized basis, up 2% year-on-year. We expect the housing sector will continue to contribute positively to growth.

Business investment grew 8.2% in the three months to September, driven by corporate profit growth of 10.4%. Investments in construction increased 9.9%, research & development expanded 8.7% and machinery & equipment 6.9%.

Fiscal policy remains expansionary. Government spending is expected to increase 4.3% in 2019 and the deficit will widen to 4.6% of GDP.

We forecast the U.S. economy will grow 2.0-2.5% in 2019.

What about growth prospects for the rest of the developed world?

Global economic indicators remain broadly positive. World real GDP growth is forecast to remain stable at 3.7% in 2019. Some regions are seeing a moderation of economic conditions following a period of faster growth, but this is to be expected as we enter the more mature stage of the cycle.

In Canada, real GDP expanded 2.1% in the third quarter. Consumer spending grew 4.0% year-on-year in nominal terms on the back of an 3.3% increase in disposable income.

Business investment expanded 5.3%, driven by an increase in machinery & equipment investment of 10.7%. With capacity utilization rates in excess of 80%, growth in consumer demand is putting pressure on companies to upgrade and expand their capital assets. Together with positive business sentiment, capital spending is expected to buoy investment going forward.

Over the third quarter, exports increased 13.7% year-over-year, outpacing import growth of 8.3%. Canada's trade deficit narrowed from $50 billion in Q2 to $32 billion in Q3.

We forecast Canadian real GDP to grow 2.0% in 2019.

Real GDP in Europe expanded 1.6% in the third quarter relative to last year. A less favourable demographic profile argues that the Eurozone should grow at a slower rate than North America, but pent-up demand and low interest rates continue to provide a positive backdrop for the economy.

We expect Europe to achieve a healthy growth rate of 2.0% in 2019. Given the uncertainty created by Brexit, the U.K. is expected to grow at 1.5% over the same period.

Elsewhere in developed markets, real GDP in Japan was flat at 0.1% in the third quarter year-over-year. The

Japanese economy is forecast to grow at around 0.9% in 2019.

What are the economic implications of a "hard Brexit" for the U.K and Europe?

The U.K. will bear the brunt of a hard Brexit. U.K. exports to the E.U. would be at risk (14% of U.K. GDP), corporate investments could be adversely affected by a shock to business confidence (13% of U.K. GDP), and the integration of the financial industry with continental Europe may face disruption (7% of U.K. GDP). In contrast, only about 6% of E.U. exports are directed to the U.K. (3% of E.U. GDP). The European economy is less exposed to an adverse outcome than is the U.K.

We do not assume that the delay of the parliamentary vote signals a no-deal Brexit. Many possible outcomes exist including a last-minute reprieve, an extension of the March 29th deadline, a U.K. general election or even a second referendum. Our 2019 forecast for U.K. real GDP growth (1.5%) is tempered by Brexit-related risk.

Are the downside risks for China and other key emerging market economies rising?

Expectations for weak growth in China surfaced in Q3 following a deceleration in auto sales. This slowdown corresponded with the expiration of a government tax incentive for car purchases. Car sales declined by 13.8% year-over-year in the three months to November. Similarly, the Manufacturing PMI decelerated to 49.7, a signal that the manufacturing sector is contracting.

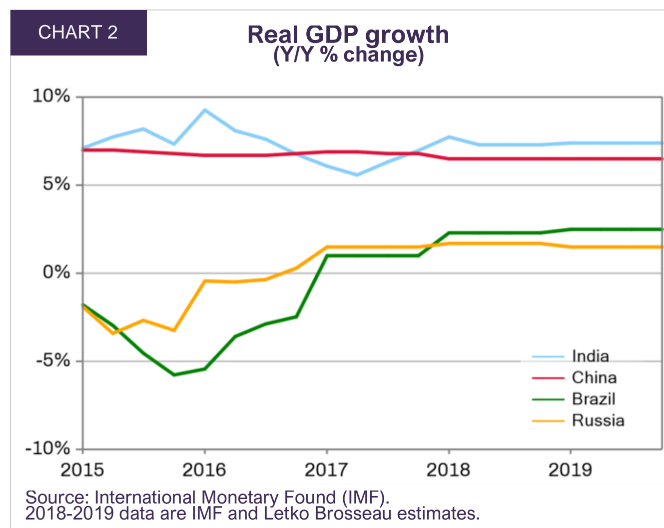
Despite an ongoing trade dispute with the U.S., China's exports were up 11.5% in the three months to November. Revenues of all listed companies grew 13.1% and a rebound in the housing sector is evident with new home prices up 9% against a year ago in October versus only 2% around the end of 2017.

