Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

December 2015

Summary

- Disruption in commodity markets and slowing activity in China contributed to weaken investor confidence. The start of the New Year has been marked by choppy trading and lower oil prices.
- Although risks to the global economic outlook remain, they should not interrupt growth. Low interest rates, subdued inflation and lower oil prices provide an accommodative macroeconomic backdrop. Global real GDP is forecast to grow above 3% in 2016.
- Declining oil prices prompted the Bank of Canada to cut interest rates twice in 2015 over concerns of a domestic slowdown. In the U.S., the Fed increased its key interest rate in response to stronger economic fundamentals. Notwithstanding diverging policy paths, bond yields still remain below expected inflation, offering unattractive negative real returns.
- Global equity returns during the past year were highly concentrated in a small group of companies trading at inflated multiples. While overall market P/E ratios are not at these excessive levels, they remain above long-term fair value ranges.
- Careful stock selection with a focus on individual valuations is essential. Our portfolios trade at a reasonable 13 times forward earnings. We continue to favour equities over bonds within balanced mandates.

The global economy faced a few headwinds

Several events slowed global economic progress over the past year. During the first half, poor weather was blamed for lackluster growth in the U.S. while a decision by the newly-elected Greek government to renegotiate the terms of its financial support hit confidence in Europe's recovery. Disruptions in oil and base metals markets continued to hurt commodity-producing regions, including Canada. During the second half of the year, a government crackdown on corruption and a downtrend in activity in China triggered fears of a protracted slowdown. Finally, worries about the effects of a U.S. Federal Reserve interest rate increase negatively affected investor sentiment.

… but nonetheless stayed the course

Despite these headwinds, global growth has not collapsed. The latest IMF forecast for 2015 indicates that world output is on track to expand 3.1% in real terms, driven by real GDP growth rates of 2.6% in the U.S., 1.5% in Europe, 1.0% in Canada and 4.0% in emerging markets. For 2016, the IMF forecasts an improvement to 3.6% real GDP growth.

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Although the global expansion is in its seventh year, the pace of the recovery from the financial crisis has been moderate, and substantial global excess capacity and pent-up demand still exist. Low interest rates, subdued global inflation and depressed oil prices continue to provide accommodative macroeconomic conditions. All this suggests that we are in the midst of a long economic cycle, with world real GDP growth ranging from 3.0%-3.5% in the medium-term.

In the U.S., strong employment will continue to support income growth and consumer spending. During the second half of 2015, 229,000 jobs were created on average monthly and wages expanded at an annual rate of 2.3%. Disposable income grew 4.1% year-on-year in November and the savings rate was boosted to 5.5% from 4.6% a year ago. Consumer spending is growing at a healthy 2.9% rate year-on-year. An annualized 17.8 million cars were sold on average over the last 3 months to December and restaurant sales were up 6.5% year-over-year in November.

U.S. corporate investment remains strong, with the exception of spending in the energy and mining sectors which account for only 4% of total non-residential investment. During the third quarter, business investment (excluding resources) was up 6.8% against a year ago. The U.S. housing sector remains well supported by a rise in household formation: 1.3 million new households were created in September versus a year ago and new construction reached 1.2 million units in November. While a strong U.S. dollar had a negative impact on manufacturing and exports, the domestic drivers of the economy remain sound. We expect real GDP growth in the U.S. to be around 2.5% in 2016.

The European economy progressed during the year and is projected to expand by 1.5% in 2015. The unemployment rate steadily declined from 11.9% at end-2013 to 10.7%. This improvement was driven by the addition of 3 million new jobs with around 820,000 created in Spain, 550,000 in France, 560,000 in Germany and 450,000 in Italy. Disposable income grew 2.5% year-on-year in Q2 2015 and as incomes rise, we expect consumer spending to continue to support economic activity.

