Letko, Brosseau & Associates Inc.

Global Investment Management Since 1987

March 2017

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.

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Research

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Summary

- Stock markets trended higher in the first quarter on improving global activity together with investors' anticipation of increased fiscal spending and U.S. pro-growth reforms. Meanwhile, bond yields continued to grind upwards.

- A stronger world economy should be beneficial for company earnings, and, by extension, equity markets. Longer-term, there remain huge unmet needs in the developing world, which will stimulate consumption in these regions for years to come.

- Global growth is gathering momentum, led by the U.S. We forecast world real GDP to expand by 3.4% in 2017.

- U.S. activity had begun to accelerate even before Trump's stimulus agenda was announced. We expect U.S. real GDP growth to reach 2.5% in 2017, with potential upside to this forecast if fiscal stimulus takes effect.

- Canada should benefit from a stronger U.S. economy and a weak currency while growth in the rest of the world is set to accelerate in 2017 on the back of improving industrial production.

- Equity market P/E ratios, particularly in the U.S., have approached the higher end of fair value ranges. In contrast, our stock portfolios are still attractively valued and trade well below current market multiples.

- Bond yields remain on an upward trajectory as central banks begin to normalize monetary policy. We are focused on capital preservation and are maintaining a low duration in our fixed income portfolios.

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Red herrings

During the post-financial crisis recovery period, global growth was hindered by difficult economic conditions in various areas of the world. In 2012 and 2013, the European economy was under pressure as Greece renegotiated its debt and troubles emerged in the Spanish banking sector. In 2014, a hike in the value-added tax caused a slowdown in the Japanese economy while Russia's invasion of Crimea negatively impacted European business confidence and investment. In 2015, the decline in commodity and energy prices hit producing economies, with Brazil and Russia falling into recession. A slowdown in China exacerbated doubts on the sustainability of world growth. Global industrial production moderated in 2015 and the first half of 2016, affecting most major developed economies, including the U.S. and Canada.

While the above-mentioned pauses in activity were accompanied by volatility in financial asset prices and fears of an end to the growth cycle, each episode proved to be a red herring. Today, investors have zeroed in on the unpredictability of Trump's geopolitical agenda. This, together with questions over the length of the equity bull market as well as the possibility that valuations are overextended have emerged as investors' top concerns.

Cyclical economic activity is gathering momentum

We highlighted in past reports that low interest rates and subdued inflation provided an accommodative backdrop, consistent with a long economic cycle. And we also warned investors against taking a too negative view as each above-mentioned shock came to the forefront.

We still do not see any current impediment to global growth's upward momentum. Global industrial production is rebounding and manufacturing PMIs suggest further improvements ahead. For the first time since 2010, all key regions of the world are expected to grow in a synchronized manner (Table 1).

Table 1: Global Real GDP Growth (Y/Y % Change)

	2015 Nominal GDP (US$ bn)**	2011	2012	2013	2014	2015	2016	2017
U.S. *	$17,947	1.6%	2.2%	1.5%	2.4%	2.6%	1.8%	2.5%
Canada *	$1,552	3.1%	1.7%	2.2%	2.5%	0.9%	1.5%	1.9%
Japan	$4,123	-0.5%	1.7%	1.4%	0.0%	1.2%	0.9%	0.8%
U.K.	$2,849	2.0%	1.2%	2.2%	3.1%	2.2%	2.0%	1.5%
Eurozone *	$11,540	1.6%	-0.9%	-0.3%	0.9%	2.0%	1.7%	1.6%
China *	$10,982	9.5%	7.7%	7.7%	7.3%	6.9%	6.7%	6.3%
India	$2,091	6.6%	5.6%	6.6%	7.2%	7.6%	6.6%	7.2%
Brazil	$1,773	3.9%	1.9%	3.0%	0.1%	-3.8%	-3.5%	0.2%
Russia	$1,325	4.3%	3.5%	1.3%	0.7%	-3.7%	-0.6%	1.1%
Developed	$44,388	1.7%	1.2%	1.2%	1.9%	2.1%	1.6%	1.9%
Emerging	$28,783	6.3%	5.3%	4.9%	4.6%	4.1%	4.1%	4.5%
World	$73,171	4.2%	3.5%	3.3%	3.4%	3.2%	3.1%	3.4%

