LetkoBrosseau

ECONOMIC AND CAPITAL MARKETS OUTLOOK

APRIL 2019

- Financial market pressures eased in Q1 as investor sentiment toward global growth improved. The MSCI World Index rebounded by 11.9% during the first three months of the year.

- Global central banks have signalled a pause in interest rate hikes. Continued liquidity significantly reduces the risk of recession. World real GDP is expected to rise by 3.5% in 2019, a marginal easing from 3.7% in 2018.

- U.S. economic activity remains resilient, driven by strong consumer and business spending. We forecast real GDP to expand 2.0-2.5% in 2019.

- A housing market slowdown and energy sector bottlenecks are responsible for more moderate growth in Canada. Our outlook for real GDP growth in 2019 is about 2.0%.

- Uncertainty on global trade and Brexit are weighing on Europe. Growth is expected to be sluggish, but positive. We expect real GDP to advance 1.0-1.5% in 2019.

- Easy global monetary conditions and a de-escalation of trade tensions support the outlook for Emerging Markets. Real GDP for the region is forecast to expand by 4.5% in 2019, more than twice the rate of the developed world.

- Over the last decade, various geopolitical and economic headlines have triggered stock market selloffs. Nonetheless, the performance of equities has massively outperformed that of fixed income instruments. Our asset allocation strategy to favour equities has paid off handsomely. We expect it to continue to do so going forward.

A marked improvement in investor sentiment drove equity markets higher in the first quarter as recession concerns eased. It is now increasingly apparent that economic activity is slowing modestly, not collapsing. Meanwhile, muted inflation is allowing global central banks to hit the pause button on interest rate normalization. This should help lengthen the business cycle by keeping the credit channels flowing.

The main risk to our outlook is an escalation of trade tensions. We believe the prospects for an all-out trade war between the U.S. and China have been significantly reduced. Ongoing talks appear to be heading toward a negotiated resolution. A compromise on trade and additional clarity on Brexit will remove the main overhang weighing on sentiment.

U.S. economic activity is resilient

U.S. real GDP expanded 3.0% year-on-year in the fourth quarter, driven by consumption and business investment. Employment remained healthy, with a monthly average 186,000 jobs created during the three months ended February. Average hourly earnings rose 3.4% year-on-year in February, providing strong support for consumer spending.

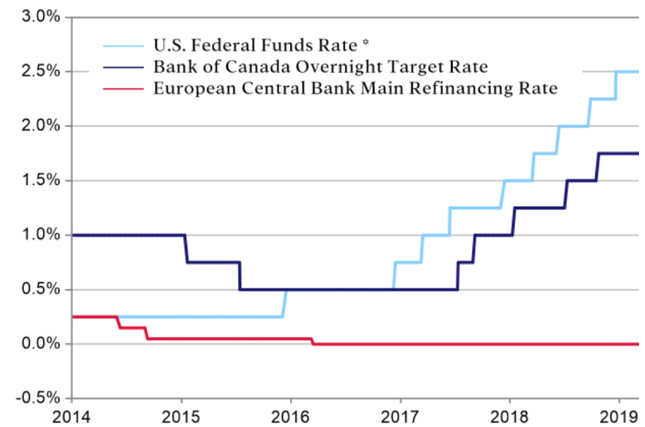
Business investment grew 8.4% in the fourth quarter against a year ago, boosted by spending on software, R&D and other intellectual property. The backdrop for capital spending going forward remains positive. Business confidence is strong and after-tax corporate profits were up 14% year-on-year, stimulated by the cut in the corporate tax rate from 35% to 21%.

The housing market cooled following a jump in the 30-year mortgage rate from 4.2% at end-2017 to 5.1% at end-2018. Meanwhile, median housing prices rose 3.6% year-on-year in February. An annualized 1.2 million homes were built in the fourth quarter, down 3.9% from a year ago. While affordability is weighing on sales turnover, the prospects for the housing market remain sound. In 2018, 2.3 million households were formed, almost twice the level of new construction, suggesting pent-up demand will continue to sustain the residential sector.

