Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

- *Many encouraging signs point toward the U.S. recovery gaining traction. Housing, retail sales and industrial production have improved since the first quarter of 2009. We believe a tentative recovery in labour markets has begun and expect job growth will resume in 2010.*

- *Given this more evident turn, we think it is very possible that U.S. real GDP growth will approach or exceed 4% in 2010.*

- *The outlook for growth beyond 2010 remains more muted. We expect government stimulus measures to be slowly withdrawn from the economy and consumer spending to remain subdued as households rebuild their savings rate to a more prudent level.*

- *Elsewhere around the world, many developed countries will face the same fiscal constraints as the U.S. while developing economies return to their longer term growth rates.*

- *The U.S. dollar is already a fairly cheap currency and we do not believe that external forces will provoke a disorderly depreciation.*

- *Prospects in the bond market are not very appealing as current yields are low and heavy government issuance in Canada and abroad could push long-term yields higher.*

- *Notwithstanding the significant rise in equity prices from March 2009 lows, one can still find quality companies trading at reasonable valuations and supported by competitive dividend yields. We believe a portfolio of well chosen equity investments will exceed the returns generated by bonds over the next 5 years.*

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The world economy has continued to improve in recent months as the U.S. and many other countries emerged from recession in the third quarter. Given this more evident turn, U.S. real GDP could be quite strong in 2010, possibly growing 4% in real terms. This reflects a brighter outlook for jobs, personal incomes, spending as well as industrial production and housing. However, we remain cautious with respect to prospects beyond 2010 as the government will begin to withdraw stimulus and U.S. consumers will adjust to a higher savings rate. Elsewhere around the world, many developed countries will face the same fiscal constraints as the U.S. while developing economies return to their longer term growth rates.

As we examine in more detail in this letter, a sustained depreciation in the U.S. dollar is unlikely for several reasons. On a valuation basis, the dollar is already a fairly cheap currency. Furthermore, external forces should not provoke a disorderly depreciation of the currency as it is in the economic interest of many countries to maintain a reasonable value for the U.S. dollar.

Over the past quarter, bond and stock prices have performed very well as both asset classes have recovered considerably from post-crash lows. Over the past year, the TSX Composite is up 30.7% while the S&P 500 is up similarly however the strength of the Canadian dollar has diluted the improvement to 6.7%. The Bloomberg Euro 500 and the MSCI World Index are up 12.1% and 13.7% respectively in Canadian dollar terms. Domestic bonds also increased in value as the DEX Universe Index recorded total returns of 5.4%. Considering the low level of interest rates and much narrower credit spreads than six months ago, our bond return expectations are modest. We continue to believe that corporate profits should see steady improvement from these levels and this should lead to healthy stock returns. Therefore, in the current environment, we still favor stocks over bonds.

A Review of the Global Economy

During the third quarter, U.S. Real GDP was 0.7% above the previous quarter although it was still 2.5% below last year's level. The quarterly improvement was strongly influenced by government action such as the "cash for clunkers" scheme which increased demand for cars and the first time homebuyer's tax credit which stimulated residential investment. A drop in income taxes and higher transfer payments contributed to a 2.4% growth in disposable incomes, which in turn helped to stabilize consumption. Firms began to increase capital spending on equipment and software, which at 6.3% of GDP is 21% below the average of the last decade and a historic low. On the negative side, destocking of inventories continued for the seventh consecutive quarter. The aggregate reduction of inventories has reduced GDP by 1%, a much larger amount than in past recessions where it had taken away no more than 0.35% from GDP. We expect inventory investment to begin to make a positive contribution in the months ahead.

Many encouraging signs point toward the recovery gaining traction. First, although not widely recognized, U.S. employment prospects have improved. Temporary employment, a leading indicator for jobs, is now up 6.5% from the lows in the second quarter. Furthermore, the monthly employment statistics show a clear trend toward lower job losses. Using seasonally adjusted data, job losses slowed from an average of 622,000 per month between October 2008 and March 2009 to less than 100,000 per month in the fourth quarter including the 11,000 job loss in November.

Interesting information can also be gathered from the raw employment data, i.e. the payroll survey without seasonal adjustment factors. Historically, autumn is the period of the year when most new jobs are created. Over the last 10 years – excluding the recession years of 2001 and 2008 – employment typically rose by 1.0% to 1.5% from September to November. In the 2009 September to November period, 1.2 million new jobs were created, an increase of 0.9%. This indicates to us that the labor market is returning to form and we are confident that U.S. job growth will resume in 2010.

