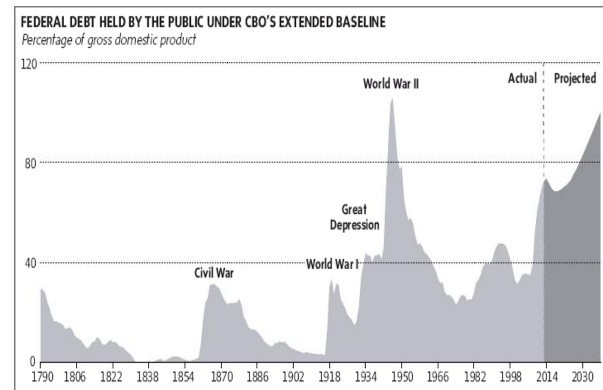
Worries in Washington

Perhaps the most important data series in the U.S. economic calendar is the non-farm payroll report released by the U.S. Bureau of Labor Statistics on the first Friday of each month. This investment commentary always looks closely at that report for some of the insights that form the Nexus outlook for markets. But on Friday October 4, investors were greeted by an eerie silence. Earlier in the week the U.S. Government shut down. Eight hundred thousand employees were sent home and many non-essential services, like the U.S. labour market report, were curtailed.

The government shutdown is only one aspect of the drama playing out in Washington at the moment. The other is the game of "chicken" the Republicans and Democrats are playing with respect to the debt ceiling. The U.S. Treasury estimates that it will run out of cash about October 17 unless Congress increases the limit on the amount of money it can borrow. While the two issues are theoretically unrelated, Republicans are using one (the debt ceiling) as a lever to negotiate with Democrats over the other (specifically, a rollback of funding for "Obamacare" which currently is tied to funding the government going forward).

There have been 17 previous government shutdowns since 1976, ranging in length from one day to 21 days. The last was during the Clinton presidency in 1996. Most investors believe that the shutdown is not a big deal and will get resolved one way or another in due course. In contrast, the debt ceiling is a big deal. If the Treasury runs out of money, there could be a technical default on its obligations, something that has never happened before. The U.S. remains the most credit-worthy borrower in the world and such a default could have profound consequences for global financial markets.

In all likelihood these issues will be resolved in some fashion after this commentary goes to print and before clients read it. We believe that even the most intransigent U.S. politicians realize the grave consequences of their actions, and we remain hopeful that a middle ground will be found soon. Nevertheless, it shines a light on a serious and growing long-term problem in the U.S. The Government simply must find a way to reduce spending and debt before the situation spirals out of control. The following projection was prepared by the non-partisan Congressional Budget Office to indicate what it thinks will happen if the U.S. Government does not alter its course. All previous spikes in U.S. indebtedness have been temporary. There is little to suggest that the current spike is.



Growth in U.S. Federal Debt[1]

Faster Growth Remains Elusive

Of course, the crisis currently engulfing the U.S. is a political one, with real economic ramifications only in the event of an extreme outcome. As we consider the current economic fundamentals, conditions in the U.S. remain much as we have described them for many quarters. Measures of employment, consumer and business confidence, and purchases of durable goods all continue to improve, but at a pace that is frustratingly slow. The very important dynamic of business investment has not improved, and recovery from the recession of 2008/2009 remains one of the weakest ever recorded. For several years we have expected economic growth to pick up one or two quarters in the future. However, this period of re-acceleration just keeps getting pushed further and further into the future.

In the spring U.S. Federal Reserve Chairman Bernanke first introduced the notion that the Fed would like to "taper" its extraordinary measures of quantitative easing as soon as it observes evidence of sustained economic strength. Following these comments, investors became convinced this would begin after the Fed's September meeting. Therefore, it came somewhat as a shock when the Fed declared that it would defer the taper; the data simply did not support the view that the economy was strong enough. For the time being, the Fed continues to inject $85 billion per month into the U.S. economy.

In Canada conditions also remain just as we described them last quarter. Economic growth is

[1] Data from the Congressional Budget Office reported in the Globe and Mail, October 5, 2013.

positive, but even more modest than that in the U.S. We have written many times about the challenges facing our economy: weak productivity, an extended housing market, high consumer debt, a strong currency providing a stiff headwind to our export industries, and generally weak commodity prices. A recent survey of Canadian chief executives reveals that only 42% of companies have recovered to activity levels last enjoyed before the 2008/2009 recession, and 12% have experienced no recovery at all. In the resource sector specifically, only 28% have recovered to their pre-recession pace.[2] Unfortunately, there is little evidence to suggest a significant improvement in the near term.

