EXECUTIVE SUMMARY

Economic Review

- *The big surprise for the quarter was the 41.6% plunge in oil prices.*
- *On a global basis, the winners from declining energy prices dominate over the losers.*
- *There is little sign of an imminent recession on the horizon.*

Investment Outlook

- *Increased market volatility will continue as central bank policies diverge.*
- *We continue to favour owning quality businesses and remain overweight equities as we see better risk-adjusted returns when compared to bonds.*
- *Where bonds are held we prefer corporate issuers; it is essential in this environment to own stable companies with strong balance sheets.*

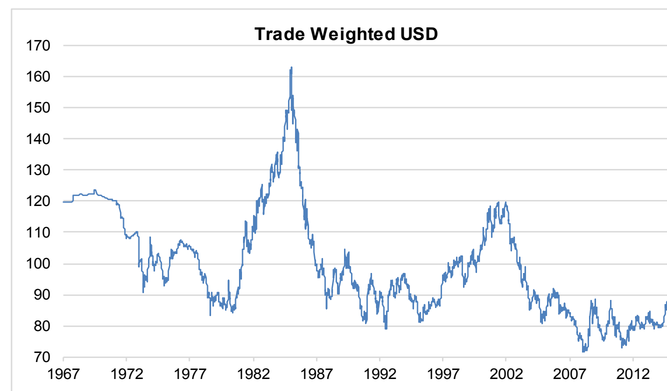
ECONOMIC OUTLOOK

The 41.6% plunge in oil prices in U.S. dollars (USD) during the quarter (-46% for the year) certainly came as a surprise to most investors. Perhaps not so much the direction, given the strength of the USD this year, but certainly the magnitude. The interplay of declining global demand, following years of increasing production at higher cost, finally became untenable. The result is a significant divergence in the prospects for various economic and financial markets around the world. The Canadian economy will probably emerge a net loser, with the decline in energy sector investments in the West more than offsetting the benefits of a lower dollar for the manufacturing sectors and the additional disposable cash due to lower gas prices for Canadian consumers. Estimates for the economic drag range from 0.25%-0.5% in 2015, although we believe that those estimates may turn out to be on the low side, as the negative impact from job losses on overly indebted households may amplify the downturn.

The U.S. economy, on the other hand, is likely a net beneficiary. The decline in gasoline prices from the June peak will have a positive impact on U.S. consumers, as will the decline in energy costs for industrial users. These positives are somewhat diminished by slower growth in energy sector investment which contributed disproportionately to the U.S. economic recovery. On a global basis, the beneficiaries of declining energy prices dominate over the net losers. For example, Russia, Venezuela and Nigeria will suffer from financial instability; however, net energy consuming countries like India, China and Japan are enjoying what amounts to a tax cut. How long we stay at these lower prices is the key question when assessing the impact on growth.

After adjusting for inflation, the price of a barrel of oil has spent much of the last 150 years in a range of $15-$40. It is doubtful that it will remain in that range, as the new supply that came into the market in the last five years is not yet economical much below $60 per barrel. One also has to consider the possibility of the U.S. government imposing dumping duties on foreign oil imports in order to protect shale industry jobs. Eventually a new (probably lower) price range will be established. Initial IMF estimates show that the boost to global growth from lower energy prices is from 0.3% to 0.8% depending on where oil prices settle.

The prospects for the U.S. economy seem reasonably positive as we enter 2015. Fiscal policy is no longer contractionary, while the prospects for consumer spending have improved with the continued upswing in job growth and the additional available spending from reduced fuel costs. These new jobs may not be high quality or full time, and there will be an impact from jobs lost in the energy sector, but overall the consumer should be on a better path in 2015. Unfortunately, the longer-term prospects for the Canadian economy are not as strong as those for the U.S. The Canadian consumer is vulnerable to rising interest rates and declining housing values. In addition, the federal government is targeting reduced spending while few inflationary pressures remain. The same logic applies to Europe and helps explain the persistent economic weakness there. Until the Eurozone is able to emerge from the weight of fiscal austerity that is imposed by some of the stronger countries, it is unlikely that ECB asset purchases will positively affect economic growth.



While oil prices grabbed most of the headlines during the quarter, the changes in monetary and fiscal policies were greater determinants of financial market prospects. The divergence in monetary policies discussed last quarter continue today and are playing a large part in changing the global investment landscape. The strengthening USD is just a recent manifestation of the impact from diverging central bank policy. During the quarter The Bank of Japan (BOJ) announced a ramping up of asset purchases to a level that is 2.5x the relative size of what the U.S. Federal Reserve did. The BOJ and the ECB want to provide more stimulus through asset purchases, while the Federal Reserve ended its asset purchases looking for the opportunity to raise interest rates. This has contributed to a turnaround in the USD, underpinning a trend that has the potential to go much further. The impact is being felt in commodity markets, as they are priced for the most part in USD. Another impact is in emerging markets, where faith in the estimated $2.5 trillion USD-denominated foreign debt has been shaken (a substantial portion of the total is from China-based

borrowers). Ultimately, a stronger USD is deflationary: its higher value buys more goods and services.

