

JARISLOWSKY FRASER LIMITED

INVESTMENT OUTLOOK

4th QUARTER 2011

Executive Summary

Economic Review

- *Europe remains the focus for financial markets.*
- *The major issue is not the default of certain European economies but the impact on the banks which hold their debt and the potential contagion effect on the worldwide banking system.*
- *Global economic growth continues to be dampened by debt reduction on the part of governments and consumers.*

Investment Outlook

- *Deleveraging will take time and therefore we expect an extended period of slower economic growth.*
- *The share price/earnings ratios of many high quality companies are attractive and equities provide better yields than government bonds while waiting for growth to resume.*
- *Where bonds are held, quality corporate issues are preferred.*

Economic Outlook

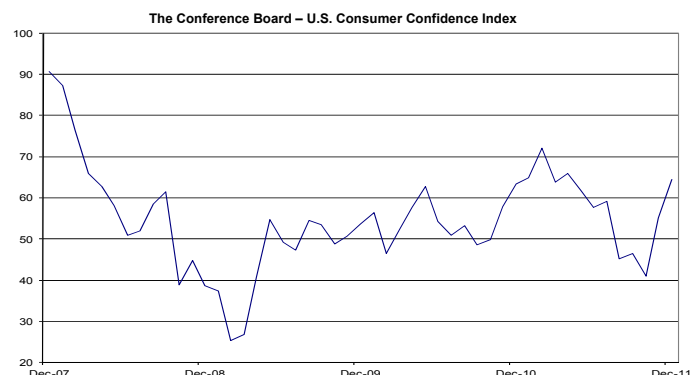
As a politically and economically tumultuous 2011 ended, investors remain focused on Europe. The high likelihood of a recession now grips most of the European Union as the implementation of fiscal restraints by many of its members will lead to slower economic growth in the near term. The impact on growth in the rest of the world will vary. With only 16% of U.S. and 10% of Canadian exports finding their way to Europe, the odds of a recession in North America are somewhat reduced. However, the potential contagion effect on the worldwide banking system remains a significant concern.

The bankruptcy of Greece is not the major issue for Germany or France. It is the impact on their banks' balance sheets as these are laden with sovereign credits from Greece, Italy and others. A default of a significant portion of these bonds would most certainly trigger a crisis as it could in essence bankrupt the banks. Hence, the willingness of the major European Union partners to issue and guarantee new securities to support the weaker countries.

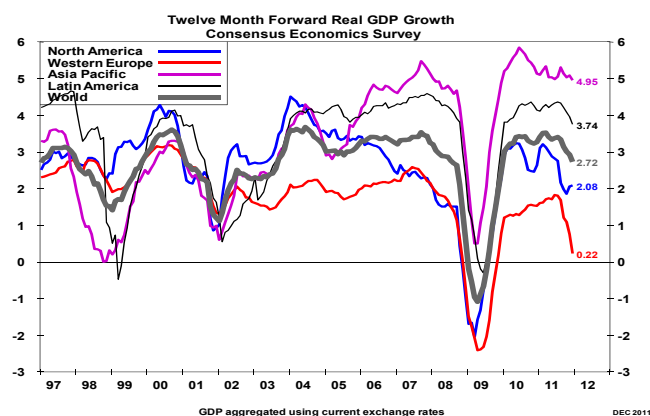
The interrelationship between banks is what makes developments in Europe so important for the global financial system and particularly for North America where many of the world's largest banks reside. It is not simply a question of how much European sovereign debt is held by other banks, but the guarantees and counterparty risk/relationships carried by them. The extent of the relationships may be difficult to quantify, but as a recent reminder, the U.S. real estate and mortgage crisis in 2008-09 had a significant effect on many of the largest European banks.

As the political leaders in Europe take what appear to be small, incremental steps in dealing with the Eurozone crisis, the rest of the world is also moving toward mitigating their risk of recession or slower economic growth. In the U.S., the political battle over reducing debt and deficits has not been resolved as the Republican ideology of cutting spending

continues to clash with the President's (Democrat) higher taxes for the wealthy approach. Despite the gridlock, leading indicators, including the rise in consumer confidence, are signaling that the consensus forecast of a 2.0% real GDP growth rate for 2012 may be achievable.



Many of the larger emerging market economies, in particular China, India and Brazil, spent most of 2011 under tightening monetary and fiscal measures as inflation and growth were exceeding comfortable limits. Slower growth emanating from their customers in the developed nations, along with some success with internal programs, has indeed resulted in declining economic growth rates. 2012 policies could potentially bring a reversal for these nations, with interest rates being lowered and some pick up in government spending. Japan is most definitely in an expansionary fiscal mode as its economy continues to rebuild post the effects of the earthquake/tsunami.

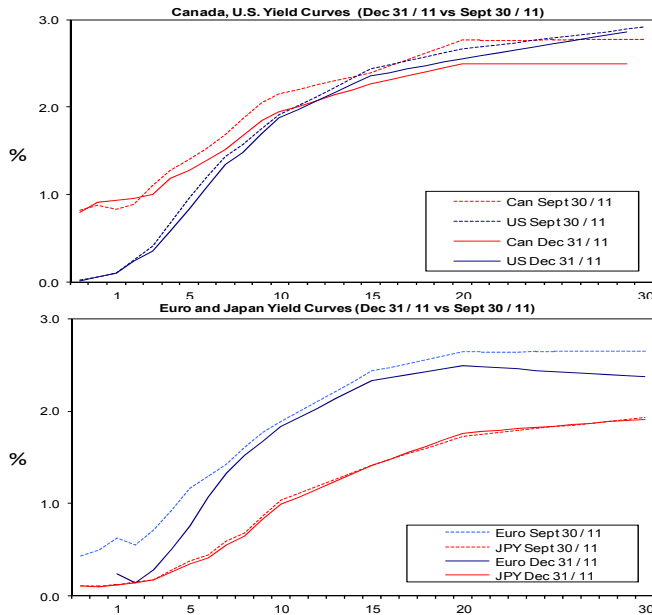


With 80% of Canadian exports still finding their way to the U.S., Canada's economic growth rate remains reliant on our southern neighbour. However, head winds remain prevalent, namely weaker commodity demand and an overheated and debt fuelled Canadian real estate market that has been oblivious to global trends.

