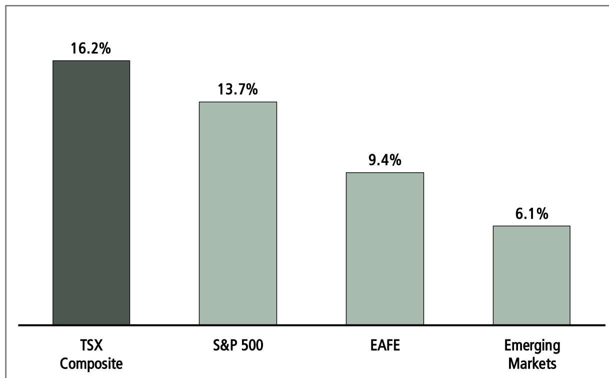
A Jolly Good Year (So Far)

Many U.S. stock market indexes hit all-time highs in early July, following the best June performance since 1955 for the S&P 500. Moreover, the first 6 months of 2019 were the best first half of the year since 1997, generating a return of 18.5%.[1] The TSX Composite in Canada also is approaching an all-time high at the time of writing and has had a similar strong start to the year, rising 16.2%.[2] The only rain on the parade for Canadian investors is the fact that a strong Canadian dollar has dampened somewhat the outstanding gains in non-Canadian stocks. As an example, the 18.5% total return on the S&P 500 was reduced to 13.7% when measured in Canadian dollars.



2019 Year-to-Date Stock Market Total Returns (in C$)

Of course, 2019 gains come on the heels of a difficult 2018, including the worst December for the S&P 500 since 1931. It took these large 2019 gains to dig investors out of the hole they found themselves in at the end of 2018 and to bring one-year returns back to a level one might consider "decent".

Throughout the last 12 months, a key driving force behind the ups and downs of the stock market seems to have been changing expectations for interest rates. In late 2018, concern abounded over the U.S. Federal Reserve's increases to its benchmark interest rate. In early January, the catalyst for the stock market turnaround was a speech by Fed Chairman, Jerome Powell, in which he signaled that changing economic circumstances would cause the Fed to abruptly switch to a "wait and see" mode. Most recently, at its June meeting, the Fed all but committed to interest rate cuts in the not-too-distant future. Of course, the cuts are the result of growing concern about the economic outlook, which might not seem consistent with a roaring stock market. But more on that later.

Improving Trends in Canada

We have used the word "resilient" for several quarters to describe the Canadian economy. Its challenges, to name just a few, have been significant: unsettled trade relationships, a difficult energy market, and unprecedented levels of consumer debt. While economic growth was weak in the last quarter of 2018 and the first quarter of this year, it managed to stay positive. Somewhat to the surprise of many, growth seems to have rebounded over the last three months and economists are scrambling to increase their second quarter GDP estimates.

Perhaps most significant has been the strength of the Canadian labour market in the first 6 months of 2019. Overall, 250,000 new jobs have been added, the best start to a year since 2010. And the jobs that have been created are high quality: 90% of the gains were for full-time employment and 86% were in the private sector.[3] Even though the recent June labour market report seemed disappointing on the surface – an overall loss of 2,200 jobs – the details of the report were quite positive. Full-time employment actually increased by 24,000 positions, and while the unemployment rate ticked up to 5.5%, it did so largely because of an increase in the size of the workforce. Unemployment levels remain extraordinarily low by any historic measure. Moreover, average hourly earnings increased by 3.8% year-over-year, the seventh consecutive month of healthy wage gains.

Another positive sign in Canada was an unexpected trade surplus in May. The May trade report revealed a $760 million surplus in the month, compared to an expected deficit of $1.7 billion and a deficit in April of $1.1 billion. Strength in motor vehicle, energy, and aircraft exports were credited with generating the surprise surplus. As well, the Bank of Canada's quarterly Business Outlook Survey recovered to positive territory in June. Reflecting this growing economic momentum, the Canadian dollar has also been on a tear, rising 4.2% against the U.S. dollar in the past six months.[4]

This good news is not to say that it will be clear sailing for our economy in the months ahead. The new

[1] Total return in U.S. dollars.

