Letko, Brosseau & Associates Inc.

Economic and Capital Markets Outlook

Stock markets around the world staged impressive gains over the past two years as stimulative actions on the part of governments and central banks led to a rebound in economic activity and a strong upturn in corporate profits. Amidst generally improving conditions, however, skeptics point to clouds on the horizon. Turmoil in North Africa and the Middle East, rising oil and food prices and, more recently, damages to Japan are occurring at a time when developed economies are dealing with the post-recessionary overhang of high deficits. This has raised questions about whether any of these events could derail the economic recovery or spark a major pullback in equity markets.

While we continue to monitor closely developments in Japan, our view based on current available information is that the estimated additional costs from Japanese reconstruction are manageable for the domestic economy and will have a muted impact on global growth. We believe that high prices for both oil and food will act as a “tax” on consumption. While the impact will be felt unevenly around the world, this development is unlikely to unduly compromise economic recoveries in the developed and developing countries.

Bringing government budgets in balance across much of the Western world remains the main challenge to global growth, one which has been discussed at length in previous letters. We reiterate our view that this impact will subtract on average about 1% from real GDP growth from most developed economies but will be partially mitigated by a return to trend growth in the rest of the world.

Our investment strategy remains unchanged. We expect interest rates to continue to rise from these exceptionally low levels and we continue to manage our bond portfolio cautiously, with relatively short duration and with careful attention paid to the quality of investments. Prospects for equity markets are markedly superior as both the quality and potential of investment ideas remain compelling. Equities should deliver solid returns and outperform cash and bonds.

March 2011

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

Review of Global Economy

Most U.S. economic indicators continue to point towards a steady increase in activity. For 2010 as a whole, real GDP increased by 2.9%. A strong rebound in durable goods spending, both by consumers and corporations, was partially offset by weak government spending and a sluggish construction sector.

U.S. growth to remain solid in 2011.

All of the cyclical indicators we monitor advanced strongly during the past twelve months. Industrial production is up by 6.3%, durable goods orders are up 7.8%, rail car loadings increased 4.9% and both trucking volumes and diesel consumption, a proxy for trucking activity, rose by 4.2% and 2.8% respectively. In addition, total inventories are 8.2% higher while the inventory to sales ratio has declined to 1.23, a historically low level. This is encouraging as it points to a faster rate of inventory accumulation and continued growth in production.

The labour market continues to show signs of gradual improvement. In the twelve months to March, total employment expanded by 0.9%. The contribution from the private sector was even stronger, as employment increased by 1.4% while hours worked rose by 2%. The bulk of job creation over the past three months has occurred in small and medium-sized firms, i.e. those employing less than 50 and 500 employees respectively. Both sectors created an average of close to 100,000 jobs per month, a feat that last occurred in 2005.

Our forecast for 2011 calls for 2%-3% real GDP growth. This will be supported by jobs expanding at a 1.0%-1.5% pace and continued moderate wage growth. As we expected, there were no meaningful changes to tax rates in the last federal budget, so our assumption of 3%-4% disposable income growth and a similar increase in consumer spending remains unchanged. We expect a significant contribution to growth from corporate investment while housing and government spending are likely to remain weak. We think the balance of risks could well be for growth to surprise on the upside. Should the U.S. saving rate decline well below current levels of around 6% and/or the trade balance improve, this could push real GDP growth above 3%.

Canada's economy expanded by 3.1% in 2010 as domestic demand continued to be very strong, up 5.8% over the same period. Like the U.S., private sector job creation outpaced overall employment (2.6% vs. 1.9%). Residential investment continued to benefit from low interest rates, while the strong Canadian dollar is stimulating corporate investment. Our forecast for real GDP growth in Canada in 2011 remains 2%-3%.

Over the past year, the Eurozone saw aggregate real GDP expand 2.1%, with Germany leading the pack (4%), and France (1.7%) and the U.K. (1.5%) recovering at a moderate pace. Italy (1.3%), Portugal (1.2%) and Spain (0.6%) appear to be emerging more slowly from recession while the economies of Greece (-6.6%) and Ireland (-0.5%) have been contracting. Aggressive cutbacks in fiscal deficits will have an impact on Eurozone countries in 2011 and we expect growth for the region to average only 1%-2% for this year.