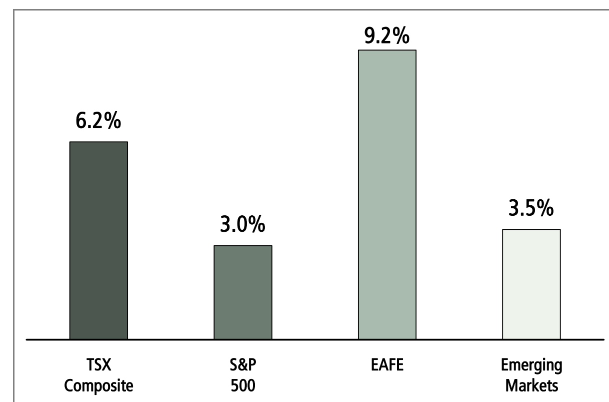
While Europe is far from out of the woods, and years away from actual improvement, thankfully it continues to be stable. Unemployment in the Eurozone overall has stayed steady around 12%, which has investors hopeful that the worst is past. Of course, the overall figure masks the gaping disparities between countries. German unemployment remains at an historically low level, while unemployment in countries like Spain, Portugal and Greece remains in excess of 20%.

Perhaps the only bright spot on the global economic scene is in Asia. Last quarter we referred to the dramatic changes introduced by Japanese Prime Minister Shinzo Abe to try and kick-start Japan's economy after almost 25 years of despair. Early indications are that it may actually be working, although there remains a long road ahead. Likewise, China seems to have surprised investors with a sudden increase in growth. Early in the year, investors worried that a slow-down in China's growth had the potential to derail the global economy. This worry was short-lived and China seems back on track.

Investors Remain Sanguine

Despite subdued economic conditions in many parts of the world, stock markets continued to climb higher in the last quarter. This may seem a bit confounding, given the many risks investors are grappling with, but probably reflects some degree of relief that several issues previous causing angst have been (at least temporarily) resolved.

Not long ago a U.S. military strike on Syria seemed inevitable, and increased instability in that region was a great concern to investors. However, a diplomatic resolution was brokered by Russia and, for the time being at least, military action seems to be off the table. Closer to home, investors gained comfort that U.S. monetary policy will continue to support the economy and markets. The Fed's September decision to delay the "taper" as well as the emergence of Janet Yellen, a noted monetary "dove", as the front runner to replace Ben Bernanke suggested that the Fed was not going to take the punch bowl away from investors any time soon.



Market Returns (C$) – Quarter ended September 30, 2013

The Bargains are Gone

One consequence of the ongoing rise in stock markets is that stocks are no longer as cheap as they were. Coming out of the 2008/2009 recession many great companies could be bought at prices well below our assessment of their value. Today, many of these stocks are fully valued. That is not to say that we are downbeat about the prospects for our holdings. Markets are not overvalued the way they were at the time of the tech bubble in 2000. It is simply that the "easy money" likely has been made. Future gains will be driven by earnings growth alone, without the concurrent valuation increases we have enjoyed in recent years. In this sort of environment, a rising tide no longer lifts all boats. Careful analysis and selection of companies with strong business models and able management teams will be critical. At Nexus we remain committed to this approach and are confident that long-term investment returns will satisfy our clients' investment objectives.

[2] *Globe & Mail*, October 7, 2013.

