JARISLOWSKY FRASER

GLOBAL INVESTMENT MANAGEMENT

INVESTMENT OUTLOOK
Q4 2015

EXECUTIVE SUMMARY

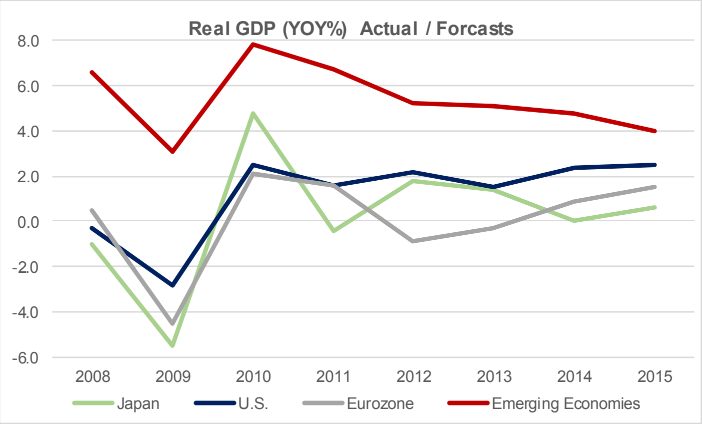
Economic Review

- *Economic growth in the United States, eurozone and Japan has improved slightly but has generally weakened in emerging markets*
- *The decline in global trade volumes is evidence of the weakness in emerging markets and commodity prices*
- *After almost eight years of zero percent short-term interest rates, the U.S. Federal Reserve raised the overnight rate by 0.25% in December*
- *The common thread from an investor point of view continues to be the search for yield as central banks drive down the returns of risk-free assets*

Investment Outlook

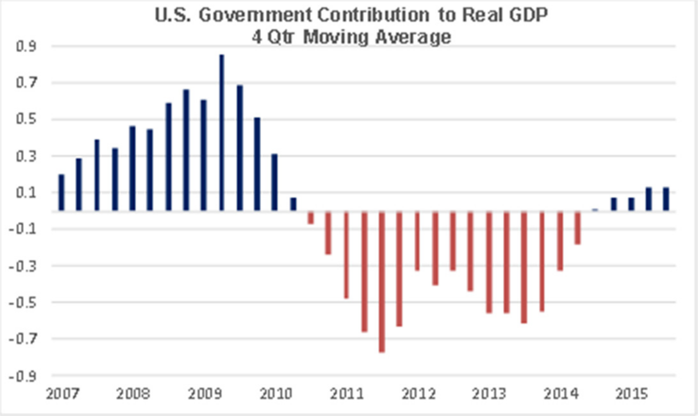
- *We continue to favour high-quality companies that have excellent management, superior assets and strong balance sheets*
- *Equities are still preferred over bonds given the low yield of the latter, although we do recognize the extended nature of the current cycle*
- *Our high-quality corporate bonds continue to offer an attractive yield pickup vs. government bonds*

ECONOMIC OUTLOOK



The fourth quarter of 2015 epitomized the performance pattern of the year, with Canada and other energy and material exporters underperforming the commodity importers. Commodity demand has fallen below previous bullish expectations, particularly for China, while supply had ramped up in response to 2011 peak prices. Given the magnitude of the subsequent decline in commodity prices, the decrease in production has not been as swift as one might expect. One reason may be that the sharp decline in the currencies of exporters such as Russia reduces their incentive to cut production as their revenues are priced in U.S. dollars. In general, economic growth in the United States, eurozone and Japan improved slightly, while growth in emerging markets was weaker. The decline in global trade volumes is evidence of the weakness in emerging markets and commodity prices.

After almost eight years of zero percent short-term interest rates, the U.S. Federal Reserve raised the overnight rate by 0.25% in December. A number of economic indicators suggested there was a need to start normalizing interest rates: an unemployment rate near 5%, rising wages, a ten-year high in vehicle sales and a 13-year low in household debt to income (in contrast to record highs in Canada). Essentially, the Fed's job in helping with the private sector's deleveraging process is done, the U.S. financial system's underlying health has been restored and the threat of deflation diminished. This was all done even with the lower fiscal spending which caused an 8% fiscal policy drag on GDP over the past five years, something the U.S. has never experienced in the past 50 years. Europe likely has a couple of more years before reaching the same juncture, but it appears that the worst of its financial system problems is behind them. Emerging economies and commodity exporters like Canada are still a weak link but they are not as great a threat to the global financial system or the global economy.