The trend in U.S. wages has stabilized over the last three months. Overall wages are still down

3.6% year-over-year but in the service sector, wages are now 2.7% higher than the lows reached in March. This, coupled with a very low tax rate and high level of government transfers explains the 2.4% expansion in disposable income. Given growing disposable income and a stable savings rate of 4.5%, retail sales have been rising sequentially. As of November, retail sales are up by 3.8% compared to the first quarter of 2009, although they are down 1.8% from last year. Excluding automobiles and volatile gasoline sales, the year over year decline in November was 0.9%. Going forward we expect to see gains as comparisons with the prior year will be easy to beat in the months ahead.

Turning to the housing market, the U.S. federal government is still making use of exceptional measures to support the residential sector. It has a large program in place to buy Mortgage Backed Securities issued by Fannie Mae and Freddie Mac and offers a cash incentive of up to $8,000 for first time home buyers. Consequently, 30-year fixed mortgage rates have remained below 5% since September 2009, a historically low level. Transactions are up 31% in October compared to the lows seen earlier in the year and home price indicators are stabilizing. The next hurdle will be to see how the housing market reacts once the government exits from its supportive programs, currently expected to end in the first half of 2010.

Indicators for manufacturing output and industrial activity show steady improvement from the troughs reached earlier in the year. The Institute for Supply Management (ISM) surveys show that manufacturing activity has been expanding in the past four months, and that new orders are rising at a faster pace than output. Orders of durable goods are also 3.5% higher than in the first quarter of 2009. Other weekly surveys of commerce indicate continuing improvement over a wide range of activity.

As we develop our economic scenario for 2010, an overriding consideration is that the extreme weakness of the first half of 2009 will make it easy to show improvement as the new year gets underway.

On the positive side, we assume there will be job growth in the year ahead. Coupled with a stable tax rate, disposable income is likely to grow by 3.0% to 4.0%. We also assume the savings rate will be stable at 4.5% in 2010; this means consumption will expand at a similar rate to disposable income. Another sector likely to contribute to growth is corporate investments in equipment and software as profits are up sequentially over the past three quarters and retained earnings are up even more given lower dividend payments. Additionally, corporate investment is at a forty-year low in relation to GDP. Finally, a rebuilding of inventories is expected.

On the negative side, corporate spending on structures is assumed to remain weak due to a difficult borrowing environment. International trade, while likely to expand overall may have a small negative impact on growth, as imports of discretionary goods which contracted sharply in 2009 will likely bounce back in 2010.

Adding all of these factors together, we think it is very possible that real GDP growth will approach or exceed 4%.

However this does not alter our longer term view that beyond 2010 growth may be more muted averaging 1%-2% over the following 3 years. Two main sectors that will challenge growth will be government and consumer spending. Current levels of government spending and taxation are resulting in fiscal deficits of more than 10% of GDP in 2009 and 2010. This is unsustainable and will need to be resolved over the medium term, likely starting in 2011. Our current perception of government intentions is that stimulus measures will be removed slowly, likely through a combination of higher taxes and government spending cuts. With respect to consumer spending, we assume that consumption will grow more slowly than income over the current economic cycle as households rebuild their savings to a more prudent level. Our 1%-2% growth scenario assumes the saving rate rises to as high as 8%. Should the savings rate settle at a lower rate of 5%-6%, real growth could be stronger by an additional 1% to an average of 2%-3%.

As we look across the world, economic signals in developed economies are in line with what we see in the United States. Canadian real GDP increased sequentially in the third quarter by 0.1%, marking the end of the recession following three quarters of contraction. The domestic economy is performing well supported by solid household and government spending. Labour markets are quite strong having created 93,600 new jobs over the past four months. In addition, credit does not seem to be as constrained in Canada as in the U.S.; household credit grew by 7.5% over the past twelve months compared to a contraction of 4.9% in the U.S. Those two factors allowed consumer spending to grow 0.5% year-over-year during the third quarter. In 2010, we expect Canadian real GDP to advance 3% to 4%, as the same factors at play in the U.S. will impact Canada. Beyond 2010 economic growth in Canada is also likely to be subpar as government will look to reduce deficits and households will try to save more.

