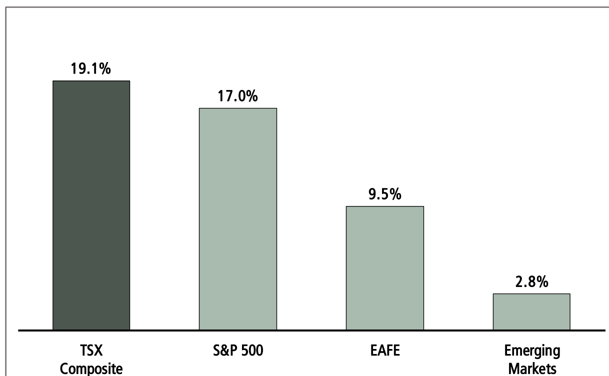
THE NEXUS REPORT

Third Quarter, 2019

Who Could Have Imagined?

Newspaper headlines cast a grim shadow over the current investment environment. Whether it be the China-U.S. trade war, the Brexit crisis, drone attacks on Saudi oil facilities, sabre rattling on the Korean peninsula, a crippling strike at General Motors, or the potential impeachment of a U.S. President, there is good reason for a sensible person to fret. Yet 2019 has been a great year for investors in Canada and the U.S. It has been more modest, but still positive, for international stock markets. In fact, the 20.6% total return for the S&P 500 (in U.S. dollars) is the best first nine months of the year since 1997. The 19.1% total return on the TSX Composite appears to trail the U.S. slightly, but is actually better than the U.S. when both are expressed in Canadian dollar terms.[1]



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

Of course, it is easy to forget the dreadful stock market returns in the last quarter of 2018 as we marvel at the recent performance we have enjoyed. The 12-month returns to September 30 are not quite so exhilarating as the graph above depicts for 2019 year-to-date. The total return from the TSX Composite was 7.1% in the 12 months ended September 30, and the return from the S&P 500 was 6.7%, in Canadian dollar terms. Decent, but not remarkable.

As we explained in the last Nexus Report, much of the renewed enthusiasm for stocks is derived from the expectation for lower interest rates.[2] The U.S. Federal Reserve obliged investors by cutting rates by 25 basis points in each of July and September, to a current target range of 1.75%-2.00%. Investors expect a further 25 basis point cut some time before the end of 2019. In Canada, rates have held steady, but remain at an historically low level.

Slowing, But Growing

There is broad agreement that the pace of economic growth in the U.S. is slowing. Where investors differ is whether this slowdown will lead to recession, or whether it is simply an adjustment to a lower, but still positive, rate of growth. The current U.S. economic expansion is the longest ever recorded and, eventually, it will end. However, we are in the camp that view a recession in the near term as unlikely.

Perhaps the strongest evidence to support recession worries is the data from the U.S. Institute of Supply Management ("ISM") manufacturing survey. This survey has a long and credible record of providing useful insight into the likely path of future U.S. growth. Periods in which the survey result is above 50 are highly correlated with economic expansion. When the survey result falls below 50 it has historically been a reliable forecast of economic contraction. The September survey fell to 47.8 from its August level of 49.1. The ISM also produces a services index in addition to the manufacturing one. This weakened in September as well, but at 52.6 remains above the important 50 benchmark. Of course, the ISM surveys are not alone in raising concern. Factory orders are soft, business fixed investment is weak and global trade is contracting.

On the other hand, the U.S. labour market continues to be remarkably strong. In September, the unemployment rate fell to 3.5%, its lowest level since 1969. The number of new jobs created (136,000) was a bit short of expectations, but the two previous months were revised higher by an aggregate of 45,000 jobs. Moreover, there was a big jump in the number of people voluntarily leaving their jobs – something that happens only when workers have a high degree of confidence in finding a new one. Remarkably, the number of unfilled job openings in the U.S. remains greater than the number of people looking for work. If everyone who wants a job lands one, there will still be unfilled job openings. Anecdotal evidence suggests that finding willing and able labour is the greatest challenge that small businesses in the U.S. currently face.

Of course, a high level of employment is critical to foster consumer confidence and drive consumer spending. Consumer spending represents approximately 70% of the U.S. economy. Manufacturing, despite its high profile, represents only a little more than 10% of U.S. GDP. It is

[1] The S&P 500 total return expressed in Canadian dollars was 17.0%.