Emerging economies in Asia and Latin America continued to push ahead. China leads the pack as real GDP advanced 9.8% over the past year, while India's economy expanded by 8.2%. Real GDP increased 6.7% in Brazil, 7% in Chile and 4.6% in Mexico.

Evaluating the damage to Japan

On March 11th 2011, an earthquake measuring 9.0 on the Richter scale struck the North Eastern coast of Japan and an ensuing tsunami hit four prefectures, killing thousands of people and causing severe damage. The situation was further aggravated as a nuclear power plant in one of the affected areas suffered significant damage leading to radiation leaks just 240km north of Tokyo. Assessing the economic impact of this tragic event is not an easy task given its recent occurrence and the fact that the situation is still evolving. However, by looking more closely at the affected regions and by combining our analysis with Japan's overall macroeconomic picture, we can try to gauge the long term effects on both the Japanese and the global economy.

Reconstruction costs within Japan's means.

Japan is the third largest economy in the world and its 2010 GDP of $5.9 trillion represents 9.5% of world GDP. The four prefectures which sustained damage account for only 7% of the Japanese economy and are mostly rural areas and less involved in international trade. As a result, the impact on global growth is likely to be muted. Nevertheless, the damage was severe and costs are currently estimated to be in the range of $200-$300 billion, most of which will be covered by the government over the next few years.

Relative to the size of the domestic economy, this cost impact remains small and within the means of the country. Although the government runs significant fiscal deficits year after year, the country as a whole maintains a positive current account surplus, which in 2010 totalled 3.6% of GDP. Japan's ability to internally finance its capital needs, along with the Bank of Japan's decision following the earthquake to increase its government bond asset purchase program by more than $60 billion, should help the country focus on reconstruction without a short term negative impact coming from the rise in public spending. We believe that the reconstruction effort in the North East region by both the government and corporations, along with an increase in activity elsewhere in the country to build items necessary for the reconstruction, will help Japan achieve a positive real GDP growth in 2011 and 2012.

What Could Derail the Economic Recovery?

Rising oil and food prices are headwinds to global economic recovery.

During the month of February, popular uprisings in the Middle East and North Africa led to concern regarding disruption in oil supplies and upward pressure on the price of oil. One of the factors spurring protests in this region was a surge in prices of basic food staples. While a discussion of the significance of these political movements on the longer term prospects for the region is beyond the scope of this letter, we would like to take a closer look at whether a sustained rise in oil and/or food prices could derail the economic recovery.

The average price of Brent crude oil in 2010 was $80/barrel. The price of oil increased from $93/barrel at the end of November 2010 to $117/barrel at the end of March 2011 following turmoil in Egypt and elsewhere. While Egypt produces oil, its oil balance is close to zero as it consumes as much as it produces. Of greater importance to the oil market is its status as a transportation hub; approximately 1 million barrels/day travel both ways on the Suez Canal. Furthermore, a crude oil pipeline runs from the Red Sea through Egypt to the Mediterranean delivering another one million barrels/day. Disruption to the flow of oil from these sources has thus far been limited. If this were to change, additional transportation time would be required to ship oil from the Middle East to Europe. There are, however, ample stocks in Europe to accommodate for such disruptions without creating any shortages.

Spare capacity in oil markets is tight; supply disruptions could cause price spikes.

The situation is quite different for Libya, which produces an estimated 1.6 million barrels per/day and supplies approximately 1.3 million barrels/day in oil exports. Compared with worldwide production of 89 million barrels/day, Libya's 1.8% share seems trivial. But it is more important to focus on the supply/demand balance in oil markets: the loss of these exports represents a significant tightening of world spare capacity. Today global spare capacity is around 4.5 million barrel/day. If we remove Libya's oil from world markets, it shrinks to just over 3 million barrels. Furthermore, more than 60% of current spare capacity is concentrated in Saudi Arabia, while the remainder is spread out more or less equally across Iran, Kuwait, the United Arab Emirates and Angola. All other oil producers are pumping as much oil as they can.