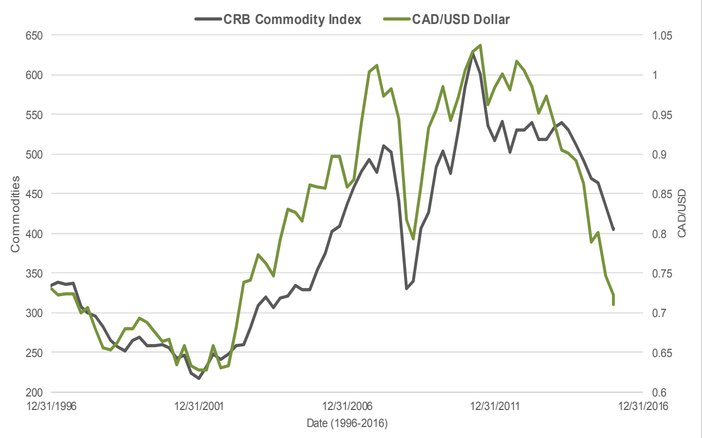


Source: Bureau of Economic Analysis

BOND MARKETS

Canadian bond yields edged lower despite the U.S. Federal Reserve's 0.25% increase in overnight interest rates. Corporate bonds continued their underperformance relative to government bonds, reflecting their greater sensitivity to economic prospects. Particular softness was seen in the energy sector, including weakness in pipeline company bonds like Enbridge. Bonds issued by Canadian banks also underperformed, with concerns surrounding their energy and household sector exposures. Market liquidity also contributed to the softness as spreads moved wider than we suspect they normally would, considering the economic backdrop.

The extra yield offered by the high-quality corporate bonds in our portfolios has reached very attractive levels, given our view that recession risks are relatively low. We do recognize that the credit cycle overall is well advanced with merger and acquisition activity at historically high levels. With fiscal policy headwinds now dissipating, however, we should start to see the strength on the consumer side in the United States show through more clearly. This year's interest rate cuts by the Bank of Canada, along with currency weakness should help cushion the Canadian economy from the declines in commodity prices.



EQUITY MARKETS

In 2015 the currency weakness boosted foreign market returns for Canadian investors with respectable double digit returns from the U.S. and Europe, after taking into account the 16.6% decline in the Canadian dollar. The generalized commodity price weakness was reflected in equity market performance with commodity exporters, such as Canada, underperforming the global markets as a whole. Were it not for the Canadian currency weakness, this would have been a year where most equity markets underperformed bonds. Within many markets, Health Care and Consumer stocks were the top performers (although Valeant was a notable underperformer in the very narrow Canadian Health Care sector), while Energy, Materials and Utilities were at the bottom. Emerging markets continued their four-year stretch of under-performance, some countries because of commodity price weakness, while others due to sluggish global demand.

Market Returns (as at December 31, 2015)

(%)	Q4	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	-1.4	-8.3	2.3	4.4	5.1
S&P 500 (C$)	10.9	21.6	20.4	9.2	4.5
S&P 500 (US$)	7.0	1.4	12.6	7.3	5.0
Russell 2000 (US$)	3.2	-5.7	7.7	5.4	5.9
DJIA (C$)	10.9	17.3	16.0	6.8	2.7
DJIA (US$)	7.0	-2.2	8.5	5.0	3.3
MSCI EAFE Net (C$)	8.5	19.0	10.8	4.9	3.0
MSCI EAFE Net (US$)	4.7	-0.8	3.6	3.0	3.5
Nikkei 225 (US$) Japan	8.7	9.9	6.7	3.2	3.3
Shanghai (US$) China	14.7	6.4	7.7	16.5	7.2
BSE Sensex (US$) India	-2.0	-8.1	-1.5	8.1	12.6
MSCI Emerging Mkts (US$)	0.3	-17.0	-7.2	1.2	6.0
FTSE TMX Canada Universe	1.0	3.5	4.8	5.0	5.8
FTSE TMX Canada 91 Day T-Bills	0.1	0.6	0.9	1.5	2.2
C$/US$	-3.5	-16.6	-6.5	-1.7	0.5

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

INVESTMENT STRATEGY

Without a doubt the substantial decline in commodity prices has been the most significant short-term influence on market performance in the past year. A much more persistent influence, however, has been extraordinarily accommodative central bank policy over the past seven years. This influence seems to have peaked as the U.S. Federal Reserve ended its purchase of bonds and has now begun to raise interest rates. The European Central Bank and Bank of Japan have also shown a reluctance to increase their level of accommodation. While some countries, like Canada, which has yet to embark on a household deleveraging process, seem to maintain a more accommodative monetary policy, their ability to drive the global economy and markets is relatively weak. The common thread from an investor point of view continues to be the search for yield as a result of central banks driving down the return on risk-free assets to sometimes negative, nominal levels. Inevitably the search for return involves investors sacrificing either quality or liquidity. Some may argue that the private sector debt was just transferred to the public sector, however, there is a big difference between the two. The “credit risk” for the public sector is only the risk of inflation, which is currently minimal, as developed countries can always print money to pay off their debts.

As the global tide of liquidity recedes, it is exposing both companies with challenged business plans and weaker countries (ones that cannot credibly print their own money). Some examples are cyclical businesses, such as shale oil and gas producers that could only operate with the help of low financing costs from the high yield bond market, and periphery countries such as Spain, that were able to borrow at only a fraction above the cost for the German government. Our focus on high-quality companies i.e. companies with excellent management, superior assets and strong balance sheets, has translated to superior relative long-term returns, particularly in periods such as the current one. Although equity returns relative to bond returns have suffered recently, we do see the economic outlook improving as the headwinds from contractionary fiscal policy and excess inventories fade and the underlying improvement in job markets can better translate into increased consumer spending. This should lead to a recovery in earnings growth from the relatively low levels of the past year. Expectations for future investment returns should be subdued as two tailwinds have dissipated — cheap valuations and the weakening of the Canadian dollar that boosted returns on foreign investments. Equities are still favoured over bonds given the low yield for the latter although we do recognize the extended nature of the current cycle.

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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