[2] Total return in Canadian dollars.

[3] *The Globe and Mail*, July 6, 2019.

[4] The Canadian dollar rose from US$0.7332 at December 31, 2018 to US$0.7637 at June 30, 2019.

NAFTA agreement (a.k.a. USMCA) remains unratified, and the profound threat of a broad disruption to global trade persists. Certain items, such as car sales, remain weak, possibly highlighting the high levels of consumer debt that we have written about before. Consumers may not be in a position to support the economy with big ticket purchases. But, as compared to our principal trading partners, Canada seems to be in reasonably decent shape.

Alternate Realities in America

This month, the U.S. economic expansion becomes the longest on record. One of the principal engines of this remarkable period has the been the enduring strength of the U.S. labour market. This strength continued in June as the U.S. economy created 224,000 new jobs, compared with an expectation for 160,000. Moreover, the details of the report were also strong, with the private sector driving most of the gains and a better-than-expected increase in manufacturing jobs. In other words, there were lots of new jobs and they were good jobs. While the unemployment rate ticked up to 3.7%, it did so, as in Canada, because of growth in the workforce. Unemployment levels remain near 50-year lows. There remain more unfilled jobs in the U.S. than there are Americans looking for work.[5]

Thanks to the robust labour market, the U.S. consumer is in remarkably good shape. Wages are growing consistently, the savings rate has increased noticeably, and consumer debt has been significantly reduced. Measures of consumer confidence remain at elevated levels, vehicle sales are strong, and retail sales are solid.

In contrast, the corporate sector in the U.S. is not nearly so sanguine. The June survey of the U.S. manufacturing outlook that is compiled by the Institute of Supply Management fell to a level of 51.7, the lowest level since October 2016. A survey result above 50 suggests continued economic expansion, but the trend of this survey over the last several months implies that growth is decelerating.

Many economists believe that this apparent dichotomy in the economy – confident consumers and cautious corporations – reflects the fact that companies can more readily appreciate the risks from America's recent penchant for trade wars. Because companies are worried, they have hunkered down, and the data reflect this. As an example, the Empire State Manufacturing Index suffered its largest decline on record in May. Nationwide, factory orders also suffered a worse-than-expected decline of 0.7% in May. There appears to be a growing industrial malaise in the U.S. and economic growth is expected to slow further in the second half of the year.

Investment Outlook

Just as U.S. businesses and consumers seem to have different realities, so too do stock and bond investors. Stock market strength in Canada and the U.S. suggests that investors have a positive outlook for the future. Valuation metrics are not extreme, but they have risen substantially over the last few years, implying growing confidence about the future.

By comparison, the future implied by fixed income investors is significantly less rosy. Interest rates have fallen considerably, with the 10-year U.S. Treasury note now trading at a yield of 2.0%, compared with 3.2% last November.[6] Even more significant is the recent yield curve "inversion". An inversion occurs when the yield on longer-term bonds falls below that of short-term ones and is considered to be strongly predictive of a future recession. The U.S. yield curve inverted briefly in March, but inverted again in late May and has remained that way since. Similarly, the Government of Canada yield curve is also inverted. Bond investors predict a reasonably gloomy period ahead.

As we wrote last quarter, both these visions of the future can't be right. Time will tell which is more prescient. Some things seem certain, however. First, is that bond returns over the next decade will be low. That is guaranteed by the current low level of interest rates. However, low interest rates are also a strong indicator that future economic growth is likely to be low as well. Investors must expect only modest gains from stock markets. That is not to say that the future is dire, but it does seem probable that the next 10 years will not be as profitable as the last 10. The good news is that there will be some individual companies that prosper in a low growth world. It's our job to find them for you. We are confident that satisfactory returns remain available to patient and disciplined long-term investors.

