JARISLOWSKY, FRASER LIMITED

INVESTMENT OUTLOOK - Q3 2014

Executive Summary

Economic Review

- *Central banks continued to be the focus of financial markets; their paths are now diverging for the first time in four years.*
- *Softer commodity prices on the back of weaker economic growth outside of North America will keep inflation pressures at bay in the short term and should mute any upward pressure on long term interest rates.*
- *Economic excesses are yet to build up, with some sectors, such as capital investment, behaving similar to what's seen at the middle stages of the business cycle.*

Investment Outlook

- *Financial market volatility associated with the withdrawal of liquidity will likely be greater than usual.*
- *The current environment continues to favour higher equity allocations as their long term return prospects are more favourable than bonds or cash.*

Economic Outlook

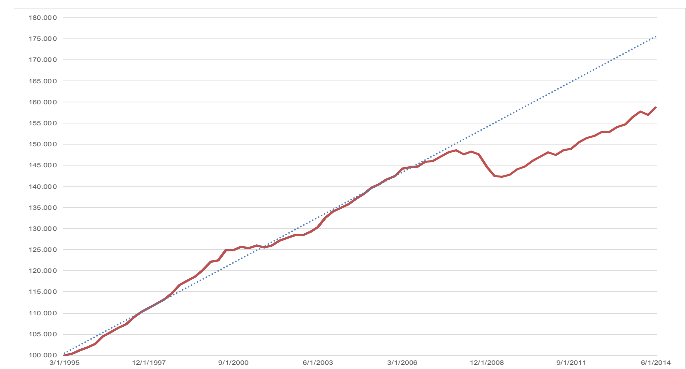
Global growth was reasonable at the start of the quarter but softened towards the end. The strongest region was Asia (excluding Japan which declined at an annualized 7.1%, after an outsized gain in Q1), followed by the North American economies, which experienced a rebound from the weak first quarter. Europe continued to stagnate, growing only 0.8% (annualized) in Q2. Within Europe, Italy sunk into its third recession since 2008, while Germany and France recorded slightly negative growth. The more forward-looking surveys from Germany that look at investor confidence and business are pointing to low probability for improvement in the near term.

GDP growth rates

The Canadian economy posted a relatively robust 3.1% annualized growth rate in Q2, with the auto and export sectors being the major contributors. The encouraging 18% (annualized, quarter-over-quarter) increase in exports was driven by auto demand from the U.S. as well as farm and forest product demand. U.S. second quarter growth of 4.6% (annualized quarter-over-quarter) was mainly attributable to strong vehicle sales and increases in fixed investment and inventories. The magnitude of the increases should be put in the context of the 0.9% and -2.1% growth rates for Canada and the U.S., respectively, in Q1. The average for the first half of the year came in close to our 2% long-term expectations.

Central banks continued to be the focus for financial markets, although their paths are now diverging for the first time in four years. The U.S. Federal Reserve continued to reduce its monthly purchase of bonds following the end of its "Quantitative Easing" program. Various members of its policy-setting committee have begun agitating to start raising interest rates back to normal levels. However, the debate surrounds what the normal level should be, given the structural headwinds that have been mentioned in previous commentaries, such as aging demographics, high indebtedness and increased supply of labour globally. The chart below highlights the substantial gap that still exists between the trend in economic growth prior to the 2008 recession and the current growth rate. This suggests that inflation pressures should not be a concern. The U.S. Federal Reserve has said as much, reminding investors that it will maintain lower than normal interest rates even if the U.S. has reached its employment and inflation targets. We expect the eventual start to raising rates will occur later than the mid-2015 timeframe currently priced into financial markets.

U.S. GDP with trendline from March 31, 1995 - December 31, 2006

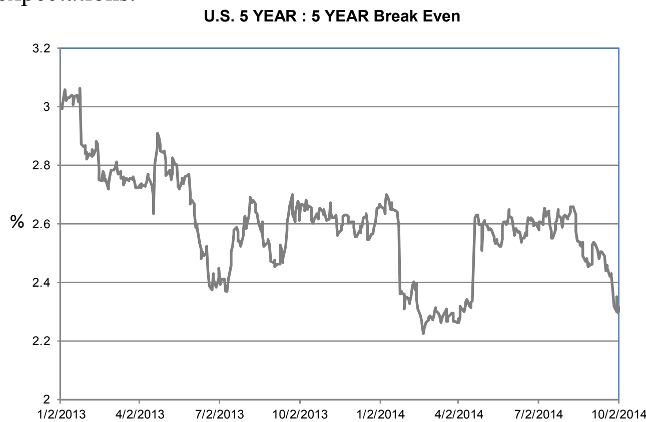


While the U.S. Federal Reserve is exiting its program for adding liquidity to the financial system, the European Central Bank (ECB) is seeking to provide more liquidity and stimulus to an economy that continues to flirt with recession. ECB President Mario Draghi announced additional stimulus, following a similar playbook to the U.S. but in a much more complicated context, given that it has to bring together all the Eurozone members' central banks, which have differing views and needs. Faced with what looks like a worse start to secular stagnation than even Japan (when comparing investment, fiscal policy and employment), the ECB is making efforts at stimulating growth but is likely to come up short without a coordinated fiscal policy. The added dynamic of political instability, which always flares up when economic conditions are weak, makes the prospects for European growth and the survival of the euro more tenuous.

