Letko, Brosseau & Associates Inc.
Global Investment Management Since 1987

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Economic and Capital Markets Outlook

About us

Letko Brosseau & Associates Inc. is an independent, global investment management firm dedicated to building long-term value for our institutional and private clients.

Contact us

1800 McGill College Avenue
Suite 2510
Montreal, Quebec H3A 3J6
Tel: 514-499-1200
800-307-8557

145 King Street West
Suite 2101
Toronto, Ontario M5H 1J8
Tel: 647-426-1987
800-307-8557

Research

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Summary

- Global growth has disappointed in the past two years, prompting investors to question the sustainability of the economic expansion. A retrenchment in energy investment and a slowdown in China dampened global industrial production in 2015 and the first half of 2016, but these cyclical factors appear to be waning.
- The U.S. economy's resilience and improving conditions in Europe are underpinning global activity. Meanwhile, signs of stabilization in China, strong growth in India and a potential bottoming of Russia and Brazil's economies are setting the stage for a gradual rebound across developing markets.
- The world economy is on track for a moderate pickup in real GDP growth from 3.1% in 2016 to around 3.5% in 2017.
- As fears over a pronounced slowdown in China and spillovers from Brexit have subsided, the U.S. Federal Reserve is likely to lead other central banks in raising policy rates. The pace of rate hikes will be gradual and will not derail the U.S. economy.
- Longer-term interest rates remain at levels well below what is consistent with an expanding economy and positive inflation. Even a modest rise in long bond yields would lead to huge losses for investors.
- Going forward, equities will benefit from mid-single digit growth in corporate profits and stable dividend yields. Our forecast for medium-term equity returns is around 6%-7%, well above the mediocre returns offered by bonds.

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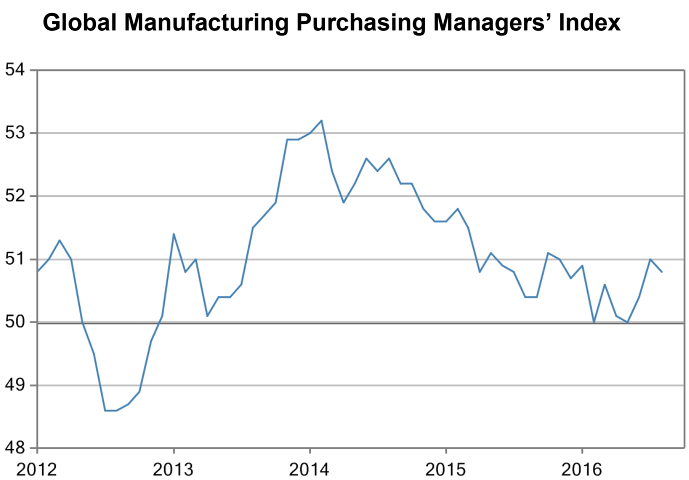
Global industrial production set to turn around

One of the puzzling aspects of global growth during the past two years is that the relatively robust rate of expansion in consumer spending has been accompanied by a notable slowdown in industrial production. The U.S., Canada, and several key emerging markets including China saw industrial production slow or turn negative during 2015 and remain soft during the first half of 2016. A sluggish global manufacturing sector has weighed on the world economy (Chart 1). Real global GDP advanced 3.3% in 2013, 3.4% in 2014 before slowing to 3.2% in 2015 and averaging less than 3.0% in the first half of 2016 versus the same period last year.

Chart 1



Source: Markit

Various factors appear to be restraining global industrial production. Two important structural trends prevalent in developed markets are the elevated penetration rate for most manufactured products and an aging population dependent on the consumption of services rather than goods. Combined, these two factors explain the long-term rise of the service industry at the expense of the goods-producing economy. In the U.S., for example, the proportion of all household expenditures spent on services increased from 59% to 68% over the last 30 years.