Asset Class Investment Review

Fixed Income

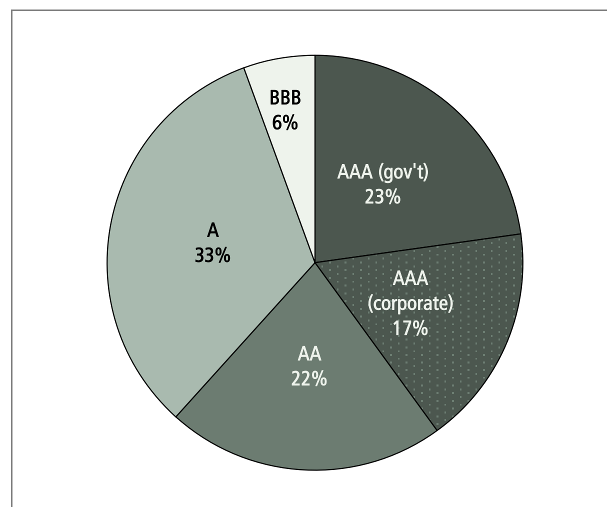
Bond yields continued to rise this quarter, although not at the same pace as earlier in the year. In early September the yield of the ten-year Canada bond touched 2.82%, on the expectation of a tapering in monetary stimulus by the U.S. Federal Reserve. Later in the month the Fed deferred this decision and yields in the U.S. and Canada fell sharply, with the ten-year Canada bond ending the quarter at a yield of 2.54%, up 10 basis points from the previous quarter end.

It seems inevitable that interest rates will gradually move higher in North America. There is widespread concern that the ultra-low interest rates will, if left in place for too long, create serious distortions in the economy. However, before rates are allowed to rise, economic conditions must improve enough so that a withdrawal of monetary stimulus will not derail the recovery. For now, we share the view of policymakers that the economic recovery remains too fragile.[3] Consequently, monetary tightening by the Bank of Canada looks to us like a late 2014 or early 2015 event.

Our bond portfolios remain positioned in three respects for an eventual normalization of rates. First, our portfolio duration of 4.8 years remains substantially less than the 6.7 year duration of the DEX Universe Bond Index (DEX). Second, our cash position remains higher than normal and our allocation to fixed income below normal. Lastly, we retain a large overweight position in top-quality corporate bonds as a means of increasing the yield in the portfolio.

Our intention at this point in the interest rate cycle is to accident-proof our holdings as much as possible. In this era of lower rates, it has been popular to buy the securities of lower credit-rated companies in an attempt to squeeze out as much yield as possible. The incremental yield is typically mere fractions of a percentage point. We think this approach exposes investors to unnecessary risk without adequate compensation. As depicted in the chart to the right, only 6% of our portfolio is in securities with a BBB rating, over 40% of the portfolio is rated AAA, and the balance is AA or A rated.

[3] "Global Growth and the Prospects for Canada's Exports." An address to the Economic Club of Canada by Tiff Macklem, Deputy Governor of the Bank of Canada. October 1st, 2013.



Bond Portfolio Credit Mix

Using our Nexus North American Income Fund as a proxy, this quarter our bonds again outperformed, returning 0.8%, while the DEX returned only 0.1%. In the last year our bond holdings returned 0.5% against a *decline* in the DEX of 1.3%.

Equities

As discussed earlier, equity markets around the world continued upward in the third quarter, showing scant regard for various ongoing concerns.

Our overall equity portfolios continued to advance, but did not quite keep up with the indices in the quarter. Over the past twelve months our Canadian and U.S. equity portfolios returned more than 10% and 20% respectively.[4] Our equity asset allocation remained fairly stable over the quarter, with a small increase in U.S. equity exposure.

Canadian Equities

As a refreshing change, Canadian equity markets did better than the U.S. S&P 500 in the third quarter (although this was largely due to a stronger C$). Our Canadian equity portfolios were up about 5% over the quarter and more than 10% over the past year.

Our strongest sector was telecom (Rogers and TELUS), which experienced a big relief rally on news that Verizon and other foreign telecoms were unlikely to enter Canada. Our bank holdings also put

[4] For more detailed performance, please refer to the Fund reports in this document or your client-specific report.

in a good showing, stemming partly from an abatement of concerns regarding the sector's exposure to a potential real estate downturn, as well as just reasonable valuations.

On the other hand, with the ongoing increase in longer-term interest rates during the quarter, stocks that had been treated by the market as bond substitutes, such as our utilities and real estate investment trusts, underperformed the market over the quarter, as investors sought "growthier" stocks.

We sold one stock – BlackBerry. While it had been damaged goods for some time, we held it with the expectation of a recovery in the business or a takeover. As events unfolded we became concerned that any sale of the company would be drawn out and damaging. We managed to exit the stock at a price well above where it was trading at quarter end. While this particular holding was unsuccessful, our Canadian equity performance remains strong.

