JARISLOWSKY FRASER

GLOBAL INVESTMENT MANAGEMENT

INVESTMENT OUTLOOK Q4 2019

HIGHLIGHTS

Economic Review

- The economy continued to surprise the pessimists as it recovered from its recent slowdown and resumed its expansion.
- Stock markets climbed the proverbial wall of worry to close at record highs while fears of recession, trade wars and Brexit grabbed media headlines.
- Globally, there have been over 50 central bank interest rate cuts in the past six months, which is the highest number since the financial crisis in 2008.

Investment Outlook

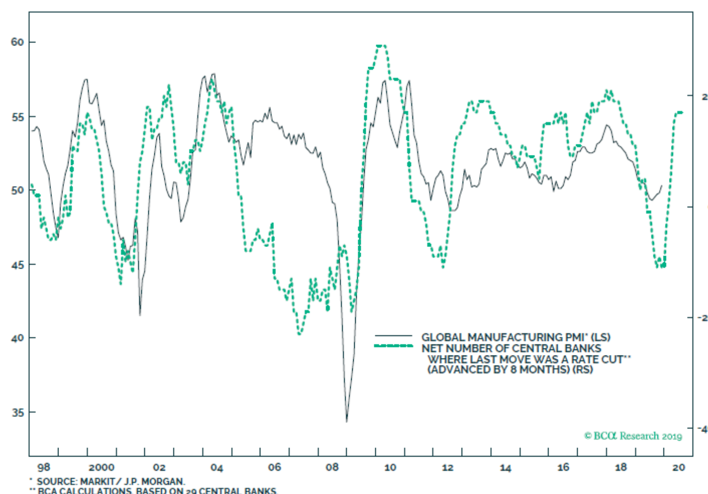
- We are optimistic that economic growth will continue as manufacturing destocking ends, along with the strong possibility of a fiscal stimulus package in the U.S.
- Central bank intervention will continue to be needed in the absence of truly significant fiscal policy stimulus.
- Long-term trend rate of economic growth will continue to be modest even without the added uncertainty from protracted trade wars and Brexit negotiations.

ECONOMIC REVIEW

The final quarter of 2019 capped off an exceptionally strong year for financial markets. Stock markets climbed the proverbial wall of worry to close at record highs while fears of recession, trade wars and Brexit grabbed media headlines. Underneath all the uncertainty, central banks continued their efforts to stimulate growth while corporate earnings grew (albeit modestly) and preliminary progress was made in a U.S.-China trade agreement.

The economy continued to surprise the pessimists as it recovered from its recent slowdown and resumed its expansion. The change in financial conditions are typically the first to signal an upcoming change in economic momentum. This year, we could see the liquidity spigots turned back on by looking at the net number of central banks whose latest policy move was a cut in interest rates. By the summer, the number had started to rise after declining for the past two years. Globally, there were over 50 central bank interest rate cuts in the past six months, which is the highest number since the financial crisis in 2008.

Even the manufacturing sector, which was the epicenter of much of the recent economic weakness, started to show some signs of stability. Consumer spending remained relatively strong, providing an important offset to the global weakness in manufacturing. We doubt that the U.S. economy could have avoided a recession without the sustained strength in consumer spending. Other areas of strength include residential construction, which has responded favourably to the decline in interest rates, and the employment environment continues to be relatively tight and is seeing firm wage gains.



BOND MARKETS

The bond market gave back some of its year-to-date gains, but overall finished with one of the strongest years in this cycle. Within the context of the strong gains this year, the pullback was minor. It was driven by the rise in yields in the fourth quarter as a result of fading expectations for economic weakness due to oncoming signs of recovery and another interest rate cut by the U.S. Federal Reserve Bank. The improved economic outlook fed directly into the outperformance of corporate and provincial bonds. In addition, foreign demand for North American corporate bonds remains strong as yields are attractive relative to Japanese and European levels. Underlying fundamentals for corporate bonds continue to deteriorate as leverage increased. On its own, increased leverage is not necessarily negative as long as the increased debt is used to fund productive investments. However, the numbers suggest that much of the debt is being used to fund the buyback of stock, which is more of a financial engineering exercise than an investment in future production.

The latest rise in yields naturally brings into question how high they can go. We expect some further increases, but absent a significant rise in inflation, the increase should be relatively limited. This is due to the fact that a recovery in economic growth is not expected to be strong, and North American yields are unlikely to deviate too far from the much lower European and Japanese levels. In addition, the elevated debt levels of corporations and Canadian households will limit the room for interest rates to increase as the pain from higher rates will be felt much sooner than it would in a less indebted economy.