Latest data suggest that the U.S. service-based economy continues to thrive: household spending on services was up 4.8% in August versus last year. Spending on restaurants and hotels was up 5.7% and health care services saw a 5.9% rise. On the other hand, U.S. manufacturing activity remained sluggish. Industrial production fell 1.1% year-on-year in August while total factory shipments were down 2.0% and new factory orders contracted by 1.6%.

The more recent weakness in industrial production growth has not been driven by structural factors but rather coincides with two cyclical headwinds: the sharp decline in the price of oil and the slowdown of activity in China.

The price of oil collapsed from $105 per barrel in mid-2014 to below $30 per barrel in February 2016. Global oil producers cut back production and stopped undertaking new projects, slashing oil-related investment from $700 billion to $400 billion. Makers of steel, machinery and parts as well as the heavy equipment industry, all of which manufacture and supply the materials to build and expand oil drilling operations, saw declines in activity. During the second quarter, total U.S. non-residential investment was flat year-on-year while investment in equipment declined by 1.6%.

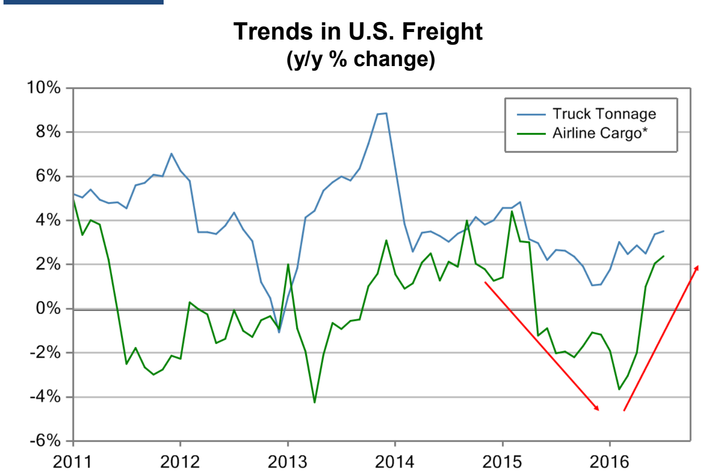
The sharp drop in oil-related capital spending is in the process of triggering a gradual return to supply/demand equilibrium in oil markets. In aggregate, the supply of oil decreased by 400,000 barrels/day in Q2 against the same period last year, with an increase in OPEC production partially offsetting the 800,000 barrels/day decline in U.S. production. Oil's recovery to a price range of $45-$50 per barrel should ease pressure on the manufacturing sector as capital spending cuts taper off. Early signs suggest we may be in the very early stages of an energy investment turnaround: the U.S. oil rig count, which plunged from 1600 in September 2014 to 320 in May 2016, has crept back up to 425 as of the end of September.

With respect to China, we reviewed the causes of the country's moderating growth in our September 2015 *Economic and Capital Markets Outlook*. Government efforts to reform the domestic financial system and clamp down on corruption resulted in a slowdown in key cyclical industries such as real estate and construction. Chinese industrial production growth declined from 8.2% in 2014 to 6.0% in 2015 while industrial company revenue growth slowed from 7% to 0.8% over the same time period. China's manufacturing malaise then spilled over to its trading partners and negatively impacted the entire supply chain.

To counteract the slowdown in the industrial economy, the Chinese government introduced numerous fiscal and monetary measures. On the monetary front, the central bank lowered the amount of cash that banks must hold in reserves in order to stimulate lending growth and cut the 1-year benchmark lending rate from 6% to 4.35%. On the fiscal front, government spending soared to an annual rate of 12% as of August. As a result, the government deficit increased from 0.9% of GDP in 2014 to about 3%. The result was immediate: bank credit surged, house prices moved up and industrial company revenues growth rebounded to the current annual rate of 3.6%. Improving conditions in China will remove a significant headwind to global manufacturing.