In December, the European Central Bank (ECB) announced it was undertaking more monetary stimulus. It increased the cost for banks to hold reserves at the ECB by 10 basis points and extended its bond buying program of €60 billion per month to March 2017 or beyond. These actions aim to boost non-financial credit growth, which improved to 1.5% year-on-year in November on the back of the ECB's prior measures. We forecast that Europe's real GDP will expand by about 1.5% in 2016.

The U.K. economy decelerated in 2015 as a cooling property market hit new residential construction. Real GDP growth in the third quarter was 2.3%, down from 2.9% at end-2014. The IMF forecasts moderate growth of 2.2% in 2016.

Canada remains negatively impacted by the disruption in the oil market. Investments in upstream oil & gas were cut by about 45% and were the main factor behind a 5.4% decline in non-residential investment in Q3. Due to strong consumer spending and residential construction, the economy managed to recoup the decline in activity suffered during the first half of the year. Spending on goods and services was up 3.1% in Q3 and the annualized level of housing starts averaged 214,000 per month over the last 3 months to November, up 13% year-on-year. A lower Canadian dollar fuelled an 8.5% increase in non-energy exports during the same period.

Going forward, we continue to believe that elevated Canadian consumer debt levels will constrain consumer spending and economic growth. While we expect oil prices to recover from current depressed levels, activity is likely to remain subdued. Our forecast for the Canadian economy is for real GDP to grow 1.5% in 2016.

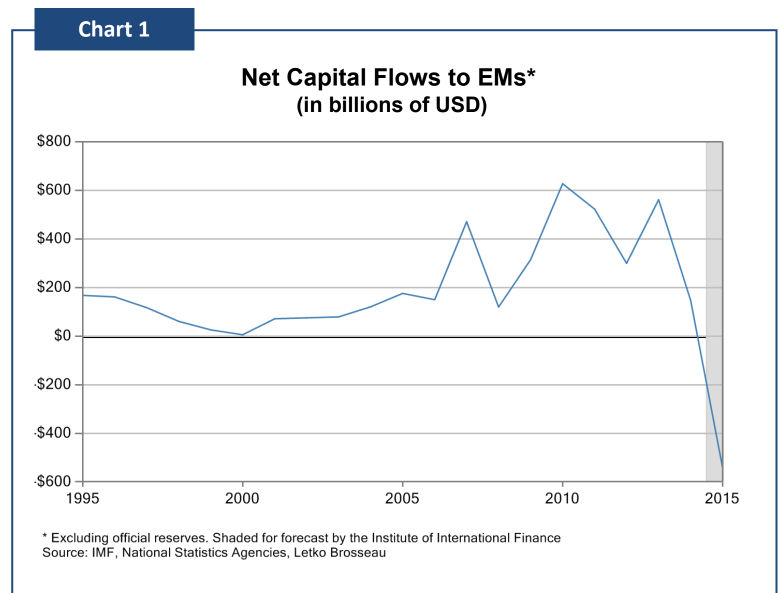
The Japanese economy rebounded in 2015 following a contraction in real GDP due to an increase in the national value-added tax the prior year. The economy expanded by 1.7% in the third quarter and the IMF forecasts growth to stabilize at 1% in 2016.

Keeping a sharp lookout for risks

While we expect positive economic growth for several more years, we remain attentive to risks that could upset this forecast. Increased capital flows out of emerging economies, cost pressures due to rising wages in the U.S., tightening conditions in the high yield market and geopolitical events such as the struggle over Catalan independence or a U.K. referendum on European Union membership are among some of the risks on the horizon. Given that emerging markets contribute about half of global growth, risks to this region warrant a closer look.

In our *Q3 2013 LBA Economic and Capital Markets Outlook*, we highlighted that as central banks lowered interest rates and injected significant liquidity into the global economy following the financial crisis, a portion of these funds found their way into higher-yielding emerging market securities. A perceived end to the Fed's zero interest rate policy stimulated a repatriation of funds back to developed markets in mid-2013, resulting in slower growth and lower exchange rates for several key emerging economies.