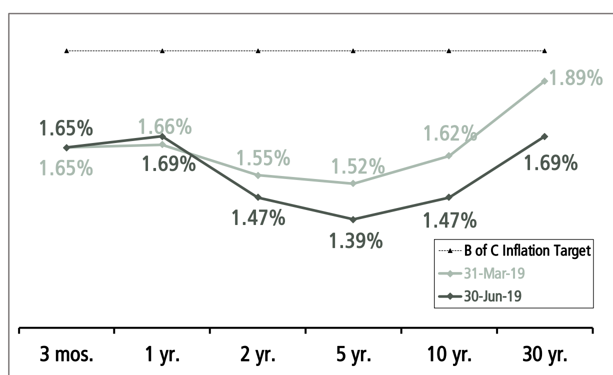
[5] The July JOLTS survey revealed there are now 0.8 unemployed persons for each job opening in the U.S.

[6] Bear in mind that the 2% yield on U.S. 10-Year Treasuries is lush when compared to the $15 trillion of government bonds around the world that have negative yields.

Asset Class Investment Review

Fixed Income

Interest rates declined over the course of the second quarter, continuing the trend that began at the start of the year. In the absence of any significant inflation, and despite years of economic expansion, there is a sense that economic growth around the globe is on the cusp of slowing. Increasing trade frictions are likely to aggravate any cyclical slowdown as well as dampen business confidence. While attention is focussed primarily on the negotiations between the U.S. and China, markets are also concerned about America's willingness to threaten tariffs on Mexico, as well as against the European automobile industry. Further complicating the outlook for interest rates are President Trump's repeated exhortations that rates are too high and his threat to make changes to the leadership and composition of the Federal Reserve Board. Besides these concerns, there is also a sense that after many years of economic expansion, it is late in the cycle and that a period of slower growth is overdue.

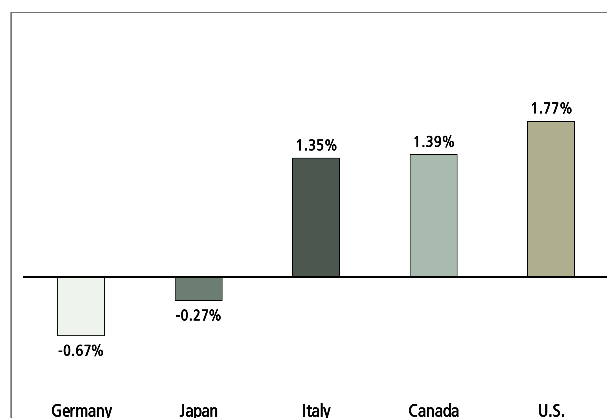


Government of Canada Yield Curve

Nexus believes it is inevitable such a slowdown will occur at some point, especially in North America and Europe, which are mature economies with aging demographics. In the developing world, which increasingly represents a larger share of global GDP, secular forces will keep economies moving ahead, but trade frictions are an undeniable drag on growth. This is particularly true in China where, despite a mighty effort to evolve its economy to be less export focussed, much of its economic activity remains tied to its role as a key part of the global supply chain.

Yet despite our acceptance that a slowdown will happen eventually, we believe that the bond market has already discounted this, and that at current yield levels, there is little attraction investing in bonds that yield less than the Bank of Canada's target for inflation (see graph 1).

In fact, the absolute levels of global interest rates continue to astound us on two fronts. First, from a policy perspective, rates are at incredibly stimulative levels – especially when combined with other forms of quantitative easing that central banks such as the European Central Bank and the Bank of Japan are undertaking. We are sceptical that even further interest rate stimulus is the correct antidote for any prospective economic slowing. Second, from an investment perspective, the current level of interest rates provides little to no protection against even moderate inflation. Only as an alternative to European bond markets, where some bond yields are negative, might Canadian bonds look attractive (see graph 2).