[2] Lower interest rates make the present value of future earnings from stocks more valuable.

important and gets a lot of attention, but it is nowhere near as important as the health of the U.S. consumer. It is the persistent strength of the consumer that makes us sanguine about a continuation of the U.S. economic expansion, even if it is at a more modest pace.

Canada Remains Resilient

The word "resilient" has been desperately over-used in the Nexus Report to describe the Canadian economy. We just can't think of a better one, and it continues to describe Canada perfectly. GDP growth seems to have slowed in the third quarter from the surprisingly robust pace of the second, but it remains satisfactory. The housing market has rebounded sharply, highlighted by rising starts, building permits and sale volumes in Vancouver and Toronto. Canadian core inflation remains right on target – neither too weak nor too hot.

As in the U.S., the most remarkable aspect of the Canadian economy is the labour market. In August, Canada created 81,000 new jobs, a blockbuster report more than four times the expected increase of 20,000. In the trailing 12 months more new jobs were created than in any previous 12-month period in Canada. The unemployment rate stayed at 5.7%, a very low rate. Just as this report goes to press, the September labour report will be released. It will be interesting to see if this extraordinary momentum continues. While consumer spending is not quite as large a component of GDP in Canada as it is in the U.S., it is still the biggest part of the economy.

As central banks around the world rush to cut interest rates to prop up their economies, the Bank of Canada is in the enviable position of not needing to do so, at least for the time being. Canada's economic resilience, however, will continue to be tested. We are an export-oriented nation and global trade flows are seriously threatened. The USMCA (a.k.a., the new NAFTA), remains unratified and political support in the U.S. may be waning. The energy market remains weak, partly due to energy prices, but also due to the challenges Canadian producers have getting their product to market. Perhaps the greatest risk to the long-term health of the Canadian economy is the unrelenting growth in consumer debt. While American consumers have repaired their personal balance sheets in the wake of the 2008 credit crisis, Canadian consumer debt has reached worrisome new highs. At the current extraordinary low levels of interest rates, Canadians seem able to service the debt. But one day interest rates will go higher, and higher interest rates could undermine the ability of the consumer to spend.

Investment Outlook

The dichotomy between stock and bond markets that we wrote about last quarter still exists. Stock markets in Canada and the U.S. are near all-time highs, clearly reflecting optimism that corporate profits will continue to expand. Valuation levels remain reasonable, and investors seem comfortable that the world will muddle through most of these challenges.

In stark contrast, the bond market seems to anticipate a much less rosy future. Interest rates are near historic lows in Canada and the U.S., and continue to trend lower. Around the world, approximately $15 trillion of government debt trades with negative yields, something that existed only in the realm of theory just a few years ago.[3] These extraordinary interest rates reflect central bank intervention to support slowing economies today, but also imply slow economic growth for many years ahead. As well, the yield curve is "inverted" in Canada, and has spent some time in an inverted state in the U.S. – another sign of bond investor angst about the outlook.[4]

As we look to the future, we can be certain that fixed income returns will be low, as that is guaranteed by the current condition of the bond market. And, since interest rates imply that economic growth will be low, that may well translate into equity returns that are more modest than in recent times. Nonetheless, we remain optimistic that there is plenty of opportunity for investors to find good companies that will separate themselves from the pack. Even if economic growth is tepid, some companies will prosper more than the average. Our job is to find them, and to deliver investment returns that offer real growth with only a modest level of risk. It's a brave new world, but the same old job!

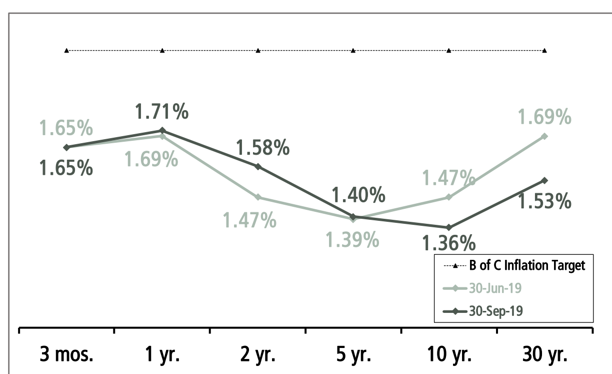
[3] The idea of a negative yield is the topic for an essay unto itself. Mechanically, a government issues a bond with a small positive interest rate and investors bid up the price. Eventually the price goes high enough that it is greater than the interest payments and principal payment received at maturity. An investor buying this bond pays more up front than the total cash flows that will be received.