Recent data suggest that manufacturing activity has bottomed. The global manufacturing Purchasing Managers' Index (PMI) stood at 50.8 in August, up from 50.0 in February (Chart 1). Progress has been notable in the U.S., Europe and China. In the U.S., while industrial production is still contracting when measuring activity year-on-year, it is improving on a month-by-month basis. This uptrend is confirmed by various indicators such as railcar loadings, trucking tonnage and air freight (Chart 2). A bottoming of these real activity indicators suggests a high likelihood of a pickup in the third quarter.

Chart 2



* Revenue Ton-Miles
Source: Bureau Transportation Statistics

Overall, the improvement in global manufacturing conditions is setting the stage for a gradual acceleration in world economic growth.

Headwinds to economic growth in the first half of 2016 gradually dissipating

The U.S. economy recorded a weak Q2 with real GDP expanding by 1.3% year-over-year as a contraction in corporate investment was a drag on activity. Robust growth in consumer spending and housing remained the bright spots, up 3.7% and 9.1% year-on-year in nominal terms.

Looking ahead, a positive outlook for jobs and wages supports continued strong growth in consumption and new home construction. This, together with a gradual improvement in industrial production and business investment, should lead to an acceleration in U.S. real GDP growth in the second half of 2016. We forecast the U.S. economy to expand by 2.5% in 2017.

Canada is also set to benefit from an easing of pressure on the energy sector and a pickup in global manufacturing. Energy currently represents about 20% of the country's non-residential investment and capex is still contracting. During the second quarter, nominal business investment declined by 5.8% against a year ago. Despite a 3.3% increase in consumer spending and an 8.0% increase in residential investment, real GDP growth slowed to a modest 0.9% in Q2.

A stronger U.S. economy, a weak Canadian dollar and a more positive climate for business investment should help Canadian economic activity rebound from current anemic levels. Over the medium term, however, growth will be tempered by elevated consumer debt levels and a too high consumer spending rate. We expect Canadian real GDP growth to move back towards 1.5% in the second half of this year and remain near this level in 2017.

The U.K.'s vote to exit the European Union does not appear to have adversely impacted confidence in Europe's recovery. The manufacturing sector PMI for the Eurozone was 52.6 in September, a level suggesting an expansion in activity, while car sales were up 4.7% in August against a year ago.

In addition, lower energy prices were a tailwind as Europe imports most of its energy needs. In comparison to the U.S. and Canada, nominal non-residential investment rose 4.1% against a year ago in Q1, led by a 6.1% increase in machinery and equipment. Eurozone real GDP grew by 1.6% year-on-year in Q2, led by Spain (+3.2%), Germany (+1.7%) and France (+1.4%). Going forward, continued monetary support by the ECB and a gradual improvement on the job front should allow the Eurozone to maintain current levels of growth into next year.

Our forecast for the U.K. is clouded by the uncertainty with respect to Brexit negotiations. The Bank of England acted quickly following the June 23rd vote to add liquidity to the country's financial system. It cut interest rates by 0.25% and announced the purchase of £60 billion worth of U.K. government bonds and £10 billion of corporate bonds. It also announced that it would make up to £100 billion available to commercial banks at a rate close to 0.25% provided that banks, in turn, used this money to make new loans. These measures should help support the U.K. economy and prevent a severe downturn. The Bank of England forecasts real GDP growth of 0.8% in 2017 compared with 2.0% in 2016.

Elsewhere, the IMF forecasts that China's real GDP will grow by 6.2% in 2017, India 7.6% and Mexico 2.3%. Brazil and Russia are expected to return to positive growth next year, with Brazil rebounding from –3.3% to +0.5% and Russia improving from –0.8% to +1.1%.

Our forecast for real global GDP is a moderate pickup from 3.1% in 2016 to 3.5% in 2017.

