NEXUS

Portfolio Management & Financial Counsel

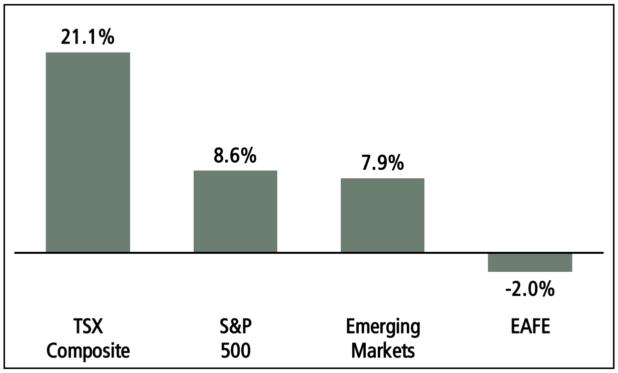
THE NEXUS REPORT

Fourth Quarter, 2016

What a Difference a Year Makes

Last year at this time we were enduring the worst start to a year ever experienced in U.S. stock markets. The Dow Jones Industrial Average plunged 6.2% in the first 5 trading days of 2016.[1] In Europe, investor nerves also frayed as the Stoxx Europe 600 dropped 6.7%. Canadian markets were a little less extreme, down "only" 4.3%. However, the market drop in Canada to start the year drove the TSX Composite into bear market territory as it was down more than 20% from its September 2014 high.

In contrast, most investors start 2017 with a smile on their face. The TSX turned out to be one of the strongest markets in the developed world in 2016, generating a total return of 21.1%. This is a big change from 2015 when it was one of the developed world's worst. U.S. markets also rebounded strongly in the second half of the year and the S&P 500 had an 8.6% total return (in Canadian dollars) for the year notwithstanding the terrible start. Moreover, as the Nexus Report is being prepared, the Dow Jones is fast approaching the "magical" 20,000 level, and other major indexes are hitting all-time highs. Clearly, investors are expecting good times ahead.



2016 Stock Market Returns[2]

Improving Fundamentals

In Canada, 2017 started with two surprisingly strong economic reports. First was the employment report for December showing 54,000 new jobs created in a month economists widely expected to show a loss of jobs. This followed a four-month stretch of already spectacular job growth – a total gain of 148,000 new jobs, which was about the same number as was created in all of 2015. Moreover, the December report reversed one worrisome aspect of the previous four months when most of the job additions were part-time or people who described themselves as self-employed. In December, 81,000 new full-time jobs were created and 27,000 part-time jobs were eliminated in what was a remarkably strong month.

Another surprise to investors was that Canada enjoyed a $0.5 billion trade surplus in November. This compared to expectations for a deficit of $1.6 billion and was the first surplus since September 2014. Not only was the positive headline surprising, but strength ran across industry sectors. After a decline in GDP in October, and a lackluster year overall, these two reports have some wondering whether the Canadian economy is about to gain momentum.

Notwithstanding these two positive developments, we are not quite ready to believe that the Canadian economy is accelerating to the upside. Despite gains in November, non-energy export volumes were down more than 2% in the first 11 months of 2016, a time when it was widely expected that the weak Canadian dollar and U.S. economic growth would be supporting a decent recovery in our economy. There remains notable reluctance among Canadian firms to invest in plant and equipment as high power prices, burdensome regulation and expensive labour make other regions a more attractive place to invest. As well, the recent disclosure that our federal government is likely to run large fiscal deficits for decades to come suggests a growing tax burden is also likely to undermine the appeal of Canada as a destination for capital investment.

While the U.S. economic recovery wobbled in the first half of the year, it gathered an impressive head of steam in the second half. As has been the case for some time, labour markets remain the driving force of the U.S. economy. While the December non-farm payroll report was technically a "miss" compared to expectations, the 156,000 new jobs figure was solid and several previous months were revised higher. This represents the 75th consecutive monthly gain – the longest winning streak since 1939.[3] As well, the unemployment rate, at 4.7%, is at a level historically believed to be lower than what is described as "full employment". Perhaps of more significance is the fact that average hourly earnings jumped 2.9% year-over-year, the strongest gain in a long time. We've been saying for some time that more rapid wage

[1] Returns in this paragraph are price only in local currency.

[2] Total returns in Canadian dollars for 12 months ended December 31, 2016.

[3] Sal Guatieri, A.M. Notes, BMO Capital Markets, January 6, 2017.

growth – putting more money in workers' pockets – is a key ingredient to help accelerate U.S. growth.

Many other measures of economic performance have also reflected an acceleration of the U.S. economy in the second half of the year. GDP growth was 3.5% in the third quarter and corporate earnings growth has improved. Moreover, since the U.S. election on November 8, confidence measures among consumers, small businesses and home builders have all moved sharply higher. In sum, economic fundamentals in the U.S. are the strongest they've been in some time.

