Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

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- Equity markets began the year with a strong recovery which faded in early April when doubts about the European economy and Spain resurfaced. These concerns should not be a surprise as it will take time for conditions to improve.

- The ECB has taken decisive action to help restore stability to the European banking system and financial markets. Additional support will be provided should it be required. Economic output for the region will likely be flat during 2012 as fiscal austerity weighs on growth. Europe's high personal saving rate should cushion the adjustment and prevent a deeper recession.

- The U.S. economic recovery continues to progress, albeit slowly. We expect real GDP to grow modestly by 1.5%-2.0% this year.

- Growth in the developing world will continue to support an expansion of the global economy.

- Interest rates in both the U.S. and Canada started to climb in March from the lows reached during the fall of 2011. Capital losses on U.S. and Canadian 10-year bonds were –2.2% and –1.0% respectively during the month. Long-term bonds are overvalued and remain at risk.

- Equities generally are well supported by attractive dividend yields and reasonable valuations. We expect that a carefully diversified portfolio of high quality companies will outperform cash and bonds in the years ahead.

March 2012

U.S. Recovery Gains Footing

The U.S. economy expanded at a modest 1.6% rate in the fourth quarter. Growth in personal spending was in line with real GDP while investment grew 7.8% year-on-year. Exports advanced 5.1% while imports were up 3.6% and government spending was down 2.8%.

U.S. on a modest growth path…

The labour market recovery has picked up. During 2011, 2.1 million jobs were created in the private sector and an additional 628,000 jobs were added in the first three months of 2012. Employment is increasing in all industries, including construction, and across firms of all sizes. We expect the labour market to continue to recover in 2012 and 2013. Leading job indicators point to healthy gains: hours worked are growing faster than employment (2.8% vs. 1.9%), temporary jobs are up strongly (8.0%), and the ISM employment index is solidly in expansion territory (56.3).

Industrial production rose 3.4% in February compared with last year. Manufacturing utilization rates have improved to 77%, close to the long term average of 79%, which bodes well for continued growth in business investment. Furthermore, durable goods orders are 8.5% higher than last year while the March reading of the ISM new order index was 54.5, signalling strong growth in order books. Looking at the transportation sector, rail and truck volumes were up 2.2% and 6.8% respectively.

… with potential upside if housing and wages pick up…

As we build our economic forecast for 2012, we assume employment gains of 1.5% and moderate wage inflation of 1.6%. Under this scenario, disposable incomes should grow by 3.0%-3.5% and support a similar increase in consumer spending. With continued firm growth in investment, no change in the government's spending rate and a stable trade balance, we expect nominal GDP to grow between 3.0%–4.0% and real GDP by 1.5%– 2.0%.

The above forecast does not take into account an upside surprise in housing and commercial real estate/infrastructure and a higher rate of wage inflation. Our base case factors a recovery in residential investment in 2013 and 2014, although this may happen sooner than expected. Similarly, investment in offices, commercial buildings and other structures, which has only recently begun to bounce back from historically depressed levels, may accelerate further. A pick up in wage inflation, currently running at only 1.6%, would also provide a significant boost to consumption and GDP.

… but downside risks include fiscal showdown and oil price spike.

There are two important risks to our forecast we are closely monitoring: a potentially large fiscal contraction will ensue unless Washington politicians come to an agreement before year-end and the price of oil may spike if geopolitical tensions escalate. The U.S. legislative calendar will be very busy during Congress' lame duck session following the presidential election. The Bush tax cuts ($250 billion) and the payroll tax cuts ($120 billion), which together represent 2.4% of GDP and 3.1% of after-tax incomes, expire at year-end. Failure to come to an agreement to extend either or both budget measures would hit incomes immediately and could drag the U.S. into recession. Furthermore, the U.S. will once again hit its limit on the debt ceiling, possibly towards the end of this year. Negotiations surrounding this issue can create significant volatility in financial markets, as we experienced during the summer of 2011. A second potential risk to our growth scenario is an increase in the retail price of gasoline. At a price of $4/gallon, the average consumer commits 14% of his increase in after-tax income to buy gasoline. Above this price, we expect that spending on energy begins to crowd out spending on other goods and services, which will lead to a slowdown in the economy.