The diverging paths of central bank policies, with the U.S. looking for the appropriate point to start raising rates and Europe and Japan looking for more ways to stimulate growth, led to a relatively significant decline in most foreign currencies against the U.S. dollar. The Canadian dollar declined by 4.7%, the euro -7.7% and the yen -7.6%. Periods of sharp and strong

appreciation of the U.S. dollar have frequently been associated with instability in emerging markets in the past, as the cost of U.S. dollar loans increase for foreign borrowers.

The near-term outlook for inflation is benign. Bond markets seem to be indicating that inflation concerns are towards the downside. The chart below gives an approximation of where the bond market is pricing inflation expectations over the next five years, starting in five years' time. The recent weakness in commodity prices and the softer global growth readings toward the end of Q3 contributed to the decline in inflation expectations.



Bond Markets

Bond markets were caught between two forces during Q3. On one side, bond investors were determining when and by how much the central banks of the U.S., Canada and England will raise short-term interest rates, while the weak growth and inflation prospects in Europe called for lower rates. The outcome for North American bond markets was an increase in short-term interest rates and a decline in long-term interest rates, with the overall Canadian bond market ending Q3 up 1.1%. Corporate bonds underperformed their federal government counterparts as the increased volatility towards the end of the quarter weighed on investors' willingness to take on additional risk.

Equity Markets

Equity markets posted mixed results in North America, gains in the Asia and losses Europe. A pause is not surprising after the recent strong gains, combined with continuing geopolitical tensions and sluggish global growth. The currency movements we highlighted above had a large impact on returns for Canadian investors in the U.S. market as only a slight gain was recorded in U.S. dollar terms. Near the end of the quarter, stock markets saw a rotation from more cyclical stocks to more defensive ones and a shift from lower- to higher-quality stocks, a clear benefit for our high-quality portfolios. The pace of mergers and acquisitions, one of many measures of market sentiment, continues to grow with the year-to-date total at almost $900 billion globally—not the extremes of 2006/07, but trending above the average. The valuation placed on companies like Alibaba, as well as biotech stocks, where the earnings payouts will be well into the future, highlights the relative attractiveness of our core portfolio of strong, quality, cash flow-producing stocks.

Market Returns - Periods ending September 30, 2014

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-0.6	20.4	8.7	8.5	7.7
S&P 500 (C$)	6.1	30.2	16.6	6.8	3.0
S&P 500 (US$)	1.1	19.7	15.7	8.1	4.9
Russell 2000 (US$)	-7.4	3.9	14.3	8.2	7.9
DJIA (C$)	6.3	22.5	12.8	4.1	1.5
DJIA (US$)	1.3	12.6	11.9	5.4	3.4
MSCI EAFE Net (C$)	-1.2	13.3	7.4	5.0	2.0
MSCI EAFE Net (US$)	-5.9	4.3	6.6	6.3	3.9
Nikkei 225 (US$) Japan	-0.9	1.8	7.4	5.8	0.6
Shanghai (US$) China	18.3	11.9	1.4	10.9	6.7
BSE Sensex (US$) India	2.2	41.3	5.5	15.1	9.6
EAFE Emerging Mkts (US$)	-3.4	4.7	4.8	11.0	9.3
FTSE TMX Canada Universe	1.1	6.3	4.9	5.4	6.0
FTSE TMX Canada 91 Day T-Bills	0.2	0.9	0.9	2.0	2.5
C$/US$	-4.7	-8.0	-0.8	1.3	1.8

Converted to Canadian funds using London 4PM rates.
Returns are annualized for periods greater than 1 year.

Investment Strategy

The extraordinary liquidity injected into the U.S. financial system over the past six years is now coming to an end. In some ways this is a typical part of the business cycle. As growth recovers, the central banks remove the stimulus applied during periods of weak economic growth, and equity markets encounter some volatility but are able to move on as economic growth rates expand. This particular business cycle has been different in amplitude, with the U.S. experiencing a greater downturn and slower recovery, despite extraordinary levels of support from the Federal Reserve. The financial market volatility associated with the withdrawal of the support will likely be greater than usual, but it does not mean that business expansion will be reversed. Softer commodity prices on the back of weaker growth outside of North America will keep inflation pressures at bay in the short term and should mute any upward pressure on long-term interest rates. Economic excesses are yet to build up with some sectors of the economy, such as capital investment, behaving similar to what is at the middle stages of the business cycle.

This environment still favours equities over bonds. As a firm, we are predisposed to higher equity allocations as their long-term return prospects are more favourable than bonds or cash. While equities have a greater volatility of returns, our philosophy of focusing on quality companies with strong cash flow franchises, along with our long-term investment horizon, alleviates much of the volatility concerns. For investors with shorter-term horizons, we understand the desire to reduce portfolio risk after strong gains. However, we would suggest that the limited prospect of a recession in the U.S. confines equity market downturns to occasional pullbacks which have been historically very difficult to time.

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