Given difficult economic conditions in a subset of developing economies such as Russia and Brazil, concerns of rising geopolitical risk and the beginning of an interest rate tightening cycle in the U.S., the risk of an acceleration of financial flows out of emerging markets is resurfacing. According to the Institute of International Finance, the region's net flows in 2015 are estimated to be negative for the first time in more than 20 years, reaching $541 billion (Chart 1). Such flows could be destabilizing if they result in tighter local financial conditions, less investment and lower levels of economic growth.



While the risks associated with foreign capital outflows are worth monitoring, we believe emerging markets are equipped to withstand lower foreign capital flows in the short-term. The developing world is in a significantly better financial position compared with the late-1990s Asian financial crisis. Aggregate foreign exchange reserves have increased 8-fold from less than $1 trillion to $8 trillion during 2000-2014. These reserves provide an important backstop to economic and financial adjustments triggered by foreign capital repatriation.

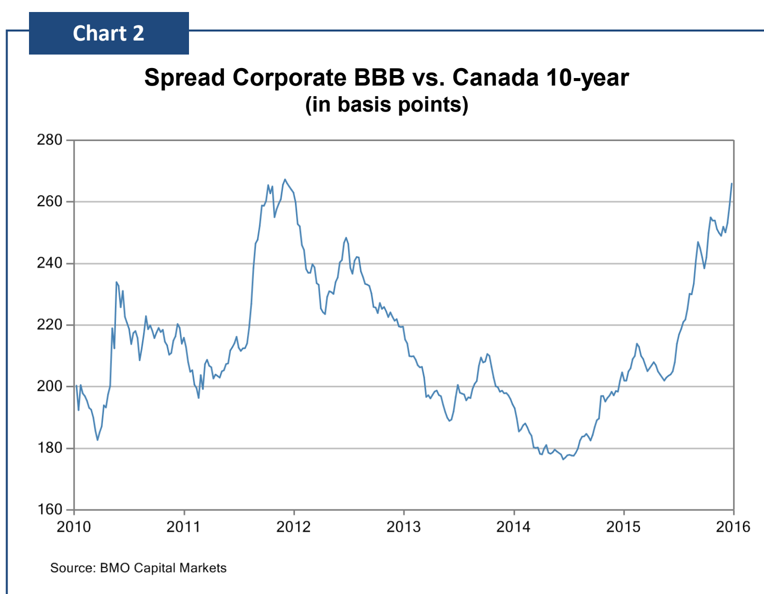
On the fiscal front, developing countries generally have latitude to stimulate their economies. At the end of 2014, the government debt-to-GDP ratio was only 9% in Russia, 22% in Indonesia, 35% in Turkey, 44% in Mexico and 55% in China. Public sector indebtedness was somewhat higher in Brazil and India at 65% and 66% of GDP respectively although this is notably lower than the average debt-to-GDP ratio of advanced economies (105%).

In China, for example, the government acted quickly as activity slowed mid-year, increasing spending by 30% compared with the previous year. The introduction of a targeted subsidy for new car purchases stimulated auto sales, which saw 24% year-on-year growth in November. While broad-based growth appears to have stabilized, China is not yet showing signs of a sustained rebound. The manufacturing Purchasing Managers Index (PMI) is above its August low but still below 50, the level associated with an expanding economy.

Although we will carefully analyse new developments in the region, we remain convinced that the fundamental drivers for growth remain compelling. Population growth and significant pent-up demand will help the region expand by a rate almost twice that of developed economies in the years ahead. Furthermore, as activity in developed markets continues to improve, emerging market exports should benefit. The IMF forecasts growth for the region to reach 4.5% in 2016.

How to navigate the current investment environment

Expectations of slower growth prompted the Bank of Canada to cut interest rates twice in 2015 and longer-term bond yields ended the year moderately below 2014 levels. The 10-year Federal bond yield declined by 40 basis points (bps) to 1.4% while the 30-year yield declined by 20 bps to 2.1%. Credit spreads widened across the spectrum with lower graded bonds suffering the weakest performance. Spreads of 10-year BBB-rated corporate bonds vs. Federal bonds increased from 200 bps to 260 bps (Chart 2) and 10-year BBB-rated yields rose by about 20 bps during the past year. The FTSE TMX Universe Bond Index generated a 3.5% return in 2015.