Citing moderating growth, recent financial market volatility and muted inflation pressures, the Federal Reserve signalled its intent to pause the rate of normalization of U.S. monetary policy (Chart 1). The core Personal Consumption Expenditure (PCE) deflator, the Fed's preferred measure of inflation, remains below its target of 2.0%, offering breathing room with respect to future interest rate increases. The Fed has also decided to reinvest the proceeds of maturing bonds rather than allowing the securities to come to term. The net effect will be to stabilize, rather than shrink, the Fed's balance sheet.

These actions should allow for credit to remain readily available. Household borrowing increased 3.1% against a year ago in the fourth quarter while non-financial business credit expanded by 6.5%. The Fed's patience is likely to extend the business cycle further out into the future.

CHART 1 **Central Bank Policy Rates**



*U.S. Rate is the upper limit of the target range
Source: U.S. Federal Reserve Board, Bank of Canada, European Central Bank

We forecast U.S. real GDP will expand 2.0-2.5% in 2019.

Temporary setbacks in Canada

In Canada, real GDP growth moderated to 1.6% in Q4 year-on-year. The job market remained strong, while housing and business investment slowed.

Residential investment declined 6.1% as a result of three factors: 1) mortgage rates have risen in response to Bank of Canada policy rate increases; 2) regulations enacted in early 2018 tightened mortgage standards, reducing demand from first-time home buyers; and 3) home prices continued to increase, albeit at a slower pace. The slowdown is most pronounced in Vancouver and Toronto, where prices have risen the fastest. Elsewhere, market dynamics remain healthy.

Business investment weakened 1% year-on-year, due to idiosyncratic issues tied to the energy sector. Canadian oil prices came under severe pressure during the fourth quarter (Chart 2). Western Canadian Select (WCS) heavy oil widened to a historic $50 per barrel discount to West Texas Intermediate (WTI), while bitumen prices traded at close to $0 in October. This price dislocation was partly caused by a lack of pipeline export capacity out of Western Canada. In addition, the temporary closure of an incremental one million barrels of refining capacity in the U.S. Midwest, which normally purchases Canadian crude oil, contributed to the supply glut.

An Alberta government-imposed production curtailment together with a ramp up in rail deliveries helped readjust the short-term imbalance. The WCS-WTI spread narrowed to under $10 per barrel at end-March.

Looking ahead, we expect the WCS discount to average $18 per barrel in 2019, which should remove the overhang on energy investments. Longer term growth of oil production in Western Canada will depend on the addition of new export pipelines. Of the three currently in the works, Enbridge Line 3 expansion and Keystone XL are projected to come online in 2020-22.

CHART 2

Price of oil (US$ / barrel)

Source: Bloomberg

Given the cooling housing market and imbalances in the energy sector, the Bank of Canada put future interest rate increases on hold. While our purchasing-power based exchange rate model suggests that the Canadian dollar is currently 15% undervalued against the U.S. dollar, some downside currency volatility can be expected if these two issues were to linger.

We believe that the Canadian economy will continue to be supported by strong consumption and that current setbacks are temporary. As is the case for the U.S., the Bank of Canada's easy money stance is likely to help extend the business cycle by keeping the credit channels open. We forecast growth to expand by about 2.0% in 2019.

Europe facing headwinds

Growth in Europe slowed markedly in the second half of 2018. Eurozone real GDP advanced only 1.1% in Q4 against a year ago. While real GDP grew 2.3% year-on-year in Spain and 2.0% in the Netherlands, it expanded by only 1.0% in France and 0.6% in Germany. Italy officially entered into a recession in Q4 after its second consecutive quarter of negative growth.

Progress continues to occur on several fronts. Eurozone unemployment declined from 8.5% to 7.8% in the 12 months to February and disposable income grew 3.2% in the third quarter against a year ago. Credit growth is positive: household credit grew 2.7% over a year ago in February while non-financial business credit expanded 1.7%. The region's fiscal stance is healthy. The Eurozone government deficit was only 0.7% of GDP in 2018, well below the high levels recorded during the sovereign debt crisis several years ago.