It should be noted that the Chinese authorities are embarking on an ambitious stimulus program. In terms of monetary policy, the People's Bank of China is lowering the level of cash that banks must hold on reserve and injecting liquidity into the commercial banking system. This should help reduce financing costs and protect against the risk of a credit crunch. On the fiscal front, Beijing is introducing various measures to lower consumers' tax burdens and increase spending on infrastructure.

The positive economic impact of this stimulus should become apparent in 2019. Real GDP growth has converged to our expectation of 6.5%, and we believe the economy will maintain this momentum in the new year.

Prospects for the other BRIC economies (Brazil, Russia, India, China) are generally encouraging (Chart 2). Indian real economic activity expanded 7.1% in the third quarter and the economy remains on track to achieve real GDP growth of 7.3% in 2018 and 7.4% in 2019 as forecast by the International Monetary Fund.

CHART 2 Real GDP growth (Y/Y % change)



Source: International Monetary Found (IMF).
2018-2019 data are IMF and Letko Brosseau estimates.

Recovery continues in Brazil, Latin America's largest economy. Real GDP expanded 1.3% year-over-year in the third quarter. Credit dynamics are improving aided by stimulative monetary policy – the SELIC (policy rate) is at a record low of 6.5%. We expect the Brazilian economy to expand 2.0-2.5% in 2019. In Russia, growth is forecast to be 1.8% in 2019.

Elsewhere, the economies of Turkey and Argentina remain under pressure. The sharp devaluations of the Turkish Lira and Argentine Peso in 2018 put emerging market debt under scrutiny, renewing concerns of a 1997-style regional contagion. In absolute terms, emerging markets' external debt stocks have nearly doubled in the last decade. While this may appear troublesome on the surface, a closer look at the data suggests this is less of a problem than suggested.

External debt as a share of GDP stood at 30% in 2018, near levels prevailing around the early 1990s and below the peak of 38% reached in 1999. Furthermore, debt profiles have improved when one accounts for foreign exchange reserves. A country-by-country analysis of the emerging world reveals that large differences exist in the level, denomination, term structure and distribution of external debt across sectors. The BRIC economies enjoy healthy net debt positions, both in terms of total external debt and foreign currency denominated external debt. Further, these markets have limited short-term exposures and foreign debt is well diversified across public and private sector entities. This is the case for many emerging economies outside the BRICs.

Turkey and Argentina face challenges. Both countries have poor positions net of reserves and significant foreign currency denominated short-term exposures, leaving these economies vulnerable. While the economies of Poland and Hungary are expanding, both carry high external debt, a cause for some concern.

On balance, there is limited risk of a broad-based emerging market external debt crisis entering 2019. Collectively, emerging markets' real GDP is forecast to grow 4.7% for 2018 and 2019, more than twice the rate of the developed world.

Energy prices are once again under pressure. Where does oil go from here?

The WTI price of oil fell about 30% from more than $70 per/barrel in September to $50 per barrel in November as a result of an unexpected increase in supply. Looming sanctions on Iran created an incentive for importers of Iranian oil to increase inventories ahead of the November 5th deadline and OECD members opened the taps on production. In addition, speculation of a slowdown in global growth began to impact prices for most major commodities.

Pipeline constraints exacerbated the problem faced by Canadian domestic producers. Western Canadian Select (WCS), the benchmark price of Canadian heavy oil, fell as low as $20 per barrel, trading at a historically steep discount of $50 to WTI.

