Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

Letko, Brosseau & Associates Inc.

1800 McGill College Avenue
Suite 2510
Montreal, Quebec H3A 3J6

Telephone : 514-499-1200
800-307-8557

130 Adelaide Street West
Suite 3200
Toronto, Ontario M5H 3P5

Telephone : 647-426-1987
800-307-8557

Over the last three months, most major economies have shown signs of stabilization or improvement. Coordinated global policy actions in the form of fiscal stimulus, low short-term rates as well as various forms of support to the banking system have helped avert a more serious contraction. This has contributed to a strong recovery in equity markets around the world. The MSCI World Index is up 36.5% since the low recorded on March 9th. Corporate bonds have rallied in conjunction while also absorbing a significant amount of new issuance as have government bonds.

These positive developments appear to suggest that an end to the recession may be at hand. In this current letter, we will start with an update on the US economy and assess whether activity is on a path of improvement. In the second part, we address the economic growth potential of foreign economies particularly Germany, France, the UK and China as proxies for the developed (ex-US) and developing world respectively to arrive at a global growth forecast.

Signs of stabilization in the US

A key element in assessing US economic prospects is the outlook for the labour market. Job losses were steepest during the six month period from October 2008 until March 2009, which saw an average of 622,000 lost jobs per month. While employment gains have yet to materialize, current trends are showing more positive signs. Job losses slowed to an average of 428,000 during the second quarter and 256,000 in the third quarter. Temporary employment, which usually leads employment as a whole, has been steady since July. Furthermore, the overall loss of jobs is roughly in line with the economic contraction experienced thus far. Employment is down 5.2% compared to the peak reached in December 2007, while GDP contracted by 3.9%. As we expect economic activity has bottomed and will begin expanding in the next few quarters, the job market should follow a similar path with its customary lag.

The manufacturing sector has now begun to show signs of improvement. The monthly Institute for Supply Management (ISM) survey moved above 50 in August and is now at 52.6 as of September. A reading above 50 is consistent with expanding manufacturing output. More importantly, the sub-index for new orders was up significantly to 63 and has held above 50 since May. A major contributing factor is the impact of automobile production, which shut down in the spring and was revived in the summer following a surge in demand created by the temporary "cash for clunkers" scheme implemented by the US Government. Excluding the transportation sector, industrial production was essentially flat during the past three months. Meanwhile, new orders over the past three months rose 5.1% above the previous three months but remain 23% below year ago levels.

The housing sector is also showing signs of stability following a three year contraction. Housing starts are up 14.9% during the past 3 months to 597,000 units. During the same period, total home sales were up 7.5%. All four major country-wide price indicators are showing tentative signs of stabilizing, while three out of the four are increasing sequentially.

As we look at current data, it seems that many sectors of the US economy have steadied albeit at low levels following a significant contraction in activity that left no sector untouched. From this base, we expect sequential improvements over the next few quarters. Several factors should help. First, federal government fiscal stimulus has yet to be fully spent. Second, monetary policy is extremely accommodative and should remain so through at least the first half of 2010. Third, inventories are lean, down 11.5% economy wide as of July versus their Q3 2008 peak.

As we look forward to 2010, we see a mild recovery in labour markets, which should contribute 2% to 3% growth in disposable income. Consumption is likely to increase similarly. We expect modest growth from two out of three investment sectors, namely residential construction, equipment and software, while non-residential construction is likely to contract further. Efforts to rebuild inventories should make a positive contribution after six straight quarters of inventory contraction. Adding these factors together, we forecast US real GDP to grow by 2.0%-2.5% in 2010. Given the very weak conditions that prevailed during early 2009, a stronger recovery next year is possible.

Growth prospects around the world

Over the past two years, we have spent considerable time developing a view on the US economy given its importance in the global marketplace and the impact of its significant imbalances, many of which have helped create the current recession. From this work, we concluded that the medium term growth prospects for the US economy were subdued. We expect average nominal GDP growth of 1.25% to 2.5% from 2010 until 2012. This should translate into modest real GDP gains of 0.75% to 1.75%. The contribution to global growth from the US will be lower than that experienced through much of the past decade.

Turning our attention to other regions of the world we try to quantify the contributions they may make to global economic growth. First, we consider Western Europe. The Euro area and the United Kingdom represent roughly 30% of the world economy, a proportion similar to the US. The three largest countries in the region, Germany, France and the United Kingdom, jointly represent two-thirds of the economic output of Western Europe and 20% of the world economy. Notwithstanding the advanced state of economic integration that occurred in Europe over the past decades, local economies still retain their particular dynamics. As of the end of Q2, the recession had different

impacts on these countries. Over the past year, real GDP fell 5.9% in Germany, 5.3% in the UK and 2.9% in France.

Over the medium term, the UK appears to have the weakest outlook as its economy shows many of the same imbalances present in the US. UK consumers, similar to those in the US and Canada have used credit to significantly increase consumption during 2002-2007. Between 2006 and 2008, the UK savings rate averaged less than 2%. During the past two quarters, the savings rate has moved back up to 3.5%. Consequently, consumption was down by 2.2% over the past year. We would expect the UK savings rate to move back up to a higher level over the next five years, seriously hampering growth in personal consumption. In addition, the UK economy is extremely reliant on the financial industry, as it provides employment to around 20% of the population, compared to less than 7% in North America. Considering the deleveraging cycle which is occurring, we think it is unlikely that the financial services sector will create many jobs in this cycle. Consequently, our outlook for personal consumption, which represents 63% of UK GDP, is for modest growth.

Another sector that contributes to our weak growth outlook for the UK economy is government. Over the next two years the UK government is expected to run significant fiscal deficits of roughly 9% to 11% of GDP. As a result, UK net debt to GDP should rise from 46% to 65%. The UK government will face tough decisions in rebalancing its finances. Given that consumption and government spending which together represent 86% of GDP will face significant headwinds, we remain concerned about the UK's economic prospects.