BOND MARKETS

Bond markets finished 2014 with a very strong quarter (+2.7%) and year (+8.8%). Weak economic growth prospects were reflected in the decline in oil prices which pushed inflation expectations even lower. Global inflation is the primary driver of long-term interest rates while short-term interest rates are more influenced by monetary policy. The prospects for the Federal Reserve to increase short-term interest rates continued to rise as economic data showed further improvements in employment trends and overall growth was broadly steady. In our view it is unlikely that the Federal Reserve will raise interest rates much if markets react negatively to the first set of hikes. What is a key focus for all central banks is overall financial conditions, i.e. the combination of interest rates, exchange rates, equity markets and credit conditions. We do not expect the Bank of Canada to raise rates in the next year as the negative impact from the downturn in the energy sector and extended consumer balance sheets reduce the necessity for interest rate increases. Corporate bonds underperformed their federal government counterparts as increased volatility in the economic outlook, and the energy sector in particular, weighed on investors' risk appetites. Provincial bonds were the best performing sector.

EQUITY MARKETS

Market Returns - Periods ending December 31, 2014

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-1.5	10.6	7.5	7.6	6.2
S&P 500 (C$)	8.8	23.9	17.8	7.3	2.7
S&P 500 (US$)	4.9	13.7	15.5	7.7	4.2
Russell 2000 (US$)	9.7	4.9	15.5	7.8	7.4
DJIA (C$)	8.4	17.2	13.6	4.8	1.5
DJIA (US$)	4.6	7.5	11.3	5.2	3.0
MSCI EAFE Net (C$)	-0.1	3.7	7.5	4.1	1.0
MSCI EAFE Net (US$)	-3.6	-4.9	5.3	4.4	2.5
Nikkei 225 (US$) Japan	-0.9	-4.2	7.0	4.4	-0.2
Shanghai (US$) China	35.3	53.9	4.2	15.4	9.8
BSE Sensex (US$) India	1.3	29.1	4.6	12.7	9.3
EAFE Emerging Mkts (US$)	-4.4	-1.8	2.1	8.8	7.4
FTSE TMX Canada Universe	2.7	8.8	5.4	5.3	6.3
FTSE TMX Canada 91 Day T-Bills	0.2	0.9	0.9	1.9	2.5
C$/US$	-3.5	-8.3	-2.0	0.3	1.5

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

Overall, most equity markets ended 2014 with positive results. The one delineating factor for equity market performance in the quarter was the individual market's exposure to the energy sector. Canada, being one of the more negatively affected economies, saw its stock market decline by 1.5% which was better than Russia's -28.7% loss, but a decline nonetheless. Europe continued to suffer from weak growth prospects and uncertainty as to the viability of the Eurozone itself. More extreme political factions that are campaigning on a Eurozone exit platform are gaining in popularity. With a number of member countries slated for elections in 2015, we expect political uncertainty to offset much of the positive ECB efforts to stimulate growth. Should the Federal Reserve raise interest rates during the year, it is worth noting that equity market performance varies significantly during periods of rising rates versus normal periods. The S&P 500 Index recorded an average 10% annual gain and increased 73% of the time since 1958. Over periods where the Federal Reserve was raising rates, the Index gained an annual average of 9.6% and was up 80% of the time.

INVESTMENT STRATEGY

Imbalances persist, with structurally weak investment compounding the excess savings that have been accumulated. The performance of the Japanese and European economies are symptomatic of this trend. The ageing demographics in developed economies continue to imply weak investment and consumption levels. Before the crisis these long-term issues were overcome with excessive debt accumulation amongst consumers. Once the credit spigot was shut off, demand plummeted. Monetary policy was the primary tool used to reinvigorate debt-fuelled demand, but it has its limitations. Unfortunately, this loose monetary policy helped the higher income earners who tend to be savers, but does not help resolve the long-standing imbalances. Monetary policy has also been prone to helping create investment bubbles and has recently contributed to the instability in the foreign exchange market and even, arguably, geopolitical instability. Redistributing income from savers to spenders can be achieved through tax policies in developed economies, while countries such as China need to do more to stimulate consumer spending. The U.S. is more likely to exit this sluggish growth period, thanks to its more innovative economy and one of the more dynamic demographic profiles in the developed world. Prospects for Japan and the Eurozone are not as encouraging.

The implications for investment returns hinge on whether many of these factors are priced into markets or not. Historically, low bond market yields suggest that only the persistence of deflationary trends are not priced in. The equity markets are still, to a certain extent, "climbing a wall of worry". We would be more concerned about the prospects for equity markets if a recession was likely or long-term deflationary factors were being ignored. Given that this does not seem to be the case, we continue to favour strong businesses and remain overweight equities, as we see better risk-adjusted returns relative to bonds. We are aware that the risks have been mounting and potential returns may be declining as the markets climb higher.

Jarislowsky Fraser's long-standing investment philosophy is to own a portfolio of businesses that produces steady earnings growth in uncertain economic and political environments. Our philosophy has not wavered, producing superior risk-adjusted returns for almost 60 years.

Sources: TD Securities, S&P, BIS and Bloomberg. The Yen and Euro currency conversion are based on Bank of Canada noon rates.

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