Prior to current events, a general uptrend in oil prices was forecast to take place as remaining spare capacity was soaked up by continued growth in demand from the developing economies of Asia. In this scenario, the impact of a gradual uptrend in prices could be absorbed by global economies with minimal disruption. The turmoil in Libya, which removes close to a third of the world's spare capacity, and the potential for turmoil to spread to other OPEC countries, has instead led to sharp jump in the price of oil.

High oil prices may act as tax on consumption.

As we try to assess the impact of the increase in the price of oil on the U.S. and the global economy, we focus on two main scenarios. First, we assume that the current price of $110/barrel is sustained during the first half of this year before declining back to $93/barrel, the level prevailing at the end of 2010. A second scenario evaluates the impact of the Brent oil price staying at $110/barrel for the full year. Neither scenario takes into account the possibility that important disruptions in oil supply occur in any of the regions with spare capacity, i.e. Saudi Arabia, Iran, Kuwait, UAE or Angola.

The U.S. is the largest consumer of petroleum, mostly through use of gasoline as a transportation fuel. In 2010, U.S. consumers purchased an average of 9 million barrels/day of gasoline. Assuming consumption stays flat in 2011, the increase in consumer spending on gasoline will range from $50 billion (Scenario 1) to $70 billion (Scenario 2). Our GDP forecast for 2011 calls for disposable income to rise by $400 billion; the increase in oil prices would be equivalent to 12% to 18% of the change in disposable income. Gasoline spending would account for 3.7% to 3.9% of disposable income, levels similar those which prevailed in 2006 and 2007.

The total dollar impact on the U.S. economy would however be somewhat larger than $50-$70 billion. In the short-term, higher oil prices act as a "tax" on consumption and serve to divert spending from other areas. The U.S. is a net importer of oil and oil products and spending on gasoline typically does not trickle through the economy via higher oil-related levels of activity. We estimate the net impact to represent around 15% to 20% of the increase in nominal GDP.

In evaluating the effects of an oil price hike on global GDP, we estimate that the increase in spending on oil and oil products will total around $500 to $700 billion this year. The IMF forecasts the world GDP to increase by $3.5 trillion so our two oil price scenarios are expected to cost 14% to 20% of the rise in GDP. Oil's share of GDP will expand from 4.1% to a range of 4.7% to 5.0%, which is in line with levels reached during 2007-2008. In our view, the rise in the price of oil, while significant, is not likely to derail the continued steady economic growth in the U.S. and the rest of the world in 2011.

Impact of food inflation more pronounced on developing vs. developed markets.

Agricultural commodities have also experienced a quick and sharp rise in prices although its impact has been unevenly felt around the world. Over the past twelve months to February the FAO food commodity index has increased by 34%.

One way to illustrate the impact of rising food prices is to compare the behaviour in consumer price indices across different economies. In developed countries, the weight of food in the consumer price index is an average of 14%. The effect of a rise in food prices would be far less than that measured by the increase in the FAO food commodity index. About three-quarters of the price paid for food in developed markets is made up of transformation, packaging, distribution and retailing costs. Therefore, the consumer price index for food (food CPI) in developed countries increased by only 1.9% in the past twelve months. This is in stark contrast to the situation in developing economies where food CPI represents on average 24% of the consumer price index. The average increase of food prices over the past twelve months was 8.9% or almost 5 times the developed country level. Developing economies are disproportionately hurt by food inflation because of lower incomes and the relative importance of basic food staples in their consumption basket.

Food and fuel price rises unlikely to derail global growth.

Another way to gauge the potential impact of higher food prices is to measure global production and calculate how much more it would cost to buy this production at current prices compared to 2010 prices. Using grain as a starting point, the additional cost brought on by a spike in grain prices is roughly $225 billion. Assuming grains represent a third of the world's food consumption and that other food commodity prices rise at a similar rate, the total impact is estimated at roughly $675 billion. We believe this calculation represents a worst case forecast, as many food commodities trade for significantly less in local markets than in export markets, due to an array of protectionist measures. In all likelihood, increases in food prices are likely to represent an additional cost of $200 to $400 billion, or around 6% to 12% of the increase in the world's nominal GDP.

