Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

Investor focus remained on Europe during the fourth quarter as the crisis of confidence regarding the fiscal sustainability of Eurozone countries and the viability of the common currency union led to a rise in interest rates in the periphery countries. Meanwhile, global equities rebounded from the summer sell-off, with the U.S. outperforming all other major stock markets. The year 2011 as a whole was marked by substantial share price volatility and performance disparity. The total returns on equities for the year (in Canadian dollars) are: MSCI World –3.4%, S&P 500 +4.4%, S&P/TSX –8.7%, DAX –15.4%, CAC-40 –14.2%, FTSE –0.1%, Nikkei –9.1%.

While investors appear to be turning a blind eye to the lack of progress on the U.S.'s fiscal front, we believe tangible change for the better is occurring in Europe. New government leadership in Greece and Italy and the election of a conservative government in Spain augur for more fiscal discipline. European banks are being obliged to shore up their capital levels by mid-2012, 7 years ahead of schedule. The ECB has implemented new measures to relieve financing constraints on Eurozone banks by providing virtually unlimited funding at very low rates. Moreover, on December 9th, all members of the European Union (with the exception of the U.K.) agreed to deepen their economic integration in the near future.

Given the negative sentiment developed over the last few months and increased reluctance of banks to lend to one another, there is a heightened risk that the Eurozone economy will either experience anemic growth in 2012 or fall back into recession. However the combination of the central bank's response and the high level of personal saving, averaging about 15% across Europe, should cushion the economic adjustment and prevent a more serious downturn. In the meantime, European equities have already built in a negative economic scenario and trade at unusually depressed valuations, close to the lows experienced in late 2008/early 2009.

During the past quarter, Canadian and U.S. medium and long-term bond prices rose as investors increasingly sought to place funds in sovereign paper perceived to be of the highest quality. In our view, this has heightened the potential risk of investing in long-term Canadian bonds. Not only are yields at exceptionally low levels, they fail to compensate investors for inflation. Equities remain our favorite asset class and we expect a higher return from owning stocks compared to both bonds and cash as macroeconomic concerns recede.

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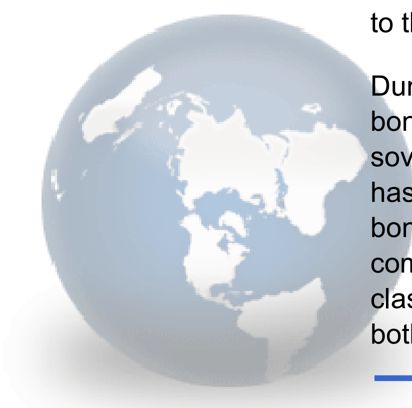

December 2011

Europe: Progress Amid Uncertainty

Tangible change occurring in Europe.

Over the past three months, leadership change occurred in Spain, Greece and Italy and in all cases co-operative, pro-European governments emerged. They were all appointed with clear mandates from elected parliaments to work towards implementing budget tightening measures, to collaborate with European institutions and to ensure that their country remains a member of the common currency union. This further demonstrates the strong political will in Europe, both in the core and peripheral countries, to continue to work towards a stronger euro and European Union.

Pro-European governments installed in Spain, Greece and Italy.

Change also occurred at the ECB. Jean-Claude Trichet ended his term as president and was replaced by Mario Draghi, previously the governor of the Bank of Italy. Once in office, Draghi quickly cut the main interest rate by 25 basis points twice, reducing the rate for short-term funding to 1.0% and broadened the collateral eligibility rules. In addition, the ECB announced that for the first time it will provide longer term refinancing to banks for terms up to 3 years in unlimited amounts. The ECB is determined to finance commercial banks freely at low rates of interest, thereby offsetting the funding constraints that have risen over the last 18 months. Meanwhile, in the wake of last summer's bank solvency stress tests, the European bank regulator, with the agreement of EU member states, has required banks to boost their capital levels by mid-2012. These measures should further improve the liquidity of European bank balance sheets.

Banks' funding pressures eased by new ECB program.

Finally, on December 9th, all members of the European Union with the exception of the United Kingdom agreed to adhere to what politicians call a "new fiscal compact". The main features are an obligation to enshrine in each country's constitution a limit on the structural deficit of 0.5% of nominal GDP. Also, countries will be prevented from running deficits larger than 3.0% of nominal GDP and the E.U. will now be able to review budgets prior to their adoption in national parliaments. There was agreement to speed up the implementation of the European Stability Mechanism (ESM) such that the facility should be up and running by July 2012 as the currently operational European Financial Stability Facility (EFSF) is due to expire in 2013. The leveraging of the EFSF is also expected to expand the funds available to provide temporary financial assistance to Eurozone member countries.