International Government 5-Year Yields (at June 30, 2019)

So, as we have felt for some time, we are prepared to "sit out" the current trend in the bond market. We continue to emphasize quality and have a shorter duration (3.6 years) than the benchmark (8.0 years). We still believe that the next significant move in interest rate levels is higher, not lower, and that at present levels bond yields anticipate much more aggressive monetary easing than what will come to pass.

Over the quarter, 2-year yields fell 0.08% (from 1.55% to 1.47%) and 10-year yields fell 0.15% (from 1.62% to 1.47%). As it did in the first quarter, the decline in interest rates generated surprisingly strong fixed income returns. The bond return in our Income Fund was 1.4% for the quarter, and 5.6% for the last 12 months. These results again trailed the FTSE TMX Canada Universe Bond Index, which returned 2.5% and 7.4% for the same periods.

Equities

After a very strong first quarter, the equity markets produced a "decent showing" in the second. The Equity Fund returned 2.9%, slightly ahead of the 2.3% return for the market benchmark. For the past 12 months, the Equity Fund returned 6.4%, in line with its benchmark.[7]

The outcome for the full quarter masked the gyrations within. Each month's return (positive or negative) was larger than the total return for the quarter. To illustrate, the blended benchmark returns for April, May and June were 3.6%, –4.1% and 2.9%, respectively. Similarly, the Canadian dollar weakened slightly in each of the first two months of the quarter, then strengthened materially in June, such that the stronger Canadian dollar deducted 2.2 percentage points from our U.S. equity returns for the 3-month period. The third quarter was a mixed one for equities – strong in the U.S. and weak elsewhere. The Equity Fund returned 1.9%, slightly lagging the market benchmark's return of 2.4%. Over the past twelve months, the Equity Fund returned 11.1%, also behind the benchmark's 12.8% return.

Canadian Equities

Nexus's Canadian stocks returned 1.1% in the quarter, behind the 2.6% return from the TSX Composite. For the 12 months, our Canadian stocks returned 5.6% outperforming the TSX, which returned 3.9%.

Our second quarter Canadian portfolio return composition relative to the TSX was a "mixed bag". In part, this was driven by what we don't hold. We have no Canadian Information Technology or Materials stocks, which did well in the quarter. Partly off-setting this was the Healthcare sector, where we also have no holdings, which turned out to be the weakest sector in the TSX (principally due to a sell-off in the frothy cannabis stocks). Our Industrial holdings did well, largely driven by CAE, which continues to grow and improve the profitability of its aircraft simulation and pilot training business. Our weakest stock was EnCana, but it is a small holding and the entire Energy sector in the TSX was also weak, such that, relative to the Index, this didn't have much overall effect.

U.S. Equities

The main contributor to our overall second quarter equity performance was our U.S. portfolio, which returned 5.8% (8.0% in U.S. dollar terms), well ahead of the S&P 500's 2.1%.[8] For the 12 months, our U.S. portfolio returned 9.1%, a snick behind the S&P 500's 9.7%.

In most quarters, we have some "plusses and minuses" across the various sectors. However, in the second quarter, our relatively good showing came from 10 of the 11 sectors, but the major contributors were Consumer Discretionary, Financials and Healthcare. Also, we hold no Energy stocks in the U.S., which helped as Energy was the weakest sector.

The strongest individual contributors were CarMax, Facebook, Dollar General, Citigroup, Microsoft, and JPMorgan (all returned more than 10% in U.S. dollars). CarMax, the largest retailer of late-model used cars in the U.S., continues its steady and profitable expansion. Its latest quarterly results showed strong same-store vehicle sales growth of 9.5% year-over-year, offering some evidence that their omni-channel (web and store) model is working. Citigroup and JPMorgan are benefitting from the extended economic cycle, which is allowing them to return excess cash to shareholders. The main negative outlier was Alphabet, which declined 8% in U.S. dollar terms in the quarter on news of slower ad growth and a U.S. Justice Department antitrust investigation of Google.