[4] An inverted yield curve is when two-year rates are higher than 10-year rates. Normally, it is the other way around.

Asset Class Investment Review

Fixed Income

Interest rates declined across most of the yield curve this quarter, consistent with the trend from the start of the year. In fact, as was anticipated, the U.S. Federal Reserve cut the fed funds rate twice, in July and then again in September. This was the first reduction to the fed funds rate since the financial crisis and was framed as a mid-cycle adjustment to counteract a global slowdown that was beginning to affect the U.S. economy. With short-term interest rates in Canada already lower than in the U.S., and with our impending election, the Bank of Canada maintained a lower profile and did not follow the lead of the Fed. In Canada, interest rates on shorter maturity bonds actually rose, while the yields for bonds greater than five years fell by between 5 and 15 basis points (see chart). As a result of the decline, bonds and interest rate sensitive equities produced another quarter of excellent returns.



Government of Canada Yield Curve

In North America, an economic expansion remains in place and, for now, the health of the consumer is the foundation for our contention that the economy will slow, but not stall. Consumption is the largest sector of both the U.S and Canadian economies (~68% and ~60% respectively). Currently, it is supported by stable levels of confidence, record levels of employment, rising wages, and low interest rates that have made debt-service affordable. But there are signs of fatigue that bear watching. After all, consumers are human and the parade of worries (impeachment, Brexit, political dysfunction, etc.) is starting to undermine consumer and small business confidence.

Outside North America, economic growth continues to slow. We are watching Europe particularly closely, as years of ultra-stimulative monetary policies have not generated much in the way of self-reinforcing growth. This quarter the ECB re-committed itself to another round of rate cuts and bond purchases in yet another attempt to drive down the cost of borrowing in the Eurozone. A reliance on trade and an aging population are at the root of Europe's problems. To Nexus, neither lower interest rates, nor the assumption of more debt by businesses and consumers, is the answer to Europe's woes. But these policies have created trillions of dollars of debt trading at negative rates which, in turn, is affecting Canadian interest rates. Across the entire Government of Canada yield curve, bonds yield less than the rate of inflation, driven to such levels by yield-starved foreign investors.

We didn't change our positioning this quarter. The fund is concentrated in shorter-maturity securities and higher-quality issuers. The portfolio duration is 3.5 years as compared to the FTSE Canada Universe Bond Index of 8.0 years. On the credit front, 80% of our holdings are rated AA or better, and only 2% of our holdings are in BBB-rated securities.

Over the course of the year, we have introduced a small position in preferred shares. Preferred shares offer investors an attractive dividend yield that is both above the yield currently available on bonds and more tax efficient for taxable clients. However, preferreds are less liquid than bonds and, as a result, are more challenging to manage. Because the rest of our holdings are highly liquid, we think incorporating a small amount of preferreds into the portfolio makes sense.

The preferred shares that we own are all "rate-reset" structures. This means that their dividends re-set every five years based on the prevailing 5-year Government of Canada bond yield at the time of reset, plus a spread. The average dividend yield on our securities is approximately 5% – a rate that should increase if interest rates move higher and decrease if they move lower. Regardless of the direction of rates, we are interested in the space because the spread, or the amount of the yield above the government rates, is very generous when compared to alternatives.

Over the quarter, 2-year yields rose 0.11% (from 1.47% to 1.58%) and 10-year yields fell 0.11% (from 1.47% to 1.36%). The decline in interest rates for longer-maturity bonds generated another strong quarter for fixed income returns. The bond return in our Income Fund was 0.5% for the quarter and 6.3% for the last 12 months. These results trailed the FTSE Canada Universe Bond Index, which returned 1.2% and 9.7% for the same periods.

Equities

The third quarter had some volatile moments, but, overall, the equity markets produced a strong quarter. The Equity Fund returned 3.7% in the quarter, ahead of the 2.6% return for the market benchmark. For the past 12 months, the Equity Fund returned 8.4%, ahead of the 6.7% for its benchmark.[5]

Recall that the 12-month return includes a very poor fourth quarter in 2018, so the 2019 year-to-date return is stunning, at 17.9% for the Equity Fund. Similarly, the Canadian dollar has been all over the map. It weakened substantially in late 2018, thereby reducing the loss from our U.S. investments that quarter, then it strengthened materially year-to-date. For the full 12 months, the Canadian dollar has added 2.4 percentage points to our U.S. equity returns.