These imbalances are expected to be temporary. The WCS-WTI spread converged to around $20 following the news that the Alberta government ordered production cuts beginning in January. Rail volume growth in 2019 should provide relief in the short-term while additional Canadian pipeline capacity should come online in the medium-term. A new agreement among OPEC members to cut production by 1.2 million barrels/day will help resolve the global supply glut.

We expect demand for oil to remain steady as the global economy continues to expand. As supply stabilizes, oil prices will normalize. WTI is forecast to converge to $70 per barrel in 2019 and 2020. Our forecast for the WTI-WCS differential is $13-$14 per barrel for the same period.

What are the red flags to watch for in 2019 and beyond?

I. TRADE WAR

The U.S.–China trade dispute is a major source of uncertainty that is contributing to financial market volatility. The deterioration of negotiations to an all-out trade war is the main risk to our economic forecast.

The U.S. delegation presented Beijing with a long list of demands packaged as a "draft framework". The U.S. administration's demands include: a reduction of the U.S.-China trade deficit; the removal of tariff & non-tariff barriers; a dismantling of barriers to investment in China; and enforcement of protection of technology & intellectual property.

The U.S. seeks to reduce its trade deficit with China by $200 billion by the end of 2020 with Chinese purchases of U.S. goods representing most of the correction. Market access for agricultural goods like soy and a reduction in tariffs on automobiles fall under this category. In return for delaying the tariff increase scheduled for January 1st, Beijing offered to reduce and remove tariffs on U.S. vehicles (40%) and resume purchases of U.S. agricultural goods. Furthermore, effective January 1st, China lowered import taxes on more than 700 goods from all countries.

China's foreign investment caps remain largely in place but there have been sector specific improvements in 2018. The foreign equity restriction in financial institutions was removed and the Chinese controlling shareholder requirement in commercial aircraft manufacturing was lifted. Further, Beijing announced that the foreign equity cap for manufacturing of commercial vehicles will be removed come 2020.

The largest differences between the two countries exist on the topic of intellectual property and forced technology transfer. Nonetheless, recent developments are encouraging. Beijing has drafted legislation aimed at prohibiting forced technology transfer by local governments. This news, when considered alongside the postponement of tariffs and other concessions, supports our view that a compromise can be reached.

II. A DEBT IMPLOSION

Corporate indebtedness has risen steadily against a backdrop of ultra-low borrowing costs. With the Fed on a path to normalizing policy rates, concerns have emerged about corporations' ability to service their debts.

While there are some areas of the debt markets that appear overstretched, in aggregate, the debt burden of U.S. non-financial corporations is manageable. The ratio of debt-to-earnings before interest, taxes and depreciation (EBITDA), a measure of leverage, reached 4 times in the third quarter. This is still below the pre-tech bubble level of 5.1 times. EBITDA-to-interest, which measures the ability to service debt, is currently 6.7 times compared with 3.6 times before the financial crisis.

As both rates and spreads normalize, debt service costs

will increase and companies with high leverage may struggle to refinance. Companies that did not use these proceeds for productive investments may face challenges. This, however, does not imply a systemic problem. At current levels, U.S. corporate debt serviceability remains viable.