Sustained higher agricultural prices are likely to have a muted effect on developed economies whereas in the developing world, a transfer of wealth may occur from urban areas toward rural areas. Implications of such a development are not necessarily negative.

Sustained high food prices will rapidly be deployed toward increasing agricultural production and could spark investment via an increase in acreage planted, purchases of new machinery or a higher level of spending on fertilizers. Unlike the case of oil, positive economic spillovers may occur although the redistribution of wealth in developing countries could create some disruption. In sum, we do not think that the current situation will have a significant impact on the world's pace of economic growth.

Main challenge to global growth remains fiscal drag from developed economies.

Notwithstanding the more recent uncertainties tied to oil and food inflation, the most significant impediment to economic growth remains the fiscal drag coming from a reduction in government spending in developed economies. Going forward, we expect that most countries with high fiscal deficits will begin to tackle the problem. In Europe and Canada, the adjustments are due to kick in this year. In Japan and the U.S., the timing is more uncertain, raising the risk that continued inaction may lead to a loss of creditor confidence. We continue to believe that cutbacks are manageable and will be spread out over a number of years, subtracting an average of 1% annually from real GDP growth from developed economies. Despite an increased risk from higher food and oil prices, we reiterate our real GDP global growth forecast for the next 3-5 years of 2.5%-3%.

Investment Strategy: Bonds

For 2011, the Obama government has decided to maintain elevated spending levels and has not yet proposed a longer term fiscal plan to tackle high deficits and rising debt. Gross debt to GDP is expected to reach 98% at end-2011. Furthermore debt issuance from April 2011 to April 2012 is estimated to be $1.6 trillion, of which only $225 billion will be purchased by the Federal Reserve, if its treasury purchase program ends in June 2011 as expected. We do not consider that 5 and 10 year U.S. Treasury yields of 2.20% and 3.4% respectively to be attractive.

Bond portfolio defensively positioned for rising rates.

In Canada, spending restraint will start in this fiscal year. We estimate that federal and provincial government deficits will be around 3% of GDP in 2011-12 and nominal GDP growth in Canada is very likely to exceed that. Therefore the gross debt to GDP ratio is expected to stabilize at 86% in 2011-12 and then begin to decline. Bond yields in Canada remain near historically low levels, with the 5 and 10 year rate at 2.75% and 3.35% respectively. Despite lower government funding needs, an improving economy and strengthening private sector demand for credit will put upward pressure on yields. Consequently, our bond portfolios remain below their target weight in bonds and with low duration.

Investment Strategy: Equities

Global equity markets around the world rebounded strongly over the past two years, with the exception of the Japanese stock market which has recently seen a sharp correction in light of the current catastrophic events occurring in that country. The total return on equities (calculated in Canadian dollars) from the lows reached on March 10, 2009 to March 31, 2011 are: MSCI World Index +47%, S&P 500 +45%, S&P/TSX +90%, DAX +53% (excluding dividends), CAC-40 +37%, FTSE +52%, Nikkei +30%.

While equity markets have not yet returned to pre-crisis peaks, a reasonable question to ask following such a sharp recovery is whether prices have run up too much too fast. Based on current year earnings, most stock markets in the world trade between 10.5 and 15 times. The 100-year average P/E ratio for the S&P 500 is 14.4 times; this suggests that valuation levels are still within a reasonable range. European equities appear to be particularly attractive, trading at an average of 10.9 times earnings with a dividend yield of 3.8%.

In addition, we do not think we are paying for peak profit margins. Using net income (after-tax) margins for different sectors of the S&P 500 as a proxy, we note that margins have bounced back strongly in all sectors since the recessionary trough of 2009. However, they are now around their average level from 2003-2007. Aggregate sector data for the S&P 500 indicate that margins in the consumer discretionary and technology sectors are at peaks while the financial and telecommunication sectors are still below margin levels prevailing during the last economic expansion.

Equities offer attractive dividends, reasonable valuations and solid corporate profit growth.

The equity portfolios we manage generally trade at valuation levels below market multiples and offer more attractive current dividend yields. Moreover, we believe that a portfolio of well chosen companies will perform better than both cash and bond investments in the next five years.

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