Europe: More Progress, Less Uncertainty

Europe's economy weakened in the second half of 2011 as negative sentiment associated with turmoil in sovereign debt markets detracted from the region's growth. Real GDP contracted by 0.3% during the fourth quarter but the economy managed to expand 0.7% over the previous year. Growth was higher in Germany (2.0%) and France (1.4%) and weaker in countries implementing fiscal austerity such as the United Kingdom (0.7%), Spain (0.3%), Italy (-0.4%), Portugal (-2.8%) and Greece (-7.5%).

As we highlighted in last quarter's letter, significant steps were taken to stabilize the banking system, deal with sovereign indebtedness and work towards a stronger European Union. We believe that European authorities have taken and will continue to take action to prevent a Europe-wide credit crunch. Indicators of broad money and credit are still expanding, albeit at very low single digit rates. This, together with a still-healthy consumer saving rate of around 13%, suggests that the European economy can avoid a deeper and more protracted contraction. Europe remains at risk of a shallow recession although our base case foresees flat GDP growth in 2012.

Europe risks shallow recession.

Two liquidity measures are particularly credited with having had a positive impact in relieving the stress in Europe's financial system and ultimately leading to a rebound in European share prices. First, in November 2011, the U.S. Federal Reserve committed to provide unlimited U.S. dollar funding to the world's major central banks. This in turn enabled the European Central Bank (ECB) to offer U.S. dollar swap arrangements to European banks, which were experiencing a significant flight of foreign money market funding in that currency. The U.S. dollar liquidity provided by the ECB via the Fed helped avoid a credit crunch.

Second, the ECB established the "Long Term Repo Operation" (LTRO) with the aim to finance European banks for up to three years in unlimited amounts. Banks could post an extended range of collateral to their respective central bank in exchange for cash and be charged a rate (currently 1%) well below that at which the market would be willing to finance them. Banks have borrowed a total of €1 trillion through the LTRO, of which about €570 billion represents new financing and €430 billion corresponds to lengthening the term of outstanding arrangements.

ECB restores stability in financial system.

These measures triggered a change in the funding markets for Europe's governments and banking system. Sovereign 10-year bond yields fell from 7.2% in November 2011 to 4.9% for Italy and from 6.7% to 5.2% for Spain. European banks were also able to restart issuing unsecured bonds; during the first quarter of 2012, €74.7 billion was raised compared with €57.6 billion between June-December 2011.

Sustained confidence in Euro sovereign markets rests on governments continuing the hard work of reducing their government deficits and promoting pro-growth policies. Government spending is falling in nominal terms in both Italy and Spain. In aggregate, Eurozone countries are targeting a 0.9% reduction of their combined deficits in 2012 to a level of 3.2% of GDP (see table). This compares with expected deficits of 9% in the U.S., 3% in Canada, 8% in the U.K. and 9% in Japan.

	2011 Nominal GDP	2011 Deficit	2012 Deficit	2014 Deficit (IMF forecast)	2011 Net Debt	2012 Net Debt	2011 public & private debt
	US$ Billion	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Ireland	217	-9	-7	-4	65	73	374
Portugal	239	-6	-5	-2	76	82	335
Greece	303	-9	-7	-3	133	90	207
Spain	1,494	-8	-5	-4	46	50	274
Italy	2,205	-4	-1	-1	100	100	224
France	2,763	-6	-5	-3	63	66	225
Germany	3,569	-1	-1	0	52	52	177
Eurozone	13,093	-4	-3	-2	61	62	226
Canada*	1,737	-5	-3	-1	34	32	187
U.K.	2,423	-9	-8	-4	62	69	273
Japan	5,869	-9	-9	-7	128	135	313
U.S.	15,094	-10	-9	-6	72	76	240

* Includes federal and provincial deficits.