In our opinion, the above measures are major accomplishments. While some may have been forced upon policymakers by the financial markets, the developments are nonetheless very significant.

Fiscal rules set to be tightened.

Notwithstanding the progress in dealing with the related issues of sovereign debt and bank stability, the European economy has been a victim of this stress and has showed signs of slowing. Real GDP increased by 1.4% over the year ended September 30th. Growth was strongest in Northern Europe, as Germany, Austria, Belgium and Finland recorded rates of expansion above 2.0%. France and the Netherlands grew 1.6% and 1.1% respectively, while both Italy and Spain were up 0.8%. Greece continues to be mired in a deep recession and paralysis associated with the crisis and real GDP contracted by 5.2%.

When looking at more recent economic indicators, the current crisis of confidence is showing up in various data. European industrial production in October was up only 1.2% over the previous year. Most recent quarterly data shows production declined in the 5 largest countries of the Eurozone and in the U.K. In addition, the December reading for the Eurozone manufacturing purchasing managers index (PMI) was 46.9, the fifth consecutive month below the watermark. A figure below 50 is typically associated with below trend growth while a reading below 47 usually presages a contraction in output. Unemployment has also risen in a majority of European countries and for the zone as a whole has moved up from 10% in June to 10.3% in October.

As we look ahead into 2012, the risk of recession in Europe has increased. Our base case foresees flat GDP growth; however given that the slowdown is just developing the outcome can vary considerably, ranging from -1% to +1%. Our current thinking is that the Eurozone will resume modest growth in 2013 as austerity becomes more neutral at the margin and confidence improves. We are convinced that the combination of prudently financed households with annual saving rates of 15% and a positive trade surplus of about 1-2% of GDP will prevent a more severe economic downturn.

Europe at risk of mild recession.

An area of concern is how the large financing needs of sovereign countries for 2012 will be absorbed. To that regard, it should be noted that the Eurozone's deficit for this year is forecast to be 3% of GDP, compared with approximately 9% in each of the U.S., the U.K. and Japan. Moreover, the refinancing of maturing debt in the Eurozone will represent less than 15% of the region's GDP compared with almost 50% in Japan and around 20% in the U.S. We believe that the resources will be available to match European government requirements. Savings generated by households will be more than enough to cover the €243 billion of new financing needs while the ECB's efforts to provide liquidity to the banking system and the leveraging of the EFSF should help reduce the refinancing risk.

Resources available for Europe's financing needs.

Economic Growth in Rest of World Moderating

The U.S. economy is growing slowly but steadily. Third quarter real GDP was up 1.5% above last year's level. Employment continues to rise, as private employment is up 1.7% year-over-year in November. The combination of labour growth and employee wage gains of about 1.8% is contributing to an expansion in total incomes (compensation) of 3.3%. This is sufficient to allow after-tax incomes to expand by 2.5% and should support a similar growth in spending.

Industrial indicators point towards further steady growth. Industrial production in November is up 3.8% annually while durable goods orders are up 7.9%. The ISM December survey for the manufacturing sector is at 53.9 and in the service sector the reading is at 52.6, in line with the current pace of economic growth. Looking at the transportation sector, railcar loadings are now running at 1.7% above last year's level, while the trucking index is up 4.9% and diesel use expanded by 4.7% over the same period.

Base case forecast for U.S. and Canada sees 1.5% real GDP growth in 2012.

As we develop our U.S. forecast for 2012, uncertainty remains on two fronts. First, a payroll tax deduction and unemployment benefit extension are set to expire at the end of February and protracted political discussions risk jeopardizing their extensions further. Second, the crisis of confidence gripping Europe may spill over to the world economy if it drags on much longer or intensifies. In our base case scenario, we assume that no further fiscal tightening occurs over the next year and that the situation in Europe unfolds along our expectations. Under these key assumptions, U.S. real GDP growth will be around 1.5% in 2012, with some downside risk in the first half should Europe slip into recession.

In Canada, real GDP grew 2.4% over the past twelve months. Employment continues to expand, up 1.2% over the past year, although the pace of job creation has slowed markedly over the past four months. The unemployment rate moved up from 7.2% in July to 7.4% at the end of November. Looking ahead to 2012, we expect real GDP to grow by 1.5 % to 2.0%, in line with our medium-term forecasts for Canada.