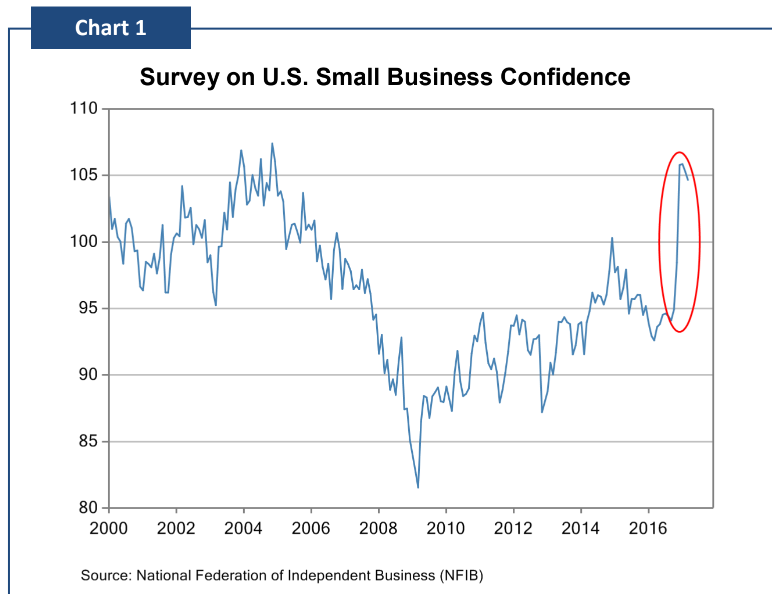
** Forecasts for the U.S., Canada, the Eurozone and China are from LBA, all others are from the IMF*
*** Based on 2015 exchange rates*
Source: IMF, LBA, January 2017

The biggest improvement is expected to come from the **United States**. A healthy consumer, a pick-up in business investment and a rise in residential construction are supporting the economy's acceleration. The oil & gas rig count troughed in May 2016 and was up 29% by the third quarter. Corporate profits rebounded by 8.7% between Q4 2015 and Q3 2016. Meanwhile, annualized car sales reached 17.9 million units last October, helping boost retail sales growth to 4.2% on a year-over-year basis.

Since November's presidential election, activity has improved further. Disposable income grew 4.0% year-over-year in January on the back of strong job creation. Early signs of wage acceleration suggest continued growth in incomes and household net worth reached $93 trillion. These factors indicate that consumer spending should contribute materially to growth in 2017.

The housing sector continues to experience buoyant demand. House prices increased 5.6% year-over-year in December and rental vacancy rates are now at their lowest level since the mid-1980s. New home construction is running at 1.29 million units per year, slightly below the 1.3 million to 1.5 million unit level that is consistent with population growth. On the corporate side, profits grew by 15.7% in the fourth quarter against a year ago and new factory orders were up 3.8% year-over-year in January. Surveys of business sentiment have picked up in the past few months, indicating that business investment should improve from current levels (Chart 1).

The pickup in U.S. activity occurred before any meaningful fiscal stimulus has been implemented by the new administration. While only general budget guidelines have been announced thus far, the message has been unequivocal: boost employment and growth.



Government defense spending is expected to rise as will spending on infrastructure projects such as roads, bridges and highways. Lower tax rates and an easing on the regulatory front remain the top objectives of Trump's agenda.

It is difficult to estimate the impact of these announcements at this juncture. There is no agreement in Congress on any offsetting measures to pay for a stimulus program. Various propositions such as a border adjustment tax, which would prevent companies from deducting the cost of imported goods in their tax return, could have unintended consequences on growth or inflation.

While the new federal budget is expected to be released later this spring, its impact may well be spread across this year and the years ahead. We will continue to assess each new measure as it is announced. Regardless, the U.S. economy is in an uptrend. After recording real GDP growth of only 1.6% in 2016, we expect growth to expand to 2.5% in 2017. Additional fiscal stimulus could lead to further upside to this forecast.

The improvement in the U.S. economy and the rebound in commodity prices are already having a positive impact on **Canada**. Real GDP growth reached 1.9% in Q4 year-on-year as Canadian exports

rebounded. The trade deficit narrowed from $45 billion in Q4 2015 to $19 billion in Q4 2016 and should continue to improve as the Canadian dollar remains relatively weak against the U.S. dollar.

Manufacturing new orders increased 3.5% in January versus a year ago while in February, the PMI index reached its highest level since 2014. Due to strong growth in Ontario, Quebec and British Columbia, the Canadian economy created 36,600 jobs per month between December and February. On the housing front, Canada's housing market continued to contribute positively to growth. An annualized 209,000 homes were built on average over the last 3 months to February, an 11% increase against the same period a year ago.