Conditions have also improved in Europe as real GDP for the EU increased by 0.3% sequentially in the third quarter, although real GDP was still 4.3% below last year's level. Amongst major countries, France and Germany experienced expansion in the third quarter. A majority of this growth was driven by higher levels of government expenditures as consumer spending and corporate investment remained flat. Activity in the UK has remained weak as consumers continued to cut spending. Japan, one of the worst hit by the downturn, is slowly emerging from recession. Japanese real GDP has grown sequentially for two straight quarters, although it was still down 4.7% compared to last year's level.

Elsewhere in Asia, Q3 activity has rebounded markedly. China's real GDP was up by an astonishing 8.9% year-over-year, industrial production rose more than 10% and exports jumped 25% from Q1 2009 levels. India is experiencing similarly strong gains, with real GDP in Q3 ahead by 7.9% year-over-year. Overall the IMF forecasts world GDP to grow by 3.1% in 2010. The majority of global growth will come from emerging nations, which are expected to grow at a 5.1% rate.

Prospects for the U.S. Dollar

Anticipations of subpar U.S. medium-term growth coupled with large fiscal and external trade deficits and expressions by various foreign governments for the need to diversify reserves away from the U.S. dollar have made investors apprehensive about the outlook for the dollar. This is understandable however our analysis suggests that these concerns may be premature. Our work indicates that the U.S. dollar is already a cheap currency. Secondly, looking at the composition of the U.S. trade deficit, we conclude that a structural trade deficit exists and that its financing is manageable. Finally, when we look at the composition of U.S. government debt, how much debt has been issued, who are the largest holders as well as prospective buyers of this debt we conclude that it is unlikely they would provoke a dollar currency crisis.

To determine the relative value of the U.S. dollar, we build fair value models for various currency pairs. The models are long term in nature and based on consumer price (CPI) parities and export price parities. For economies that are closely connected such as the U.S. and Canada, currencies normally trade within a +/- 10% range of parity. For countries that are not as closely tied, the range will typically be wider. Although not yet at extreme levels, the U.S. dollar is undervalued on our CPI parity model against all major traded currencies at current exchange rates. The U.S. dollar is at a 7% discount against the Canadian dollar, a 15% discount against both the Euro and Sterling and a 23% discount against the yen. Furthermore, it should be noted that the U.S. dollar has already experienced a notable depreciation Since 2002, it has fallen 34% against the Canadian dollar, 31% against the yen and 38% against the Euro while rising by 11% vs. Sterling.

A common justification for a sustained depreciation of the U.S. dollar is the large and persistent U.S. trade deficit. We split the trade issue into two parts, a structural deficit and a cyclical deficit. The structural shortfall relates to a long-term dependency on imported oil and cheap manufactured goods from China. The cyclical deficit has more to do with current economic conditions and should be more transient. The U.S. is the world's largest oil consumer. Indeed U.S. infrastructure encourages oil consumption, be it in urban development, mass transportation system adopted and other. Currently, the U.S. consumes about 18 million barrels per day, of which 10 million barrels or 55% are imported. During the past twelve months, the trade deficit attributed to oil amounted to approximately $200 billion. Assuming oil prices stay in a range of $65-$80/barrel over the next few years, the trade deficit from oil will be $235 billion to $300 billion.

The other important structural trade deficit arises from trade with China. We assume this deficit is structural since these imported goods benefit to a large extent from Chinese labour cost advantages that cannot easily be substituted by local production given that most of the production chain has already moved abroad. During the past twelve months, the U.S. trade deficit with China amounted to $240 billion.

Consequently, the structural trade deficit amounted to $420 billion in the past twelve months while the total trade deficit was $390 billion. The difference between the two or the “cyclical” trade sector is therefore actually in surplus. This should not be surprising considering that imports fell by 20.4% during the recession and the lower level of the U.S. dollar has helped the export sector.

The key question is whether or not a steady trade deficit can continue to be financed. We think it can and will. Both China and OPEC countries have an economic interest in a stable U.S. economy. They need to sell their production of goods and oil into this market. Therefore we believe they will continue to finance this structural deficit to which they are parties. Additionally, since China and many oil exporting countries have currencies that are either openly or de facto pegged to the U.S. dollar, they are also likely to keep much of the proceeds of their sales in U.S. dollars in order to maintain their exchange rates.