EQUITY MARKETS

The fourth quarter saw very strong equity returns, which took many indexes to all-time highs. Positive catalysts in the quarter included the tempering of Brexit uncertainty due to a significant majority in the U.K. election results, progress on the trade front with a U.S.-China "phase one" deal reached, and ongoing monetary accommodation from key central banks globally. Emerging markets

fared particularly well as a result, recouping some of the ground given up earlier in the year, in comparison to other equity classes. The Canadian market was a laggard, though still posting strong gains for the full year. The U.S. markets continued to be very strong, and maintained their lead globally. Other developed markets also participated in the year-end rally, with Swiss and French markets posting exceptional gains for the quarter and year alike.

From a sector standpoint, Information Technology continued to lead the way in most geographies. Lower interest rates boosted the attractiveness of these cash generative business models, and higher secular growth rates provided a favourable backdrop. The Health Care sector also posted better performance, with some relief due to more tempered policy language from U.S. presidential hopefuls. Conversely, Consumer Staples lagged in the quarter as investors digested rich valuations and potentially slower growth rates from some of the key multinational players.

While asset markets were particularly vibrant in the fourth quarter, economic data from many core areas continues to be subdued. In the Eurozone, manufacturing and survey data continue to indicate a fairly muted environment. While this data is not generally forward looking, it points to a growing disconnect between asset prices and economic fundamentals, as well as the continued effects of accommodative monetary conditions underpinning much of the current market movements. We are monitoring the recent "stabilization" in European PMI's for a potential positive turn in economic activity in Europe as we move forward.

Market Returns (as at December 31, 2019)

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	3.2	22.9	6.3	6.9	7.2
S&P 500 (C$)	6.8	24.8	14.2	16.0	9.6
S&P 500 (US$)	9.1	31.5	11.7	13.6	9.0
Russell 2000 (US$)	9.9	25.5	8.2	11.8	7.9
DJIA (C$)	3.8	16.2	12.4	13.0	7.3
DJIA (US$)	6.0	22.3	9.9	10.6	6.7
MSCI EAFE Net (C$)	5.9	15.8	8.1	7.8	5.4
MSCI EAFE Net (US$)	8.2	22.0	5.7	5.5	4.8
MSCI Emerging Mkts Net (US$)	11.8	18.4	5.6	3.7	7.5
FTSE Canada Universe Bond	-0.9	6.9	3.2	4.3	4.6
FTSE Canada 91 Day T-Bills	0.4	1.6	0.9	0.9	1.6
C$/US$	2.1	5.3	-2.2	-2.1	-0.5

Converted to CAD using London 4pm rates. Returns are annualized for periods greater than one year.

INVESTMENT OUTLOOK

The performance of markets in 2019 epitomizes that of the past decade, where central banks were a dominant influence. The recent year would not have seen such strong returns had central banks not shifted from restrictive to stimulative stances. Easier monetary policy lowered interest rates, which facilitated stock buybacks. Without those buybacks, it is estimated that 2019 would have seen flat or declining corporate earnings on a per share basis (when the share count is reduced through buybacks, the earnings per share increases even though the overall level of earnings remains unchanged).

It is unlikely that we will experience the same level of support from central banks in 2020, as economic momentum continues to recover and inflation pressures build in the short term. Without central bank support, equity markets will need to see stronger economic growth in order to continue their advance. We are optimistic that this will occur as manufacturing destocking ends, along with the strong possibility of a fiscal stimulus package in the U.S. given the talk of middle and lower income tax cuts heading into the election. The U.S. Federal Reserve also seems more willing to let economic reflation persist for longer in order to make up for past misses in their inflation targets, effectively raising the bar for future interest rate hikes. Overall, the short-term outlook suggests potential for upside surprises as the consensus seems to be assuming muted news. An environment of improving global growth also suggests a weaker U.S. dollar, as non-U.S. economies tend to be more sensitive to global growth momentum, proportionately benefitting their currency vs. the U.S. dollar.

In the longer term, our expectations continue to be limited by secular headwinds. Developed economies are heavily indebted, have underinvested in productive capacity, and are facing demographic headwinds due to an aging population base. In sum, the long-term trend rate of economic growth will continue to be modest even without the added uncertainty from protracted trade wars and Brexit negotiations. Central bank intervention will continue to be needed in the absence of truly significant fiscal policy stimulus. We expect more uncertainty in the increasingly multi-polar geopolitical world which would only be magnified by a potential second term for President Trump. His re-election would allow him to put his "America First" trade and foreign relations policies into overdrive.

All returns are expressed in Canadian dollars unless otherwise indicated.

Sources: TD Securities, S&P and Bloomberg. This document is prepared for general circulation to clients of Jarislowsky, Fraser Limited (JFL) and is provided for information purposes only, it is not intended to convey investment, legal, tax or individually tailored investment advice. All opinions and estimates contained in this report constitute JFL's judgment as of the time of writing and are provided in good faith. All data, facts and opinions presented in this document may change without notification. This is not a solicitation for business. Past performance is not a guide to future performance. Future returns are not guaranteed. No use of the Jarislowsky, Fraser Limited name or any information contained in this report may be copied or redistributed without the prior written approval of JFL.