Overall, the Canadian economy should benefit from a cyclically stronger U.S., a weak Canadian dollar and higher government spending as reconfirmed by the recent budget. Longer-term prospects are still hindered by structural factors, including elevated house prices and household indebtedness. We forecast real GDP growth in Canada to average around 2.0% in 2017.

During the fourth quarter, **Eurozone** real GDP expanded by 1.7% year-on-year, led by Spain (3.0%) and Germany (1.8%). The French and Italian economies both grew by 1.1%. Eurozone consumer spending remains well supported by employment growth. The unemployment rate fell to 9.6% in January and the economy created 310,000 jobs per month between January and September 2016.

Notwithstanding concerns on the political front, with upcoming elections in France, Germany and possibly Italy, recent data support an acceleration of growth going forward. The manufacturing PMI reached 55.4 in February, its highest level since 2011, while non-financial business credit increased 2.1% in January versus the previous year. Overall, we expect Eurozone real GDP to expand between 1.5% and 2.0% in 2017.

The **U.K.** is forecast to slow from 2.0% in 2016 to 1.5% in 2017, due to Brexit-related readjustments while **Japan**'s economy could surprise to the upside. Japanese real GDP growth reached 1.6% year-on-year in Q4 as residential investment jumped 7.1% and the trade balance went from a ¥1.2 trillion deficit to a ¥6.3 trillion surplus.

Elsewhere in the world, real GDP in **China** increased by 6.8% in the fourth quarter against a year ago while **India** grew 7.0%. **Russia** (–0.2%) and **Brazil** (–2.5%) recorded a second year of negative economic growth but the rise in commodity prices has led to a stabilization of activity in both countries. The IMF 2017 forecast for real GDP growth is 1.1% in Russia and 0.2% in Brazil.

Overall, we forecast global growth to accelerate from 3.1% in 2016 to 3.4% in 2017.

Positive long-term structural drivers underpin global growth

At a time of improved economic conditions driven by cyclical factors, we believe it is worth reminding ourselves that two significant structural forces underpin the long-term demand for global goods and services.

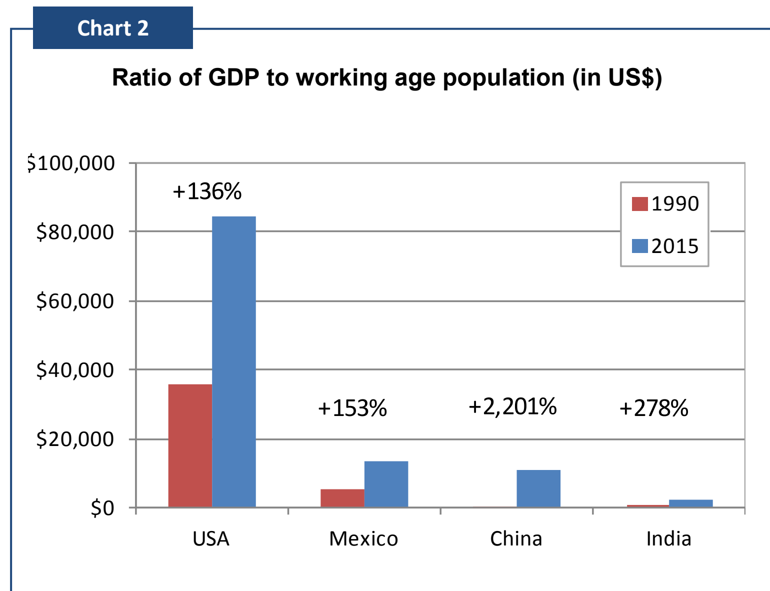
First, the world's population is expanding by 80 million individuals per year, growing at an annual rate of 1.1%. Global population is expected to reach 8 billion inhabitants by 2024 and emerging markets are at the forefront of this increase. In 2017, the developing world will account for about half of global growth. This ratio is expected to increase to 62% over the next five years and keep rising thereafter as growth in this region continues to exceed that of developed economies.

Second, developing and low-to-middle income countries are in a long-term economic catch-up phase. In general, their populations are younger, their economies are in dire need of advancement in infrastructure and health care and they have comparatively low levels of penetration of financial services.

In 1990, the ratio of GDP to the working age population, a good measure of prosperity, was about $36,000 in the U.S. This compared with $475 for China, $640 for India and $5,400 for Mexico (Chart 2). A quarter century later, this measure increased 136% in the U.S. to $84,500. Meanwhile, as emerging economies grew faster, it reached $11,000 in China, $2,440 in India and $13,660 in Mexico.