Going forward, we foresee that this equilibrium will evolve although it will be a process lasting many years. We do not anticipate the trade deficit with China will shrink over the next economic cycle but the U.S. is developing an interest in reducing its dependency on foreign oil. Views are slowly emerging on how reducing this depency can be achieved through improved conservation and stimulating the development of domestic energy sources such as natural gas, ethanol and bio-fuels. Implementing such changes may be slow and incremental but should they occur, approximately half the total trade deficit would disappear.

Turning to the issue of U.S. foreign debt financing, we note that concurrent with the growth of the trade deficit over the last decade ownership of U.S. Treasury bills and bonds has increased steadily. As of September 2009, outstanding U.S. government debt amounted to $7.6 trillion of which 46% or $3.5 trillion was held by foreigners. Of this $3.5 trillion, $2.4 trillion was owned by central banks and other state controlled entities, while the remainder was in the hands of the foreign private sector.

Foreign ownership of U.S. debt therefore currently represents 24% of U.S. GDP. This will continue to move higher as the growth of U.S. debt outpaces GDP growth for at least the next two years. However it is still far below the levels of 50% to 60% of GDP which have historically been the threshold leading to significant currency problems. Furthermore, all U.S. debt is issued in U.S. dollars, so a depreciation of the U.S. dollar would not create a situation where debt obligations spiral out of control. In recent exchange rate crises in Mexico, Argentina, Russia, and Brazil, large amounts of debt had been issued in foreign currencies and could not be serviced when their own currencies collapsed.

The largest buyers of U.S. Treasuries ranked by size of outstanding holdings are: China ($800 billion), Japan ($750 billion), OPEC countries ($190 billion) and Brazil ($145 billion). Large financial centers, such as Switzerland, Luxembourg, the UK and the Caribbean, jointly hold $590 billion. All of the above-named buyers have continued to accumulate U.S. Treasury bills and bonds over the past two years, a period during which U.S. debt levels steadily rose and interest rates fell.

Countries with a pegged exchange rate (China, several OPEC countries) or managed exchange rates (Japan, Brazil) need U.S. dollar reserves to maintain or influence the level of their own currencies. Second, as the U.S. represents roughly 30% of global GDP and many contracts for commodity goods and services are priced in U.S. dollars, countries and individuals alike will keep holding U.S. dollar assets to hedge these activities. Third, the U.S. market for Treasuries and bills continues to be the deepest and most liquid debt market in the world. Consequently, we think it is unlikely that the U.S. dollar’s status as the world’s most important currency will change over the medium term.

Looking at the composition of the world’s foreign exchange reserves, the U.S. dollar accounts for 63% of such reserves while the euro represents 27%. Over the past decade, the U.S. share of these reserves went down by roughly 10%, mostly to the benefit of the euro. Going forward, this trend could continue to play out at a measured pace although a few factors could slow this transition. First, the dollar is cheap. Second, countries in the Euro zone face fiscal difficulties that are very similar in size and scope to that of the U.S. Third, the regulatory environment in the Euro zone is still a work in progress as exemplified by the different national attempts to rescue banks and the current standoff regarding Greece's fiscal difficulties. Finally we note that money supply growth in the U.S. has been moderate. M1 is up 5.7% year-over-year as of December 2009 while M2 is up 3.2%. We do not believe this to be excessive given recent circumstances and the Fed's ability to manage this growth. In our view, holders of U.S. dollars have not and are unlikely to be alarmed by these trends. Consequently, while currencies will continue to fluctuate, we do not foresee a disorderly depreciation for the U.S. dollar.

Investment Strategy: Equities & Bonds

When making our asset allocation decision, we determine expected return scenarios for both bonds and equities over the medium term.

The yield curve between 3-month and 10-year bonds is steep in both the U.S. and Canada due to extremely low administered rates. Nonetheless, the absolute yield on 10-year bonds is close to historical lows. Also, credit spreads on provincial bonds and corporate bonds have compressed significantly since the first quarter of 2009. Using current bond prices, our expected return for high quality bond portfolios should be around 3% over the next year.

Considering that S&P 500 operating earnings are currently expected to be $70 in 2010, up from the trough of $63 in 2009 but still reflective of a subpar earnings environment, it is feasible that earnings come in at $110 to $125 over the next five years. Factoring in a reasonable earnings multiple of between 12x to 16x, expected returns on equities are likely to be in a range of 9% to 15%. Furthermore, 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 believe a portfolio of well chosen equity investments will exceed the returns generated by bonds over the next 5 years and thus continue to prefer stocks over cash and bonds.

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