Other Equity Investments

We remain invested in two non-North American equity holdings within our Balanced and Equity Funds. These are externally-managed pooled funds called EQIT (international developed market equities) and EMEC (emerging market equities).[9]

Headwinds continue (trade tensions, slow growth, Brexit), but GDP growth has perked up slightly in Europe and trade negotiations are progressing (well, at least this past week...), such that it was a good quarter for our international holdings. EQIT returned 4.2% in the quarter and EMEC was up 2.4%. Combined, their 12-month return was 5.0%, slightly behind the overall North American equity market, but substantially ahead of their international benchmark of 0.5%. This strong relative performance arises from the manager's quality emphasis. Longer-term returns for the combined holdings remain strong, up 12.6% per year over the last three years. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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[7] All the return data in the Equities section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar. For more specific performance, please refer to the Fund reports in this document or your client-specific report.

[8] Except where indicated, all U.S. and international returns are measured in Canadian dollars.

[9] Both funds are managed by teams from JPMorgan Asset Management in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund generated a total return of 2.9% in the second quarter. This return compares to the 2.3% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 6.4%, in line with the benchmark return of 6.5%. From a longer-term perspective (3 years and up), our returns remain attractive on an absolute basis and above the benchmark. More detail on the Fund's performance is presented in the table below.

In Canada, the equity market gained 2.6% in the quarter. Our Canadian holdings generated positive returns of 1.1% but underperformed the TSX Index. The Canadian Information Technology (IT) sector had a particularly strong quarter which we did not participate in, given that our IT holdings are concentrated in the U.S. Another factor that detracted from our performance was our lack of investments in the Gold sub-sector, which had a large upswing in the second quarter.

In the U.S., the equity market gained 2.1% in the quarter. Our U.S. holdings outperformed, generating a 5.8% return. The main positives were stock-specific, with sizable gains in CarMax, Facebook, Dollar General, Citigroup, Microsoft and JPMorgan, all of which had price increases of 10% or more in U.S. dollars.

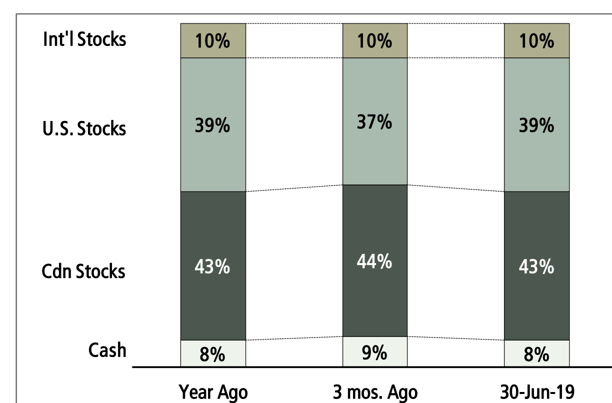
Our international holdings performed well in the quarter. The developed markets fund, EQIT, rose 4.2% and the emerging markets fund, EMEC, gained 2.4%.

At the end of the second quarter, the Fund's cash position was 8%. Our allocation to Canadian stocks was 43%, while U.S. stocks represented 39% of the mix. The remaining 10% is allocated to geographies outside of North America, which expresses our view that exposure to international markets will provide long-term benefits to the Equity Fund.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	2.9%	1.1%	5.8%	3.4%
Benchmark	*2.3%*	*2.6%*	*2.1%*	
One Year				
Fund	6.4%	5.6%	9.1%	5.1%
Benchmark	*6.5%*	*3.9%*	*9.7%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91Day TBill, 50% TSX, and 45% S&P 500 (in C$) (rebalanced monthly); (b) for Cdn Stocks: TSX; and (c) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at June 30, 2019



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 2.5% in the second quarter. This return compares to the 2.4% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 6.8%, surpassing the benchmark return of 6.5%. From a longer-term perspective (3 years and up), our returns remain attractive on an absolute basis and above the benchmark. More detail on the Fund's performance is shown in the table below.