World output will continue to expand.

Around the world, economic activity has remained relatively steady. Japan is slowly bouncing back from last March's devastating earthquake; its real GDP is now at the same level as 2010. In the developing countries of Asia, Chinese economic growth was 9.1% in the third quarter. India's real GDP was up by 6.9% while most Southeast Asian countries have been growing in a range of 3.5% to 6.0%. In South America, the major economies are growing at a 5% pace, with the exception of Brazil where real GDP growth slowed to 2.1%. As of September, the IMF was expecting global real GDP to expand by 4% in 2012, the same rate as in 2011 and somewhat slower than 5.1% recorded in 2010. This forecast may be revised downwards in their next update, but we still expect world output to expand in 2012.

Why Bonds Are Risky

Investors' search for safe haven…

Our forecast for moderate economic growth in developed countries over the medium-term has now become the mainstream view. However, we did not expect mid and long-term interest rates to decline as they have. We believed the burden of large fiscal deficits across much of the developed world together with recovering economies and a gradual return to borrowing by the private sector would eventually create upward pressure on interest rates. In fact, the 30-year Canadian bond yield has now reached a historically low level of 2.55%.

…pushes Canadian interest rates to unsustainable lows…

The rally in Canadian bonds began in earnest during the summer of 2011 as a series of unusual liquidity-driven events unfolded. As late as early July, 30-year yields were 3.5%, around the same level as the beginning of the year. Since then, they steadily declined to 2.55%, recording a total return of 20.1% for 2011. Yields began to fall as the debt ceiling negotiations in the U.S. were pushed to the deadline for default. Simultaneously, investors began to demand higher risk premiums for Spanish and Italian debt as the crisis of confidence in periphery country debt began to spread to the larger European countries. The heightened uncertainty created a so-called "flight to quality" as bonds of certain countries, such as Canada, Germany, the U.K. and even the U.S. were the preferred investment refuge of international investors.

Canadian bonds have benefited from safe haven status as, in absolute and relative to other developed nations, our fiscal situation is good. Levels of gross and net government debt are in line or below other G7 countries, while our deficits are now smaller than nominal GDP growth, setting the stage for an improvement in public debt metrics going forward. Consequently, Canada is still rated AAA and this credit rating is unlikely to change in the near future. The steady interest of foreigners in accumulating Canadian-issued debt securities has increased in importance. In 2010, foreigners bought C$99.3 billion worth of Canadian money market and bonds, which represents 6.1% of nominal GDP. This compares with C$10.9 billion or 0.7% of GDP purchased in 2007. In the first nine months of 2011, the pace slowed, but foreigners still bought C$55.1 billion worth of fixed income securities, representing 3.2% of nominal GDP. The cumulative impact of non-domestic purchases has had a dampening effect on interest rates, although its magnitude is hard to quantify. Merrill Lynch estimates that 10-year Canadian bond yields are roughly 1% lower than what they would be without foreign inflows. As these flows slow down or reverse, these positive effects are likely to turn and rates to bounce back to more normal levels.

…as Canada benefits from foreigners' flight to quality.

Real interest rates are negative in most developed economies. Using the simple calculation of the real interest rate as the nominal rate of interest on a 10-year bond less the current rate of inflation, real rates in Canada are around -1.0% and they are similarly negative in the U.S., U.K. and Germany. We believe this to be an unsustainable situation. In the countries listed above, the yield curve is positively sloped, which means savers receive much less than the 10-year yield on their short-term deposits. How long will investors accept to place funds in deposit instruments that do not protect the purchasing power of their savings?

Current yields offer no compensation for inflation.

In addition, many central banks appear to be tolerating higher inflation rates. The most obvious case is the Bank of England, which has kept the bank rate at 0.5% with inflation running at 4.8%. In the US, many Fed governors are openly musing about allowing higher rates of inflation to provide the central bank with more leeway to spur economic growth through a low unemployment level. Even in Canada, in its November update on inflation targeting, the Bank of Canada stated there may be a case for allowing inflation to run above target for longer periods of time in case of economic uncertainty.

Central banks' tolerance for higher inflation…

We are concerned that acquiescing to higher rates of inflation in the short term may bode ill for the longer term outlook for inflation. Although most forward looking indicators for inflation show a pretty benign picture, an important risk to the upside is not priced in the markets. This risk stems from the inclusion in world markets of the significant labour forces in emerging Asia and South America. Jointly, the labour forces of China, India and Brazil represent 27% of the world's population. As these workers' incomes rise, their levels of consumption will increase and their patterns of consumption will change. This will translate into an increase in demand for many resources including oil, minerals and foodstuffs. This process is already underway and is manifest today as oil still costs $110 per barrel even though most OECD countries are experiencing declines in consumption. Over time, as the supply of money remains ample and the demand for money increases, there will be a continuous upward pressure on price levels and ultimately on interest rates.