Canadian Equities

Nexus's Canadian stocks returned 5.1% in the quarter, well ahead of the 2.5% return from the TSX Composite. For the 12 months, our Canadian stocks returned 10.3%, outperforming the TSX which returned 7.1%.

Our third quarter Canadian portfolio outperformance was the main driver for the overall Equity Fund's outperformance relative to its blended benchmark. Most of the sectors where we have holdings did well, with Utilities and Real Estate helping the most. These sectors received an assist from lower interest rates and also benefitted from investors showing more interest in stocks with strong cash flows instead of "growthier" stocks. On a stock-specific basis, Metro and Brookfield Infrastructure Partners were each up more than 15%. Another relative benefit, as occurred in last quarter, came from stocks we don't hold. The Canadian Healthcare sector (principally the cannabis stocks) fell 30% in the quarter, making it the weakest sector in the TSX for two quarters in a row.

During the quarter, in some accounts, we trimmed our holdings of two stocks that have performed well and became relatively large holdings as a result. These were CAE and Thomson Reuters. Both are dominant global competitors in their respective markets.

U.S. Equities

The equity performance of our U.S. portfolio in the third quarter was also good. These stocks returned 4.1%, ahead of the S&P 500's 2.9%.[6] For the 12 months, our U.S. portfolio returned 8.3%, ahead of the S&P 500's 6.7%. As is typical, we had a mixed bag across the various sectors. The relatively good performance of the overall U.S. portfolio stems from our Consumer Discretionary, Financial and Technology holdings. Our weakest sector in the U.S. was Healthcare, with both Pfizer and Gilead trading down.

The strongest individual contributors were PRA Group, Dollar General and three tech-related holdings, Western Digital, Apple and Alphabet (although the latter is now actually in Communication Services), with all up more than 10% in US dollars. Some of these returns are just the normal ebb and flow of investor sentiment. As referenced earlier in this report, the U.S. consumer is doing well, and Dollar General, with its solid business model, is a direct beneficiary. Apple also benefits from a robust consumer. Early indications are that its new iPhone lineup is being well received.

As was the case with some Canadian holdings, we trimmed some of our larger U.S. positions that have increased in valuation – Apple, Microsoft and Dollar General – really just to manage down the risk in the portfolio.

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).[7]

Global headwinds for our international holdings continue (trade tensions, slow growth, Brexit… nothing new here!). EQIT declined slightly in third quarter, down 0.4% and EMEC fell 2.4%. Nonetheless, their combined 12-month return was 6.5%, largely in line with the overall North American equity market and substantially ahead of their combined international benchmark of 0.8%. This strong relative performance arises from J.P. Morgan's quality emphasis. Longer-term returns for the combined holdings are good, up 8.6% per year over the last three years. We remain comfortable with these holdings. Their valuations are attractive and we value their contribution to the diversity of a Canadian-based investor's portfolio. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

[5] 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.

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

[7] Both funds are managed by teams from J.P. Morgan Asset Management in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund generated a total return of 3.7% in the third quarter. This return compares to the 2.6% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 8.4%, better than the benchmark return of 6.7%. From a longer-term perspective, our returns remain attractive on an absolute basis and relative to the benchmark.

More detail on the Fund's performance is presented in the table below.

In Canada, the equity market gained 2.5% in the quarter, continuing the solid gains achieved in the previous quarter. Our Canadian holdings outperformed, delivering a 5.1% return. Our outperformance was driven by several stock-specific positives including substantial gains in Metro and Brookfield Infrastructure Partners. We also benefitted from avoiding the Healthcare sector (principally the cannabis stocks) which were dragged down by the unlicensed production scandal at CannTrust Holdings and the weight of lofty valuations.

In the U.S., the equity market gained 2.9% (in Canadian dollar terms) in the quarter. Our U.S. holdings outperformed, generating a 4.1% return. The main positives were stock-specific, with sizable gains in Western Digital, PRA Group, Dollar General and Apple.