For the second quarter in a row, fixed income delivered strong returns with interest rates declining in both the U.S. and Canada and corporate bond spreads moving lower. The benchmark returned 2.5% in the quarter, which surpassed the 1.4% return of our bonds. Nexus's current positioning emphasizes high quality and has an average bond maturity date that is well below that of the benchmark. This positioning reflects the view that there is little compensation for taking additional interest rate or corporate credit risk. However, it also means that in periods where there is a strong rally in bond prices (a decline in yields), our returns will underperform the benchmark.

In equities, our Canadian stocks rose 1.3%, but underperformed the TSX Index. This was more than offset by strong performance in our U.S. holdings, which benefitted from sizable gains from several individual stocks including CarMax, Facebook, Dollar General, Citigroup, Microsoft and JPMorgan, all of which had price increases of 10% or more in U.S. dollars.

Our international holdings also provided a tailwind in the second quarter. The developed markets fund, EQIT, rose 4.2% this quarter and the emerging markets fund, EMEC, gained 2.4%.

At the end of the quarter, cash represented 6% of the Fund's asset mix, bonds were 29% and stocks accounted for the remaining 65%. These asset allocations continue to remain close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	2.5%	1.4%	1.3%	5.6%	3.4%
Benchmark	*2.4%*	*2.5%*	*2.6%*	*2.1%*	
One Year					
Fund	6.8%	5.6%	7.3%	10.5%	5.0%
Benchmark	*6.5%*	*7.4%*	*3.9%*	*9.7%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day TBill, 30% FTSE TMX Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: FTSE TMX Universe Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at June 30, 2019

	Year Ago	3 mos. Ago	30-Jun-19
Int'l Stocks	8%	8%	8%
U.S. Stocks	29%	29%	29%
Cdn Stocks	28%	29%	28%
Bonds	27%	26%	29%
Cash	8%	8%	6%

Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 1.5% in the second quarter. This return compares to the 2.5% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 7.0%, underperforming the benchmark return of 7.4%. From a longer-term perspective (3 years and up), our returns remain above the benchmark and are attractive on an outright basis. More detail on the Fund's performance is displayed in the table below.

Our bond holdings produced a return of 1.4% in the quarter, underperforming the benchmark which returned 2.5%. Interest rates declined in the period and the spread of the yield on corporate bonds over government bonds of the same term narrowed. Both factors were responsible for the Fund's positive returns and the relative underperformance compared to the benchmark. We continue to structure the Fund's bond holdings with a high-quality and short-maturity emphasis. Despite the resulting underperformance in the quarter, this positioning reflects our outlook for interest rates and the current risk/reward profile of the fixed income market.

The decline in interest rates in the quarter, and the inversion of the yield curve led to some re-positioning of our holdings. Additionally, we had the opportunity to purchase some high-quality bank floating rate notes during the quarter — a position that allows us to collect returns that are slightly better than the yield on fixed-coupon bonds of a similar term, but reduces the risk of a price decline, should interest rates move higher.

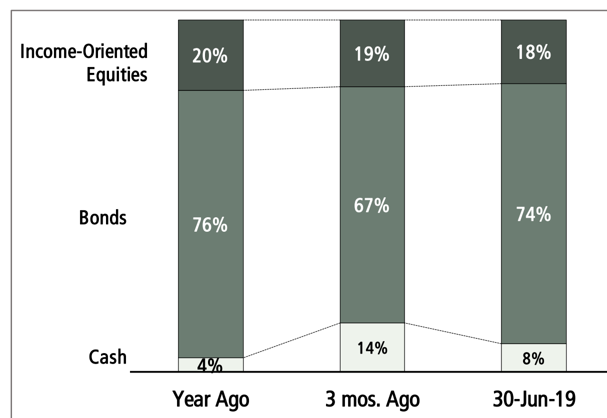
Our holdings of income-oriented Canadian and U.S. equities provided a tailwind to the Fund's performance this quarter. Specifically, our U.S. stocks were up 7.2% (in Canadian dollar terms) and our Canadian equities produced a 1.6% gain, both adding to the Fund's overall return.