U.S. Equities

After a stellar couple of years, our U.S. equity portfolio was disappointing – flat to slightly down over the quarter. Nonetheless, our U.S. holdings have returned more than 20% over the past year and more than 50% in total over the past two years.

No one stock or sector explains our performance, with the main theme being similar, but more acute than we described above for Canada. Simply put, investors have been rotating out of the quality stocks we tend to favour and into more cyclical stocks. We remain comfortable with our positioning.

We added two new names – Sirona Dental Systems and Gilead Sciences. Both are in the healthcare sector, with strong competitive positions and growth prospects.

Sirona manufactures and sells products to dentists. It has two well-established product lines – dental instruments and dental chairs – and two higher-growth product lines – imaging (X-ray) equipment and a leading-edge "Ceramic Reconstruction" system that allows a dentist to design, build and install a crown for a patient in one sitting.

Gilead is a pharmaceutical company. The bulk of its $10 billion of annual revenue is from a portfolio of HIV/AIDS drugs, although it has other respiratory, cardiovascular and influenza drugs. The company has an exciting new treatment for Hepatitis C that is in the final phase of regulatory approval. HepC is a very serious disease that can severely impair liver function and result in high lifetime healthcare costs. Gilead's HepC combination drug therapy appears to have fewer side effects and a markedly higher cure rate than the current treatment. Other companies are also developing new HepC drugs, so Gilead is expected to share the market, but enjoy the benefit of a first mover advantage.

Finally, we sold our small holding of Mallinckrodt, the specialty pharmaceuticals business that was spun out of Covidien.

Other Equity Investments

We still like the prospects and valuation levels for the two non-North American holdings in our Balanced and Equity Funds. These are externally-managed pooled funds called EQIT (international developed market equities) and EMEC (international emerging market equities).

EQIT has enjoyed an especially strong period. It was up more than 8% for the quarter and has had a total return of more than 40% over the past two years.

In response to concerns about the tapering of monetary stimulus, EMEC was down 0.2% over the quarter, but is up almost 6% over the past twelve months. Despite higher growth potential, emerging market stocks trade at a material discount to those in the developed world, as illustrated below.

Equity Market	Forward Price/Earnings	Dividend Yield
Canada	14.1x	3.1%
U.S.	14.3x	2.1%
EAFE	13.4x	3.2%
Emerging Markets	10.5x	2.9%

Yield and Valuation as at September 30, 2013

Pooled Fund Reports

Nexus North American Equity Fund

This quarter the Equity Fund managed an advance of 2.0%, which compares unfavourably to the 4.5% advance of the Fund's benchmark. There wasn't any particular corporate development or holding that accounted for the difference in returns. In fact, our under-performance was spread across both the Canadian and U.S. markets. As noted earlier, the weak relative performance reflects a rotation by investors from income-oriented and defensive stocks, such as REITs, healthcare and consumer staples companies, into more cyclical sectors, where we are under-represented. In particular, in the U.S. our selections of healthcare, technology and banking stocks all lagged the S&P 500 index. Despite the relative weakness, we retain considerable enthusiasm for each of our holdings in these sectors. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review – Equity section of this report.

Our allocation to EQIT, our investment vehicle for developed markets outside of North America, also produced a strong return of 8.4%, as evidence grew that economic and political conditions in Europe and Japan were stabilizing or improving.

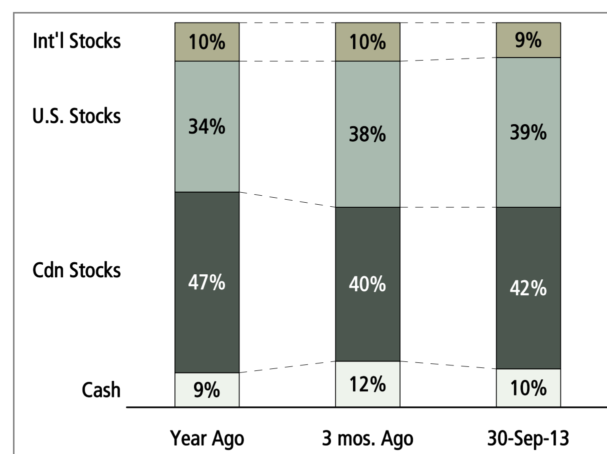
Long-time clients know that we select our holdings for their long-term attractiveness and that the composition of our portfolios looks significantly different than either the TSX or the S&P 500 indices. So it is not uncommon to have periods where our portfolio returns differ from that of the market. Returns for longer periods continue to exceed our benchmark and, most importantly, are attractive on an outright basis. The Fund has returned 14.3% in the last twelve months and has provided an annual average return of 8.7% for the last 10 years. More detail of the Fund's performance is laid out in the table below.