…may sow the seeds for future pressure on interest rates.

Dividend yields above 10-year bond yields.

Considering the above, the proposition of buying long-term bonds remains less palatable than ever. We illustrate this via a simple example outlining the potential returns on bonds versus stocks over the next 5 years. Looking at 10-year and 30-year federal and provincial bonds and assuming yields return to the average level prevailing from 2003- 2008, the best performing bond generates a zero annual return while the worst performing one loses 3.8% annually. In contrast, even if we assume a pessimistic scenario of zero earnings growth and an unchanged price multiple, an investor can earn 2.1%, 2.9% or 4.5% strictly through dividends on U.S., Canadian and European stocks respectively.

Risk/reward for bonds is poor.

Our overall investment objective is to generate positive and above average returns for our clients over the medium to long run. In the management of our bond portfolios, our primary aim is to avoid losing money. We acknowledge that we may forsake benefiting from temporary and unusual liquidity events that can drive the price of bonds even higher. But such events are inherently difficult to time and forecast and we remain concerned about the risk of losses when interest rates move back to normal levels. Therefore, in view of the current abnormally low level of interest rates, we maintain our bond portfolios at a short duration and remain underexposed to the bonds as an asset class.

Stocks Remain Preferred Investment

Currently, dividend yields on Canadian, U.S. and European equity indexes are comfortably above 10-year government bond yields. The simple arithmetic above shows that stocks can outperform bonds with dividend income alone. Using a more realistic assumption of growth in earnings in line with our forecast for nominal GDP (4%) and even with multiples remaining flat at current levels, stocks generate a return of 6.3% per year. Under a positive scenario of earnings growth returning to its long-term average from 1970-2007 (7%) and multiples expanding to 16x, the annual return on stocks would be 15%.

Equities expected to deliver superior returns vs. bonds and cash.

Therefore, the emphasis in our portfolios will continue to be on stocks over cash and bonds. We favour a global approach over Canadian equities alone for three principal reasons. First, we aim for more industry diversification than what is achievable in the Canadian market. Second, Canadian stocks trade at a higher P/E multiple than all other major developed markets (except Japan) at a time when the Canadian dollar is somewhat expensive relative to the U.S. dollar and in line with the Euro. Third, the current level of Canadian consumer indebtedness may gradually dampen personal spending in the years ahead, suggesting that Canadian growth (and by extension corporate earnings) are unlikely to outperform their foreign counterparts.

Our portfolios have a significant weight in large capitalization stocks with worldwide operations which are a good way to gain exposure to emerging market economies. In aggregate, these stocks now trade at a discount to most indices, the opposite of that which prevailed in the past. Sectors that we favour include energy, finance, telecommunications and healthcare.

The long-term outlook for the oil industry is favourable. Oil spare capacity is tight: current consumption has grown to about 90 million barrels per day and there is perhaps 1 million barrels of extra capacity. This is the lowest level of excess capacity witnessed in many years and presents a risk of higher prices and even potential supply issues given political tensions in several key oil producing regions.

The global bank and insurance sectors are amongst the most depressed, with many companies trading at 5 times earnings and 50% or less of book value. Our view that global growth will march on in 2012, notwithstanding the risk of a mild recession in Europe, suggests that this sector has the potential for a strong recovery.

Telecommunications offers stable revenues and profits along with exceptional current dividend yields which in many cases are more than double the yield on Canadian and U.S. 10-year sovereign bonds. Growth drivers for the industry include increasing smart phone penetration, data transmission and high speed internet, trends expected to remain in place for many years.

Healthcare and big pharma appear to be emerging from a period of extremely negative investor sentiment associated with patent expiries of key blockbuster drugs such as Lipitor. The industry has been responsive to this challenge and we believe pipelines for many of the major companies are quite promising. In addition, huge unmet health needs in developing markets, aggressive efforts to cut costs, excellent dividend yields and depressed stock market valuations suggest significant potential in this sector.

The above industry comments represent just a brief description of the multiple opportunities and strategies we believe will prove very lucrative in the years ahead.

We would like to wish you all a healthy, happy and prosperous New Year. We would also like to thank you for your patience and confidence during what has been a very volatile period.

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