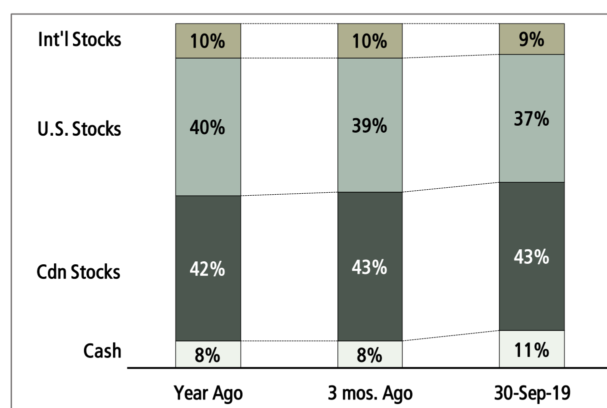
Our international holdings modestly detracted from performance in the quarter. The developed markets fund, EQIT, fell 0.4% and the emerging markets fund, EMEC, declined 2.4%.

At the end of the third quarter, the Fund's cash position was 11%. Our allocation to Canadian stocks was 43%, while U.S. stocks represented 37% of the mix. The remaining 9% is allocated to geographies outside of North America, which expresses our view that exposure to international markets will provide a long-term diversification benefit to the Equity Fund.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	3.7%	5.1%	4.1%	-1.2%
Benchmark	*2.6%*	*2.5%*	*2.9%*	
One Year				
Fund	8.4%	10.3%	8.3%	6.6%
Benchmark	*6.7%*	*7.1%*	*6.7%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Canada 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 September 30, 2019



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 2.7% in the third quarter. This return compares to the 2.1% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 7.9%, slightly ahead of the benchmark return of 7.7%. From a longer-term perspective, our returns remain attractive on an absolute basis and ahead of the benchmark.

More detail on the Fund's performance is shown in the table below.

Fixed income markets continued their stretch of excellent returns, with the bond benchmark generating a 1.2% gain in the third quarter. Our bonds gained 0.5% in the period, underperforming due to the decline in yields on bonds with longer maturities. Nexus's bond positioning continues to have an average maturity date that is well below that of the benchmark, which reflects our belief that there is inadequate compensation available for being exposed to the volatility inherent in longer-maturity bonds. However, this positioning also means that in periods when there is a strong rally in bonds, our returns will underperform the benchmark.

In equities, we recorded strong gains in both Canada and the U.S., which provided a sizable tailwind to the performance of the Balanced Fund. Our Canadian stocks outperformed by a wide margin, gaining 5.5% as compared to the benchmark return of 2.5%.

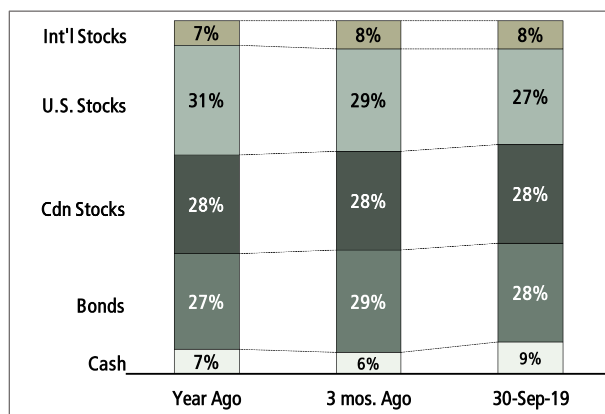
Our international holdings modestly detracted from performance in the quarter. The developed markets fund, EQIT, fell 0.4% and the emerging markets fund, EMEC, declined 2.4%.

At the end of the quarter, cash represented 9% of the Fund's asset mix, bonds were 28% and stocks accounted for the remaining 63%. 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	2.7%	0.5%	5.5%	3.8%	-1.2%
Benchmark	*2.1%*	*1.2%*	*2.5%*	*2.9%*	
One Year					
Fund	7.9%	6.4%	12.2%	8.4%	6.5%
Benchmark	*7.7%*	*9.7%*	*7.1%*	*6.7%*	

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

Investment Returns – As at September 30, 2019



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 1.4% in the third quarter. This return compares to the 1.2% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 7.9%, but lagged the benchmark return of 9.7%. From a longer-term perspective, our returns remain attractive on an absolute basis and above the benchmark in most measurement periods.

More detail on the Fund's performance is shown in the table below.