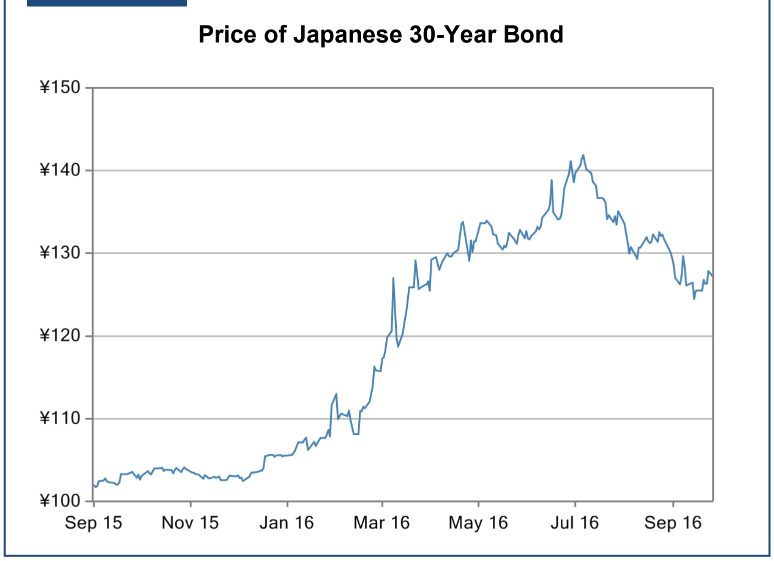
Bond buyers beware

Improving worldwide economic activity questions the need for continued massive liquidity measures that have been put in place by various global central banks. In the U.S., the fed funds rate remains at 0.25%-0.50%, a level associated with extremely easy monetary conditions. The Bank of Japan, the Bank of England and the ECB continue to buy billions of dollars of bonds every month to boost money supply and support their economies. As growth picks up, the need for these extraordinary measures will diminish.

Given dissipating headwinds to growth and healthy domestic economic data, the Federal Reserve will likely lead the world's central banks in normalizing policy rates. As of August, the U.S. unemployment rate stood at 4.9%, a level lower than in December 2007, before the Great Recession. While consumer price inflation was below 2.0% due to subdued energy prices, core inflation (excluding energy and food) was 2.3% in August. Median wages and hourly earnings rose by 3.3% and 2.4% respectively.

In the weeks leading to the Fed's decision on interest rates on September 21st, which ultimately left rates unchanged, global bonds sold off sharply. U.S. Treasuries maturing in 30 years declined by 5% in 4 days and 7% from July's peak. Worldwide, long bonds experienced similar price declines. Japanese long-term bond prices dropped 12%, German bunds declined 7% and even the Government of Canada's 30-year bond fell 6% (Chart 3).

Chart 3



While bonds recouped their losses going into month-end, such yield volatility is a reminder of how much money can be lost in bonds in a short time frame. Meagre yields do not offer sufficient return potential to cushion investors from the downside risk to capital.

On the other hand, an improvement in economic conditions will continue to support corporate profits even if central bank policy rates begin to rise. As noted above, the fed funds rate is abnormally low and a path of gradual, incremental hikes from this level is unlikely to destabilize growth or adversely hit corporate profits. **Interestingly, during the past eight Fed monetary tightening cycles dating from 1950 to 2007, the S&P 500 reached its peak on average 30 months after the first rate hike and generated an average total return of 9.5% over the twelve month period following the first tightening.**

We continue to exercise caution, however, in the selection of companies for our equity portfolios. Valuations have risen on the back of a supportive macro environment and low interest rates. At the end of September, the price-to-earnings (P/E) ratio of the S&P 500 based on estimated 2017 profits stood at 16.3X while that of the S&P TSX was at 16.1X, the DAX 12.2X, the FTSE 15.2X and the MSCI World 15.5X. While these are not overly rich valuations by historical standards, some sectors of the market are trading at excessive levels and could come under pressure in a rising rate environment.

We continue to focus on strong businesses trading at reasonable valuations which offer excellent potential to grow their earnings. Our equity portfolio is priced at a reasonable 13X forward earnings and offers a 3.1% dividend yield. This fundamental approach with careful attention to prices paid is, in our opinion, the most effective way to maximize long-term returns including in a rising rate environment.

We remain overweight equities within balanced mandates and are avoiding all exposure to long-term fixed income instruments.

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