Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

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In our last review of economic and financial market conditions written at the end of March, we expressed the view that turmoil in credit markets, while very serious, would moderate and bank losses related to this would subside as the year progressed. The large drop in the value of the US dollar was providing strong stimulus to US exports and would keep this important economy growing, albeit slowly. Since then, however, a new factor has emerged which is primarily responsible for a deterioration in economic conditions: higher energy costs.

The price of crude oil at the end of March was $100 per barrel and has recently traded above $140. Since early 2007 the price has increased $80 per barrel adding an incremental cost to the world economy of $2.5 trillion. At $140, oil consumption would account for 7.3% of global GDP, compared with 3.9% at $60. The previous peak occurred in 1979–1981 at 6.6% which then combined with record high interest rates to contribute to a widespread economic slowdown.

Consumers are only just beginning to respond to this heftier energy bill. Consumption is down about 350,000 barrels a day, or 1.7% of US daily consumption. In other developed economies consumption is currently flat or falling. We believe that these are early moves towards adjustment by businesses and consumers.

The developing world has not yet seen a drop off in demand, but it should be noted that oil prices are subsidized in many countries. Recently, large countries, such as India, China, Malaysia and Indonesia, have cut subsidies and allowed local prices to rise. On the supply side, Saudi Arabia and Kuwait have announced increases in oil production, albeit modest. In addition, oil drilling is running flat out across the world. Assuming some success in exploration and some conservation we believe it is possible that prices may well plateau and recede at least slightly.

In our view the impact on economic activity of the recent rise in energy costs has not been captured in recently published economic indicators. During the first quarter when oil prices averaged $93, real GDP in the US grew 2.5% over last year's level as exports grew 18%. However more recent year over year data indicate slower growth with employment 0.3% lower in June, industrial production off 0.1% in May and retail sales growth in April and May up 2.5-3.0%.

Looking forward, a key element in this analysis is what share will higher energy costs take from any increase in personal disposable incomes. At an average oil price of $120 per barrel, total energy costs in the US will have risen $300 billion or 50% to $900 billion in 2008. Given that incomes are forecasted to grow $500 billion, it would appear that these higher costs are manageable. However, this leaves only $200 billion to grow the remaining $9.3 trillion of consumer expenditures. Whether this means recession for the US or not, it does suggest rather stagnant economic conditions for the balance of 2008.

Nations that have lived with higher energy costs such as those in Europe appear to be adjusting better. April industrial production in the Eurozone was 3.9% above last year's level. However, recently published data for May indicate a slowdown in both industrial production and retail sales in Germany. As in the US, it may be too early to have a true measure of the effects of higher petrol prices.

Across the world, key emerging economies such as China, India, Brazil and Russia are experiencing strong rates of growth. Although they will be negatively impacted by a slowdown in developed economies and higher inflation, our expectations are such that their growth rates will stay high as there remains much to do in these countries to catch up with more developed countries.

Given current commodity inflation across almost all items, it is tempting to expect central banks to move towards raising interest rates. In Europe there has been a slight move with overnight rates rising ¼% since year-end. In America, the threats from the credit crisis have been a greater concern and as a result the Fed will continue to keep short rates low until stability has been restored to the banking system and the economy is on a clear growth path.

Global stock markets have been very weak since the year began. European indices are off 25%, Japan 15%, Hong Kong 24% and the US S&P 500 is 15% lower (all expressed in local currency). Current valuation levels indicate that global markets are trading at a P/E ratio of 14x current year forecasts and 13x 2009 profits.

Looking at industry groups, we believe that several are very conservatively valued. Share prices for oil companies don't reflect today's higher oil prices but rather assume $65 - $70 per barrel. As such, these trade at very large discounts to net asset values. These companies remain an important element of our portfolios.

Regarding the financial sector, massive provisions have been made related to sub-prime and other credit. The global banking system has taken $265 billion in write-downs between July 2007 and May 2008. This is slightly above our previous estimate of $235 billion total losses to be incurred across all loan categories excluding corporate bonds. Going forward we expect provisioning to be concentrated on traditional loans, including credit cards, consumer and business loans. These are considerably smaller and consequently we expect a moderating trend in loss provisioning as the year progresses. Profitability for banks should improve significantly once general reserves have been re-built and the benefits of improved lending spreads are realized. Valuations are very reasonable with many leading banks trading at P/E multiples based on normalized profits of 5-7x and current dividend yields of between 5-8% and higher.

Two sectors that offer stable revenues, strong cash flows and excellent balance sheets are healthcare and telecommunications. In the healthcare sector, valuations are more reasonable than they have been for many years with P/E multiples around 10x and many companies offering handsome dividend yields. This is also true of the telecom sector where profit growth remains strong, particularly in wireless services.

In conclusion, there are many difficult issues in the current environment, but we believe much is already reflected in current prices and this is exactly what presents opportunity. We believe that equities offer far more interesting return potential today than bonds.

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