There remain huge unmet needs, which will stimulate consumption in these regions for years to come. It is estimated that a newborn American baby will consume, over the course of its life, 19,826 eggs, 7 washing machines, 10 televisions, 5 refrigerators, 15 computers and 12 cars. To have the same prosperity level as the U.S. in 2050, China will require an annual nominal growth rate of at least 6.9%, India 11.8% and Mexico 6.0% over the next 33 years. Although these specific growth rates may not be acheived, the convergence of emerging markets towards developed economies will march ahead.

We are confident that a rise in global population and worldwide convergence to developed economy prosperity levels offers plenty of long-term investment opportunities.



The challenge of investing in prosperous times

Equity investors have taken note of the acceleration in the world economy. During the first quarter, stock market indices around the world recorded positive total returns (in C$): the S&P 500 was up 5.3%; S&P TSX 2.4%; DAX 9.0%; CAC-40 5.9%; FTSE-100 4.1%; and the Nikkei 3.3%. Over the same period, the MSCI Emerging Markets Index was up 10.6%.

At current levels, the S&P 500 Index trades at a price/earnings (P/E) multiple of 18 times estimated 2017 earnings, which pushes U.S. stock market valuations towards the higher end of fair value. Valuations in other regions of the world are less elevated. Using MSCI indices for comparability, Canada trades at 17x expected earnings, Japan 16x, Europe 15x and Emerging Markets a very reasonable 13x.

At a time when global growth is accelerating and stock prices climb to new highs, price sensitivity becomes more important than ever. Our portfolios trade at 14x and are well diversified across geographies and industries.

Examples of companies which offer interesting upside potential while priced at reasonable levels include **Aegon**, one of the world's largest providers of life insurance, pension and asset management

products. Known as Transamerica in the U.S., the company trades at only 7x 2017 earnings and offers a 5% dividend yield. **Merck**, a leading pharmaceutical company specializing in oncology, auto-immune diseases and vaccines, recently launched two new drugs which have multi-billion dollar potential, one of which may revolutionize cancer treatment. It trades at 16x 2017 earnings with a 3% yield. Canada's **Celestica**, a manufacturer of IT servers, storage and networking equipment, is poised to benefit from the trend to outsource IT industrial manufacturing. The company trades at only 10x earnings.

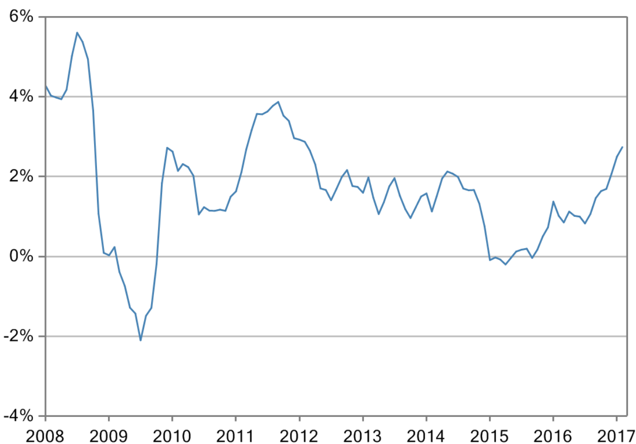
We remain attentive to valuations and are focusing on the fundamental drivers of the companies in which we seek to invest. Our portfolios are well positioned to benefit from the longer-term structural forces underpinning growth and offer protection against short-term shocks. We believe that this classical approach to investing will continue to deliver strong results in the future.

The bond correction has begun

Bond yields have climbed in the last six months, inflicting the most damage on holders of long-term instruments. Federal bond yields with maturities of 10 and 30 years jumped by 63 and 65 basis points, which translated into losses of 5.4% and 14% respectively. The FTSE TMX Index declined by 2.2% during the same period.

We believe the correction has just started. Bonds are still extremely overvalued and prices remain inconsistent with a positive macroeconomic backdrop. Furthermore, inflation across the developed world has begun to pick up. The U.S. Consumer Price Index rose 2.8% in February against a year ago (Chart 3). The Federal Reserve took note of the CPI's rise and raised the Fed Funds rate by 0.25% in March, its third hike since December 2015.

Chart 3



Source: Bureau of Labor Statistics

Looking ahead, inflation pressures will build as global growth accelerates, which will put pressure on the Fed to further tighten monetary policy. While the Bank of Canada may take a slower approach to normalize rates, bond yields across the curve are likely to be sensitive to rising inflation, especially for longer maturities. By keeping a short duration, our bond portfolio is well positioned to preserve capital at a time when rates may increase significantly.

We continue to favour carefully selected equities over bonds 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.