At the end of the second quarter, the Fund's cash position was 8%, income-oriented equities accounted for 18% and the balance, 74%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.5%	1.4%	1.6%	7.2%
Benchmark	*2.5%*	*2.5%*		
One Year				
Fund	7.0%	5.6%	15.2%	16.7%
Benchmark	*7.4%*	*7.4%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE TMX Universe Bond; (b) for Bonds: FTSE TMX Universe Bond. In addition to bonds, up to 20% of the Fund's portfolio may be invested in equities.

Investment Returns – As at June 30, 2019



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund ("NIEF") holds two underlying funds: EQIT (invested in international developed market equities) and EMEC (invested in emerging market equities).[10]

In the second quarter, NIEF had a total return of 3.5% compared to the 0.8% total return of the Fund's blended benchmark. Over the past year, the Fund has returned 5.0%, significantly outpacing the benchmark return of 0.5%. Longer-term returns for both EQIT and EMEC have also been strong, with EQIT up 11.4% per year and EMEC up 14.1% per year over the past three years. More detail on the Fund's performance is presented in the table below.

In international developed markets, the headwinds we noted last quarter persist, but sentiment has improved. On the one hand, Brexit remains unresolved and a definitive resolution to global trade tensions has not been concluded. On the other hand, things may not be as bad as the market previously perceived: European GDP growth ticked higher in the quarter and signs of progress on the trade front offered some relief from the fear that a full-blown trade war is imminent.

Emerging market (EM) equities rose a modest 0.6% (in U.S. dollar terms), as geopolitical concerns continued to weigh on sentiment. In particular, the state of global trade continues to be a source of consternation for EM investors. Over the longer term, we expect many EM companies will benefit from growth in the developing world that will be driven by positive demographics, urbanization, increasing consumption and productivity improvements. It's our belief – shared with the fund manager – that companies best positioned to capture these trends will be well-managed firms with distinct competitive advantages and solid financial positioning.

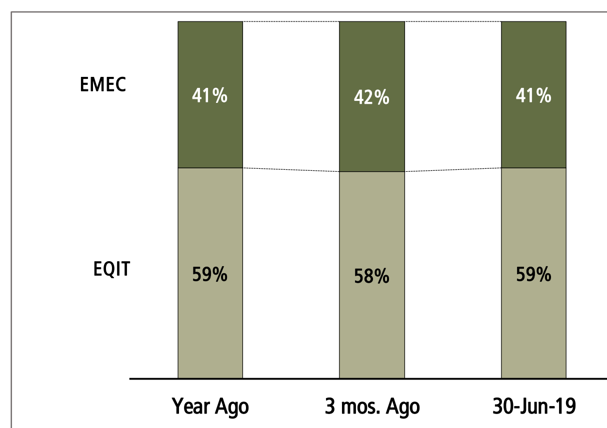
While geopolitical relations remain a key uncertainty (trade tensions, Brexit), we continue to believe that the long-term prospects for our international investments are compelling. These markets are attractively valued relative to the U.S. and Canada and offer the added benefit of diversification and growth opportunities that are not available in North America.

At the close of the second quarter, the International Equity Fund's investment in EQIT accounted for 59%, while EMEC accounted for 41%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	3.5%	4.2%	2.4%
Benchmark	*0.8%*	*1.5%*	*-1.5%*
One Year			
Fund	5.0%	3.2%	7.8%
Benchmark	*0.5%*	*0.5%*	*0.6%*

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: 75% MSCI EAFE (in C$) and 25% MSCI Emerging Mkts (in C$) (rebalanced monthly); (b) for EQIT: MSCI EAFE (in C$); and (c) for EMEC: MSCI Emerging Mkts (in C$).

Investment Returns – As at June 30, 2019



International Equity Fund Asset Mix

[10] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 23 developing countries. EQIT and EMEC are managed by JPMorgan Asset Management in the UK. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.