While consumer and government finances are in relatively good shape, businesses are facing headwinds. Uncertainty on trade, including the prospects of U.S. tariffs on motor vehicles, is having a material impact on business sentiment. The manufacturing sector's Purchasing Managers' Index (PMI) was less than 50 in March, suggesting that the sector is contracting. Industrial production declined 1.4% over the last 12 months to January and non-financial corporate profits declined 1.1% against a year ago in Q3.

In the face of slowing business activity, the European Central Bank (ECB) announced a series of measures to stimulate economic activity. First, it committed to maintaining policy rates at their current level until at least the end of 2019. In addition, it reintroduced its targeted longer-term refinancing operations (TLTROs) program whereby banks have access to very cheap funding in order to make new loans. This measure was instrumental in 2014 and 2016 in boosting credit growth.

Also weighing on sentiment are the negotiations surrounding Brexit. The situation is volatile and the ultimate outcome remains unclear at this time. As we highlighted in our January Economic and Capital Markets Outlook, the negative outcome of a hard Brexit would be felt more severely by the U.K. The country's exports to the E.U. account for 14% of its GDP compared with only 3% of E.U. GDP destined for the U.K. Given the resulting uncertainty, the European economy could also suffer from a period of slower business investment as companies delay capital investments. We believe that the risk of contagion to Europe and to the rest of the world is limited. While Brexit may be disruptive, the setback would be temporary as companies eventually adjust to the new trade dynamic.

We forecast Eurozone real GDP to grow by 1.0-1.5% in 2019. Given the turmoil surrounding Brexit, the short-term outlook for the U.K. economy is unclear. The IMF forecasts that U.K. real GDP will expand by 1.5% in 2019 but we believe downside risks are significant. In this context, we reiterate that our exposure to the U.K. is very limited. Only 1% of our total equity (and 3% of our non-Canadian equity) portfolio is exposed to U.K.-domiciled companies. The majority of these holdings are multinationals with limited exposure to the domestic economy.

The outlook for emerging markets remains positive

During Q4, real GDP in China expanded 6.4% year-over-year and is expected to grow by 6.2% in 2019. India's economy advanced 6.6% in real terms during the same period, underpinned by strong increases in consumption and investment spending. The IMF forecasts that India will grow by 7.5% in 2019. Accommodative monetary and fiscal policies are boosting activity in both countries. Elsewhere, Brazil recorded its eighth-consecutive quarter of expansion (1.1% year-on-year) against a backdrop of record low interest rates. Russia grew 2.7%.

With easy monetary conditions in developed markets and three of the BRIC economies, the outlook for emerging markets is positive. On balance, emerging markets' real GDP is forecast to expand by 4.5% in 2019, more than twice the rate of the developed world.

Despite the negative sentiment on trade and Brexit, the IMF continues to forecast an expansion in global growth, not recession. World real GDP is expected to rise by 3.5% in 2019, a marginal easing from 3.7% recorded in 2018.

Asset allocation recommendation: continue to favour equities

Global equity markets rebounded in Q1, following a volatile end to 2018. A pause in the Fed's pace of interest rate hikes together with signs of progress on U.S.-China trade talks eased investors' recessionary concerns. The U.S. stock market recovered considerable lost ground, returning to 3.3% below its September peak while other markets rose in tandem. Year-to-date, the total return (in Canadian dollars) for the S&P 500 is 11.3%; S&P/TSX 13.3%; DAX 4.8%; FTSE-100 9.6%; Nikkei 4.3%; and the MSCI Emerging Markets Index 7.5%.

Our assessment of last quarter's decline was that pessimistic views of the economic cycle were overdone, and we cautioned against reducing exposure to equities. Indeed, over the last 10 years, several geopolitical and economic headlines have triggered temporary setbacks in the stock market, including the European sovereign debt crisis, the fear of secular stagnation and falling bond yields, and worries over a recession in China.