The picture in France and Germany is more positive given that consumers in these countries have not been lured into excessive spending by cheap credit. Furthermore, the savings rate in Germany, currently at 11%, remained very stable both before and after the financial crisis. French households are saving even more, setting aside 15% of their after-tax incomes. This makes it possible to hypothesize consumption growing more quickly than incomes in the next cycle.

Regarding government spending, both France and Germany are expected to run fiscal deficits of 6% to 7% of GDP in the next two years. As both countries are in the European Monetary Union they are bound by the Stability and Growth pact. The main requirements of this fiscal accord are to run deficits lower than 3% of GDP and have a net debt to GDP ratio of less than 60%. Both requirements were lifted for the fiscal years 2009 and 2010 in light of the recession. By the end of 2010, France's net debt to GDP ratio is expected to be 70%, compared to 60% for Germany. Starting in 2011, both countries will therefore need to reduce their fiscal deficits.

As we aggregate these different parts, we forecast a similar rate of expansion in Western Europe as in the US, with real GDP growing by 1.0% to 1.75% which is modestly lower than the 2% average experienced between 1995 and 2009.

In the developing world, China has grown at a high pace over the past twenty years. China currently represents 5% to 7% of world GDP, and accounts for half of developing Asia's economy. Between 1990 and 2009, the Chinese economy grew at an average rate of 9.3%. If we assume that China is able to sustain real GDP growth of 8% over the next three years, which is in line with the government's stated objectives, close to 20% of global growth would be contributed by that country over the next four years.

How might we be convinced that China will be able to maintain such a high growth rate? First, China's labour force should be expected to continue to grow at a brisk pace as a result of continued migration of workers from the country to the city. Given an urbanization rate of below 50%, and a stated government objective to continue the path toward urbanization, the active urban labour force should be expected to continue growing at a vigorous pace.

Another feature of the Chinese economy is the significant role played by government. It targets growth objectives and uses many levers to ensure these objectives are met. The current 5 year plan has an annual goal of 8% real GDP growth. It emphasizes improvements to the country's transportation and energy sectors. China is in a very strong position to launch these major infrastructure programs; its fiscal budget is balanced and its foreign debt to GDP is only 12%. In addition, the central bank owns a significant amount of foreign reserves which represent roughly 45% of GDP.

While international trade is very important to China - the net trade balance is positive and represents 8% of GDP - we believe a transition is underway whereby domestic investment and consumption will play a more important role in future.

Other countries in Asia have much in common with China i.e. globally competitive and growing workforces, low levels of government debt and large foreign exchanges reserves. In addition, many countries in the region enjoy trade surpluses. Given these conditions, we think these countries are very likely to grow at a significantly faster rate than North America and Western Europe.

Our hypothesis of subdued real GDP growth in the area of 1.0%-1.75% in North America and Western Europe which account for 60% of world GDP should be complemented by growth in emerging economies of about 4-5%. When we aggregate the forecasts for the world economy as a whole, we envisage real GDP growth to average 2.5% to 3.0% over the next 3-5 years.

Given this economic backdrop, we have endeavoured to construct portfolios that capture the potential in faster growing regions while not ignoring interesting opportunities in developed markets. Today we hold a number of companies operating almost exclusively in emerging economies. This is supplemented by positions in companies based in developed countries that are actively involved in emerging markets through local subsidiaries or as suppliers of various goods or services. A third way we have positioned the portfolios to benefit from stronger growth in developing economies is by investing in sectors that supply their basic needs, particularly those such as energy, agricultural inputs and other raw materials.

Bonds remain unattractive

Interest rates are generally low today and the corollary is that bond prices are high across the developed world. In the US, while the yield curve offers a somewhat higher spread than normal between shorter-term treasuries and mid to longer-term instruments, absolute yield is low. Ninety-day t-bills offer 0.05% while 10 year bonds yield 3.4%. The yield curve is similar in Canada. Rates offered by national governments have remained steady notwithstanding heavy issuance of new bonds.

Credit spreads have narrowed considerably. Canadian provincial bonds such as 10 year government of Ontario have narrowed from a historically high 160 basis points to 60 basis points above comparable Canada bonds. Spreads on a 10 year BBB rated corporate bond have compressed even more, from 550 basis points to 230 basis points. Riskier bonds have begun to trade at similarly rich prices making for less than interesting prospects for bonds over the next 12 to 18 months. Therefore, we continue to maintain the average duration of our bond portfolios below their respective benchmarks.

Equities offer fair value

Stocks are now trading at approximately 15 times 2010 estimated profits in the US with similar valuations apparent in other major markets. In the context of today's low bond yields, many stocks are distributing dividends that are above the income one might receive from owning a 10 year bond. Therefore, it is reasonable to expect that P/E multiples might expand. Another positive is the apparent success of Western Governments in stabilizing their respective financial systems, which has significantly reduced uncertainty and volatility. These actions have helped to reopen the debt and equity markets. Consequently, many companies have been able to raise capital over the past six months, reducing the risks of bankruptcies and its ripple effects.

In the current market, one can still find well financed companies with strong market positions in many sectors trading at reasonable valuations supported by competitive dividend yields. Therefore, we prefer owning stocks to cash and bonds.

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

This report is based on information obtained from sources believed to be reliable but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the report. The opinions expressed are based upon our analysis and interpretation of this information. As part of this analysis, Letko, Brosseau & Associates, Inc. makes forecasts concerning the economy, market changes, certain risks and other related matters. By their very nature, such forecasts involve inherent risks and uncertainties. Therefore, we caution readers not to place undue reliance on these previsions.