Sources: Eurostat, OECD, IMF, Federal Reserve Board, U.S. OMB, Canada Dept. of Finance, Statistics Canada, Letko Brosseau

Looking ahead, Europe is forecast to be in a significantly stronger position than the U.S. by 2014. Net government debt to GDP will stabilize at 64% while it is projected to increase to 86% in the U.S. Furthermore, fiscal retrenchment in Europe will be at an end while the U.S., according to our estimates, will still be recording deficits north of 6%.

Economic Growth in Rest of World Steady

In Canada, real GDP was up 2.2% in the fourth quarter compared to the prior year. Business investment was ahead 12.9% and is likely to remain robust given high prices for commodities and sustained growth in the U.S. According to a Statistics Canada survey for capital spending intentions in 2012, investment is expected to grow by 7.2% this year.

After a strong start during the first 6 months of 2011, the labour market cooled significantly. Employment growth slowed to 1.1% in March compared with last year and only 45,000 new jobs were added over the past six months. Our growth forecast for Canada in 2012 is around

2%, under a scenario of strong capital investment, a low rate of job creation and the absence of any fiscal drag.

Japan is still dealing with the after-effects of the March 2011 earthquake, although the economy is showing signs of recovery. Real GDP was down 0.6% over the past twelve months, but advanced 1.5% between the third and fourth quarter of 2011. The turmoil in financial markets did have an impact on the developing world as most countries saw growth rates moderate towards the end of 2011. Real GDP was up 8.9% in China, 6.1% in India and 6.5% in Indonesia while advanced economies in Asia saw steady growth, with real GDP up 5.2% in Malaysia, 3.6% in Singapore, 3.4% in South Korea and 1.9% in Taiwan. In South America, growth slowed to 1.4% in Brazil but held at solid levels in Chile (4.8%) and Mexico (3.7%). Eastern European countries experienced fairly good gains: real GDP was up 4.3% in Poland, 8.2% in Turkey and 4.8% in Russia. The IMF expects the global economy to expand in 2012 although it downgraded its forecast for real GDP growth from 4% to 3.25%.

Global economy forecast to grow 3.25% in 2012.

Risk/Reward Favours Equities over Bonds

Interest rates in both the U.S. and Canada fell sharply during the summer months and remained low until March 2012. Yields on five-year government bonds have moved up 45 basis points recently, while ten-year yields are up 20 basis points in Canada and 40 basis points in the US. Currently, five and ten-year yields are 1.6% and 2.2% in Canada and 1.0% and 2.2% in the U.S. Interest rates in both countries are still below those prevailing in July 2011 and we believe the path towards normalization at higher yield levels will continue. We maintain a low exposure to bonds and the duration of our portfolios is being kept short.

Stock markets around the world have moved up and are now well above September 2011 levels. The MSCI World Index (expressed in Canadian dollars) is up 15.3% over the past six months and 3.4% higher than at the end of March 2011. Since September 2011, U.S. equities have outperformed all other developed markets: S&P 500 +20.9%; S&P TSX +8.1%; DAX +20.2%; CAC-40 +15.7%; FTSE +12.8% and Nikkei +5.0%.

Stocks should outperform cash and bonds over the medium-term.

Rising markets have led to an expansion in price-to-earnings multiples but these ratios remain in line with historical norms. The P/E ratio based on forecast 2012 profits is 13.4X for the S&P 500, 12.9X for the S&P TSX and 10.8X for the Bloomberg Euro 500. The weighted average P/E ratio of our 100 largest stock holdings is 11.5X and the average dividend yield is 3.3%. We believe that our equity portfolio is well positioned to offer substantially higher returns than bonds and cash in the years ahead.

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