On December 16, the U.S. Federal Reserve raised interest rates from 0%-0.25% to 0.25%-0.50%. If inflation pressures develop, further rate increases are likely although they should remain modest in the near term. We continue to caution against taking additional interest rate or credit risk by purchasing long-dated bonds or lower quality corporate credits. These risks are not properly compensated by the mediocre yield pick-up that such strategies offer. Excessive valuations, particularly in long-term bonds where yields remain below expected inflation levels, suggest that bond investors should expect poor returns in the medium-term.

World equity markets delivered flat total returns in 2015, with the MSCI World Index down 0.3% in U.S. dollars (up 18.9% in $CA). Earnings in the U.S. were compressed due to a higher U.S. dollar and struggling resource sector. In Canada, declines in oil and mining stocks had a bigger impact given the index`s larger exposure to these sectors; the total return for the S&P TSX was –8.3% At year-end, global equity market price-earnings ratios were at the higher end of a reasonable valuation range: the S&P 500 traded at 17.3X 2016 earnings; the S&P TSX at 16.5X; the Bloomberg Euro at 15.6X and the Nikkei at 18.1X.

While underlying economic conditions remain supportive of equities, market valuations warrant caution as they remain subject to unanticipated events, as evidenced by choppy trading in the opening days of the New Year. Global equity returns during the past year were highly concentrated in a dozen companies trading at excessive multiples. It is difficult to justify the euphoric expectations built into the stock price of a company like Amazon, the top Index performer in 2015. Its valuation is 120X based on expected 2016 earnings. This implies that as the company matures and the price-earnings multiple converges towards historical fair value, either the stock price must decline by 87%, or earnings must increase by 800%.

At the other end of the spectrum, energy-related stocks had the weakest performance with the sector down 22% in 2015. An increase in OPEC's oil production, with Saudi Arabia adding 2 million barrels/day and Iraq 1 million barrels/day, fuelled concerns that oil prices would remain depressed for a significant time. It should be noted that the oil industry will be unable to increase production without significant new investments. Low oil prices have compelled the industry to reduce capital spending by 35% in 2015 and cut a further 30% in 2016, so we expect that oil supply will readjust downwards. Early signs are already apparent in the U.S., where oil output began to fall in 2015 after expanding by 1 million barrels/day each year between 2012-2014.

In addition, global oil demand was strong during the year, up 2.5 million barrels/day leading to total global consumption of 96 million barrels/day. A breakdown of oil demand indicates that 29% is consumed by trucks and industrial vehicles, 29% is used in the petrochemical industry, 25% is consumed by passenger cars, 10% is used for heating oil and 7% by jet fuel. These sources of demand are sticky and slow-moving. For example, the demand for passenger automobiles grows by 3% per year, which represents about 30 million additional cars on a global car park of 1.1 billion. Even under an aggressive scenario in which electric vehicles account for 90% market share of new car purchases in 10 years, they would account for less than 20% of the car park and the global car fleet would still consume 28 million barrels of gasoline/day in 2020. Despite a temporary imbalance, global oil supply/demand dynamics remain tight. As demand continues to increase and absorbs excess supply and production readjusts lower in response to massive cuts to energy spending, there will be upward pressure on oil prices.

We believe that a fundamental assessment of the intrinsic value of a business as well as price discipline in executing buy and sell decisions will dictate future returns. Despite evidence of market exuberance built into the prices of certain companies, our equity portfolios trade at a reasonable valuation of 13X 2016 earnings, 7X 2016 cash flows and offer a 3.5% dividend yield.

Looking forward, scientific advancements in health care, robotics and alternative energy have the potential to transform society and drive future growth. The greater investment rewards lie in participating in the potential of successful innovative businesses through an equity stake rather than the low yields offered by debt issuers.

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

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