Despite this, the MSCI World Index generated a total return of 237.1% in Canadian dollars. Meanwhile, the Barclays Global Aggregate Bond Index (USD Hedged) was up 58.3% over the last 10 years and the FTSE Canada Bond Index was up 54.0%. Over the last 5 years, the MSCI World Index increased 66.0% while Global and Canadian bonds rose 44.5% and 20.3% respectively.

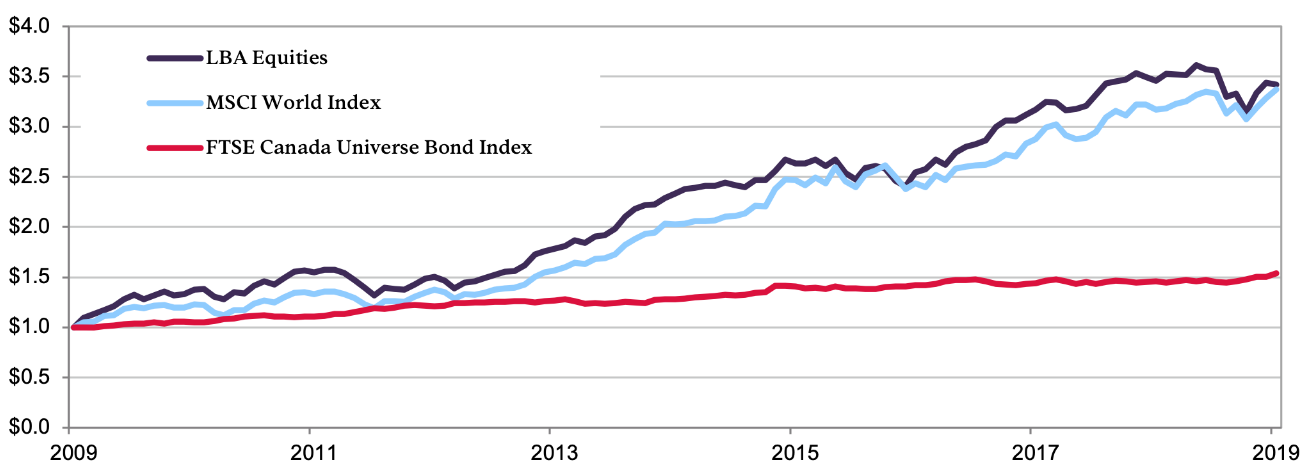
To put this in perspective, if an investor placed C$1 million in March 2009 in global equities, the portfolio would be worth $3.37 million at end-March 2019. If the funds had been invested in the FTSE Canada Bond Index, the market value would be $1.54 million. An equivalent investment in Letko Brosseau equities would be worth $3.42 million (Chart 3).

We currently do not see any signs that we are nearing an economic inflection point. Equity valuations are still reasonable and the outlook for corporate profits is positive. The S&P 500 trades at 17.2x expected 2019 earnings; S&P/TSX 15.3x, Bloomberg Euro 500 14.2x and MSCI Emerging Markets 12.6x. Our portfolios trade at even more attractive levels. Our global equity holdings are priced at 11.3x estimated 2019 earnings and our emerging market investments at 10.7x.

We conclude with our often-repeated recommendation: a portfolio of carefully selected equities should continue to outperform cash and bonds over the medium term. This asset allocation strategy has paid off handsomely over the last decade and we expect it to continue to do so going forward.

CHART 3

Value of C$1 million invested in March 2009



Source: Letko Brosseau, Bloomberg, from March 31, 2009 to March 31, 2019. LBA Equities represents the cumulative total return in the Letko Brosseau Global Balanced (Canadian Bias) Composite.

About Us

Letko Brosseau is an independent investment manager founded in 1987. The firm manages approximately $28 billion in assets for more than 450 institutional investors and several thousand private clients.

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