From an asset mix perspective, we made few changes to the relative weightings of our holdings. We reduced our cash position slightly to 10%. At that level it remains higher than target but ready to be put to work as opportunities arise. We maintained our allocation outside North America at just more than 9%. Our holdings of Canadian stocks, 42%, and U.S. stocks, 39%, remain roughly equal at this point in time.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	2.0%	4.9%	-0.5%	4.5%
Benchmark	*4.5%*	*6.2%*	*3.0%*	
One Year				
Fund	14.3%	10.4%	21.1%	18.4%
Benchmark	*14.5%*	*7.1%*	*24.8%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% DEX 91-Day T-Bill, 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, 2013



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Balanced Fund managed an advance of 2.1%. This compared unfavourably to our benchmark, which advanced 3.3%. Our bond holdings provided a small positive return this past quarter, earning 0.7% against the DEX return of 0.1%.

However, our equity holdings underperformed the market indices. There wasn't any particular corporate development or holding that accounted for the difference in returns. In fact, our under-performance was spread across both the Canadian and U.S. markets. As noted earlier, the weak relative performance reflects a rotation by investors from income-oriented and defensive stocks, such as REITs, healthcare and consumer staples companies, into more cyclical sectors, where we are under-represented. In particular, in the U.S. our selections of healthcare, technology and banking stocks all lagged the S&P 500 index. Despite the relative weakness, we retain considerable enthusiasm for each of our holdings in these sectors. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review – Equity section of this report.

Our allocation to EQIT, our investment vehicle for developed markets outside of North America, also produced a strong return of 8.4%, as evidence grew that economic and political conditions in Europe and Japan were stabilizing or improving.

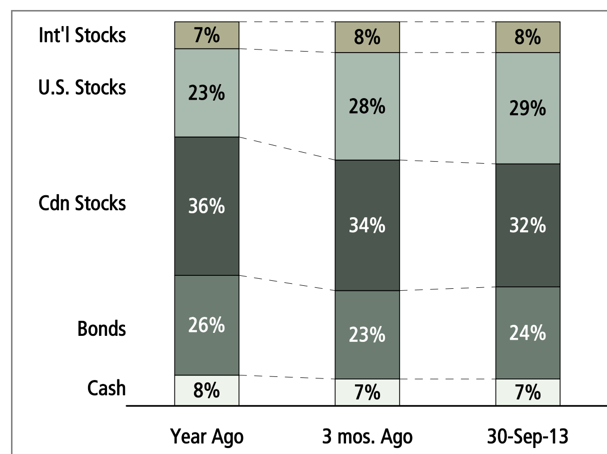
Long-time clients know that we select our holdings for their long-term attractiveness and that the composition of our portfolios looks significantly different than either the TSX or the S&P 500 indices. So it is not uncommon to have periods where our portfolio returns differ from that of the market. Returns over the last year and for longer periods continue to exceed our benchmark and, most importantly, are attractive on an outright basis. The Fund has returned 11.3% in the last twelve months and has provided an annual average return of 8.0% for the last 10 years. More detail of the Fund's performance is laid out in the table below.

From an asset mix perspective, we made few changes to the relative weightings of our holdings. We remain fully invested and, although our cash position of 6.5% remains slightly higher than the long-term guideline, we remain underweighted in bonds, with an allocation of only 24%. As a result, our total allocation to equities remains above target with most of the overweight distributed between our U.S. and non-North American holdings.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	2.1%	0.7%	5.7%	-0.6%	5.7%
Benchmark	*3.3%*	*0.1%*	*6.2%*	*3.0%*	
One Year					
Fund	11.3%	0.6%	11.5%	22.3%	20.7%
Benchmark	*8.4%*	*-1.3%*	*7.1%*	*24.8%*	

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

Investment Returns – As at September 30, 2013



Balanced Fund Asset Mix

Nexus North American Income Fund

Relative to the modest changes normally expected from fixed income investments, the performance of the Income Fund rebounded strongly last quarter. The Fund increased 1.3% while the DEX returned only 0.1%. In the year-to-date, the Income Fund has managed a small positive return of 2.2% compared to the *decline* in the DEX over the same period of 1.6%. More detail on the Fund's performance is laid out in the table below.