Fixed income markets continued their stretch of excellent returns, with the bond benchmark generating a 1.2% gain in the third quarter. Our bonds gained 0.5% in the period, underperforming due to the decline in yields on bonds with longer maturities. Nexus's bond positioning continues to have an average maturity date that is well below that of the benchmark, which reflects our belief that there is inadequate compensation available for being exposed to the volatility inherent in longer-maturity bonds. However, this positioning also means that in periods when there is a strong rally in bonds, our returns will underperform the benchmark.

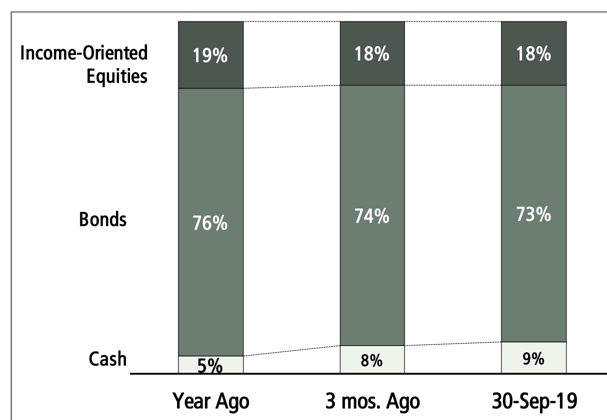
Our holdings of income-oriented Canadian equities provided a significant tailwind to the Fund's performance this quarter, gaining 7.1%. Our U.S. stocks proved to be a minor detractor, declining 0.7% (in Canadian dollar terms).

At the end of the third quarter, the Fund's cash position was 9%, income-oriented equities accounted for 18% and the balance, 73% was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.4%	0.5%	7.1%	-0.7%
Benchmark	*1.2%*	*1.2%*		
One Year				
Fund	7.9%	6.3%	21.5%	6.3%
Benchmark	*9.7%*	*9.7%*		

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

Investment Returns – As at September 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).[8]

In the third quarter, NIEF declined 1.2% compared to the 0.7% decline of the Fund's blended benchmark. Over the past 12 months, the Fund has returned 6.5%, significantly outpacing the benchmark return of 0.8%. Longer-term returns for both EQIT and EMEC have also been attractive, with EQIT up 7.7% per year and EMEC up 9.8% per year over the past three years.

More detail on the Fund's performance is presented in the table below.

In international developed markets, worries regarding global economic growth momentum were top of mind for investors. The full effects of the US/China trade fight remain unknown, but there was evidence in the international data (particularly in the Eurozone) that economic activity is softening. To counter these trends, monetary authorities responded to the perceived weakness: 16 central banks around the world lowered rates in the third quarter. This helped fuel a recovery off the August lows, but the result was still a decline for the period.

Emerging market (EM) equities also had to contend with the uncertainties created by global trade tensions. What's more, several concerning geopolitical issues bubbled up in EM regions, including the Hong Kong/China conflict and disputes between a variety of countries including India/Pakistan, Syria/Turkey and the U.S./Iran. We continue to share the belief of the fund manager that the best strategy to navigate the ups and downs of EM investing is to own financially sound companies that are well managed and benefit from long-term competitive advantages.

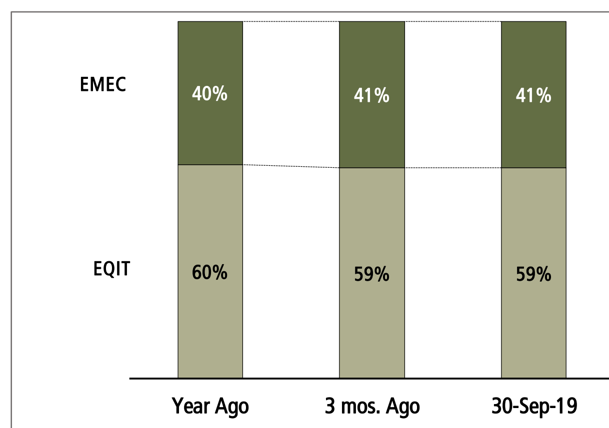
We anticipate that our international investments will deliver attractive long-term returns and provide an important diversification benefit. As compared to investments available in North America, our international holdings offer compelling valuations as well as opportunities for earnings growth.

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

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-1.2%	-0.4%	-2.4%
Benchmark	*-0.7%*	*0.1%*	*-3.1%*
One Year			
Fund	6.5%	5.3%	8.3%
Benchmark	*0.8%*	*0.9%*	*0.2%*

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 September 30, 2019



International Equity Fund Asset Mix

[8] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 26 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.