Overall, our forecast for slow global economic growth remains intact as the process of deleveraging by governments in many developed nations and by consumers in the western world continues to take hold. The potential of a crisis spawned by the European banks is just one of many risks that remain.

Investment Outlook – 4th Quarter, 2011

Bond Markets



The charts above illustrate that longer term interest rates moved lower in the last quarter of the year, as they did throughout 2011. This movement reflects the attempt to spur economic growth in most developed economies last year. Short term interest rates began the year at already low levels and central bankers were not active in this area. However, the purchase of long term bonds by the U.S. Federal Reserve and European monetary agencies did help drive yield curves lower.

Corporate spreads (the yield received in excess of a government bond of equivalent term) also widened in the fourth quarter, as they did through most of the third quarter. While this is typical and reflective of the slower growth environment, it seems ironic given that government balance sheets are the ones that have deteriorated in this economic cycle, while many corporate balance sheets have, in fact, improved.

Equity Markets

Market Returns - Periods ending December 31, 2011

(%)	3M	1 Yr	5 Yrs	10 Yrs	15 Yrs
S&P/TSX	3.6	-8.7	1.3	7.0	7.0
S&P 500 (C\$)	9.3	4.6	-2.9	-1.6	3.4
S&P 500 (US\$)	11.8	2.1	-0.3	2.9	5.5
Russell 2000 (US\$)	15.5	-4.2	0.2	5.6	6.3
DJIA (C\$)	9.4	8.1	-3.1	-2.5	2.3
DJIA (US\$)	12.0	5.5	-0.4	2.0	4.4
MSCI EAFE Net (C\$)	1.0	-10.0	-7.2	0.1	1.4
MSCI EAFE Net (US\$)	3.3	-12.1	-4.7	4.7	3.4
Shanghai (US\$) China	-5.5	-16.5	1.8	7.5	8.0
BSE Sensex (US\$) India	-13.3	-35.7	-0.1	17.6	8.5
EAFE Emerging Mkts (US\$)	4.5	-18.2	2.7	14.2	7.1
Dex Bond Universe	2.1	9.7	6.4	6.5	6.7
DEX 91 Day T-Bills	0.2	1.0	2.0	2.4	3.1
C\$/US\$	2.3	-2.4	2.7	4.6	2.0

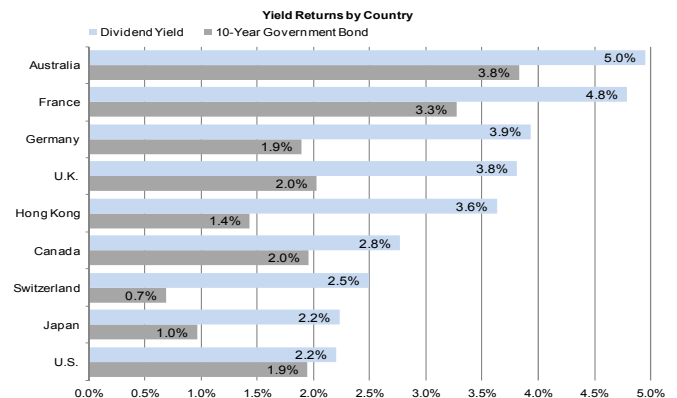
Converted to Canadian funds using London 4PM rates.
Returns are annualized for periods greater than 1 year.

Optimism with respect to some of the steps taken by European leaders resulted in positive rates of return in most equity markets during the fourth quarter of 2011. For the year however, returns were mostly negative as there was a recognition that the factors that affected growth in the recent year will remain with us for some time to come. The largest declines were experienced in higher priced emerging markets and where commodity and/or financial stocks dominate the indices. Small gains were achieved by larger “blue chip” U.S. stocks as these are viewed to be better able to manage through an economic slowdown.

Investment Strategy

Deleveraging is a process that takes time and, as a result, a longer term slow growth environment remains our most likely economic scenario. We must also take into account that interest rates, both long and short term, may remain relatively low for some years to come. We have dwelled little on inflation in this summary, but suffice to say that upward pressures currently remain muted in most of the developed world. Central bankers may tolerate some movement in inflation rates beyond the 1-2% range as bank and government balance sheets remain laden with debt and lower interest rates reduce the potential of default. North American consumers also continue to be levered despite recent improvements in savings rates.

Current government bond yields provide little or no return on an absolute basis and are negative after accounting for inflation and taxes. Corporate bond yields are somewhat better, but remain susceptible to longer term inflation rates. Equity markets today provide dividend yields that are competitive with bond yields.



The risk of further price erosion is most certainly causing many retail (and some institutional) investors to shy away from equities, but current share price/earnings ratios, for the most part, look attractive. They have only previously reached current levels in times of significantly higher inflation/interest rates. We prefer shares of companies where dividends are secure. Earning a dividend yield and waiting for growth to reaccelerate is our core strategy. Capital gains may take some time to materialize, but we prefer waiting as opposed to locking into currently low long government bond yields. Where bonds must be held, we prefer quality corporate issues with a high degree of certainty of principal repayment.