Returns over the last year and for longer periods continue to exceed our benchmark. Although low in nominal terms, returns have been quite consistent, and the Fund has delivered stability to investors for whom capital preservation is a priority. The Fund has returned 3.3% in the last twelve months and has provided an annual average return of 6.3% for the last 10 years.

Last quarter, the bond market continued to weaken, although not at the pace of the previous quarter. After allowing for interest earned over the period, returns from the bond market were essentially unchanged. The boost to returns in our Income Fund came partly from outperformance of our bond holdings, but mostly from our allocation to "Other Income-Oriented" securities. These holdings recovered smartly from where they had ended the second quarter, benefitting especially from the change in sentiment regarding the pace of Fed tapering of its Quantitative Easing program in the last weeks of September. A more detailed explanation of developments in the bond market appears earlier in the Asset Class Review – Fixed Income section of this report.

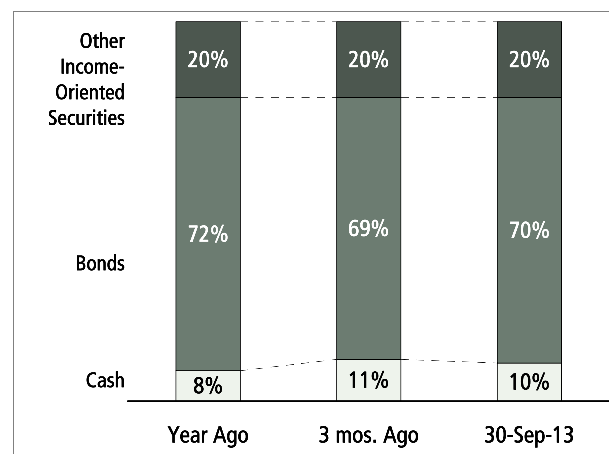
We continue to expect very moderate returns from our bond investments and better returns, albeit with greater volatility, from our allocation to "Other Income-Oriented" securities.

Looking at asset mix, our subdued outlook for the return potential from fixed income has meant we remain under-invested in bonds, with an allocation of 70%, and we continue to have a substantial cash balance – 10% – that we think can be deployed back into the bond market when rates are higher. Our holding of "Other Income-Oriented" securities remains at the Fund's practical limit of 20%.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.3%	0.7%	6.0%	-2.2%
Benchmark	*0.1%*	*0.1%*		
One Year				
Fund	3.3%	0.5%	11.1%	23.7%
Benchmark	*-1.3%*	*-1.3%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: DEX Universe Bond; (b) for Bonds: DEX Universe Bond.

Investment Returns – As at September 30, 2013



Income Fund Asset Mix

Financial Market Summary

Market Levels

Canada	September 30, 2013	December 31, 2012
TSX Composite Index	12,787	12,434
91-Day T-Bill Yield	0.98%	0.93%
30-Year Government of Canada Bond Yield	3.07%	2.37%
Prime Rate	3.00%	3.00%
Exchange Rate (US$/C$1)	0.9706	1.0051
United States		
Dow Jones Industrial Average	15,130	13,104
Standard & Poor's 500 Index	1,682	1,426
30-Year U.S. Treasury Yield	3.69%	2.95%

Market Returns for Periods Ended September 30, 2013 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
DEX 91-Day T-Bill Index	0.3%	1.1%	0.9%	2.1%
DEX Universe Bond Index	0.1%	-1.3%	5.6%	5.2%
TSX Composite Index	6.2%	7.1%	4.8%	8.4%
S&P 500 Index (in C$)	3.0%	24.8%	9.4%	4.7%
MSCI EAFE Index (in C$)	9.2%	29.4%	5.7%	5.1%
MSCI Emerging Markets Index (in C$)	-1.1%	8.1%	9.8%	n.a.

Notes:

[1] Market returns represent total returns, including income and capital appreciation (or depreciation).
[2] Market returns are compound annual rates for periods of more than 1 year, but are not annualized for shorter periods.