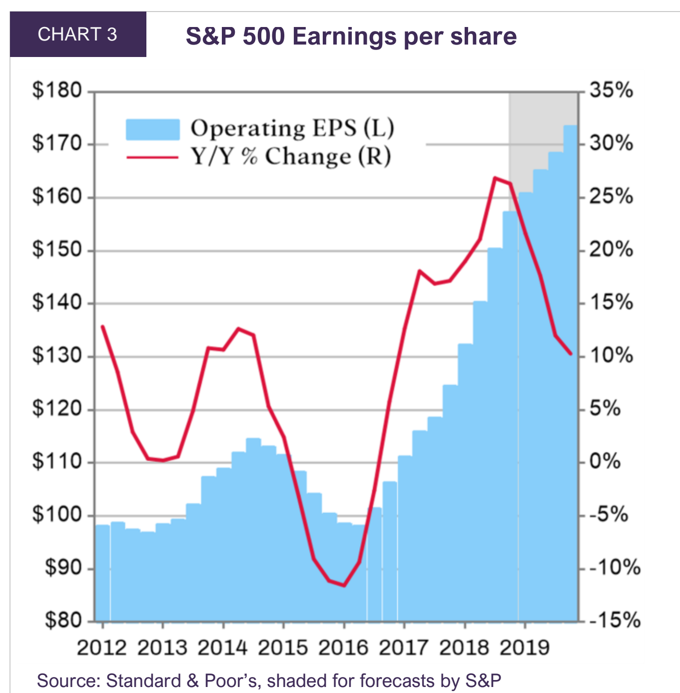
How are you protecting the portfolio in this uncertain environment?

Global equity markets ended the year in negative territory. Expressed in Canadian dollars (and in local currency), the MSCI World Index total return was -0.7% (-8.7%); the S&P 500 +4.0% (-4.4%); the S&P/TSX -8.9% (-8.9%); the DAX -15.2% (-18.3%); the FTSE -6.4% (-8.7%); the Nikkei -0.5% (-10.4%); and the MSCI Emerging Markets Index -6.8% (-14.3%).

We believe the most effective way we can limit equity market risk is to focus on careful stock selection, avoid overpaying for investments and diversify the portfolio across various sectors and geographies. As discussed above, recent market weakness appears tied to fears that company earnings will take a hit if the global economy enters a recession.

We remain of the view that earnings are still growing and the medium-term outlook for profits is favourable (Chart 3). Valuations are attractive (Table 2). Indeed, there is a disconnect between market prices and corporations' underlying value. For example, several of the energy companies in our portfolio are trading at close to a 40% discount to their net asset values while our auto holdings are priced around 7 times earnings, an inexpensive multiple given the context of a growing economy. Less cyclical, more defensive sectors are also significantly discounted from their fundamentals. Our telecommunications companies generally trade at forward P/E multiples of between 8 to 15 times while offering an average dividend yield of around 4.5%.

CHART 3 **S&P 500 Earnings per share**



Source: Standard & Poor's, shaded for forecasts by S&P

TABLE 2 **Equity valuations**

	Price/Earnings 2019	Price/Cash Flow 2019	Dividend Yield
S&P 500	14.3	10.1	2.3%
S&P/TSX	12.6	7.6	3.6%
Bloomberg Euro 500	12.1	7.4	4.3%
Nikkei	14.5	9.0	2.3%
MSCI Emerging Markets	10.6	6.6	3.4%
LBA Global Equities	**9.7**	**5.5**	**3.7%**
LBA Emerging Market Equities	**9.4**	**6.2**	**4.5%**

Source: Bloomberg

At year-end, the S&P 500 traded at 14.3 times 2019 earnings, the S&P/TSX 12.6, the Bloomberg Euro 500 Index 12.1, the Nikkei 14.5 and MSCI Emerging Markets 10.6. Our global equity portfolio trades at a reasonable 9.7 times 2019 earnings – a 32% discount to the U.S. index – and offers a 3.7% dividend yield. Similarly, the Letko Brosseau Emerging Markets portfolio is valued at 9.4 times 2019 earnings, providing a 4.5% dividend yield. All this persuades us that there is now considerable potential in both the short- and longer-term for above-average returns in global equity prices.

Turning to fixed income, we have eliminated the major risks in our bond holdings by avoiding exposure to long-term bonds and by keeping the majority of the investments in high quality securities.

Preservation of capital remains our priority. We are confident our portfolios are well positioned to weather this period of volatility.

Wishing you a healthy and prosperous New Year.
The Letko Brosseau Team

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

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About Us

Letko Brosseau is an independent investment manager founded in 1987. The firm manages approximately $30 billion in assets for more than 450 institutional investors and several thousand private clients.

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