The Age of Entropy

In a recent research piece Société Générale dubbed the current period as the "Age of Entropy".[4] For those who forget the basic laws of thermodynamics, entropy is a measure of molecular disorder or randomness. The second law of thermodynamics states that entropy can never decrease; disorder and randomness can only increase. After the Brexit vote in June and the election of Donald Trump as President of the United States in November, it seems to us that SocGen is onto something in coining this phrase.

While the Brexit vote in the UK took most of the world by surprise, the election of Donald Trump may be even more significant for the world economic and political order in the period ahead. Few people expected he could be elected, and those who speculated on the possibility were certain it would generate a sharp sell-off in markets. "Wrong", as the President-Elect liked to chirp in the debates. Instead, markets are strongly positive, reflecting a belief that the new administration will be much more business-friendly than the outgoing one.

Of concern to many, however, is a greater level of uncertainty that comes with the new administration. Examples are plentiful. Trump has repeatedly stated that he will repeal the Affordable Care Act (a.k.a. Obamacare), except on those occasions when he has said he will modify it simply to get rid of the bad parts. What will he do? Will it be better or worse? There is no way to know as there is nothing explicit to evaluate. Similarly, financial services regulations are expected to be loosened with changes to the Dodd-Frank Act. This has the possibility of being good, but there is scant detail on what is intended. Corporate tax rates will be lowered and U.S. companies may be permitted to repatriate foreign cash without punitive taxation. Good news for sure, but the possibility of a border tax on imported goods is not. Of course, Trump's protectionist rhetoric has many afraid that tariffs or the ripping up of trade agreements will turn out to have a significant negative impact on the U.S. economy. The President-Elect has pledged to spend heavily on infrastructure. Are there sensible shovel-ready projects identified? And last but not least, the international community remains deeply uncertain over his approach to Russia, China and Iran… and whether he really will build a wall on the Mexican border.

In short, there is a chance that the Trump administration will be beneficial for the economy and for markets. But there is also a chance that trade wars or confused domestic policies lead to a less desirable world. We are in uncharted waters. It is the Age of Entropy.

Investment Outlook

It is axiomatic that in an uncertain world there should be little confidence in what lies ahead in the coming months. Nevertheless, surveys show active fund managers are the most bullish they have been since 2008, and newsletter writers reflect similar optimism.[5] The contrarian in us sees this as a warning sign. The current economic expansion is the fourth longest in history. If sustained until mid-2019, it would be the longest ever. Perhaps we are due for a setback? Stock markets have had a great run since 2009, and one may reasonably wonder whether earnings will justify higher stock valuations. In Canada, the uncertain trade environment puts a particularly large dark cloud over our economy.

As always, however, our investment approach affords us the luxury of focusing on the long term. Rather than worrying about whether the U.S. Federal Reserve will raise interest rates two or three times in 2017, we can concentrate on the likely trend of rates over several years (namely, slowly higher). We can search for companies that will earn more money in the future regardless of how the new U.S. administration's policies play out. If we buy these growing earnings streams at a fair price, portfolios will prosper. Today, as always, Warren Buffett is right. Investing is simple, but not easy.

[4] Quoted in *Barron's,* January 7, 2017.

[5] *Barron's*, January 7, 2017.

Asset Class Investment Review

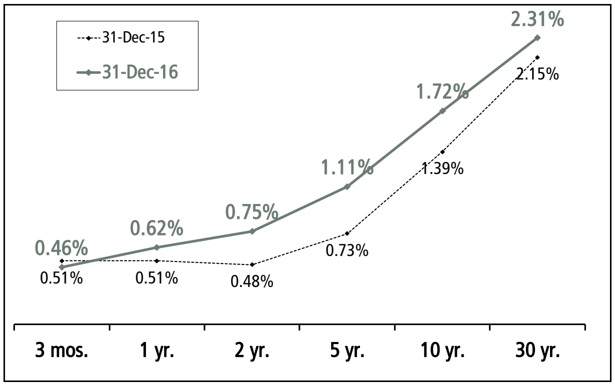
Fixed Income

What a difference one quarter makes! After an uneventful first three quarters of the year and a particularly quiet third quarter, the bond markets underwent a major upheaval in the last three months of 2016. Benchmark Canada ten-year bonds rose from 1.00% to 1.72%, taking them above where they began the year (1.39%). Not only did yields rise this quarter, but the yield curve also steepened – meaning longer maturities rose more in yield than did shorter-term securities. Over the course of the fourth quarter, the difference between the yield of 2-year and 10-year Canada bonds rose from 0.48% to 0.97%, a reflection that investors anticipate more future interest rate increases.

Rates moved higher for two simple reasons. First, from even before the U.S. election, economic data was showing a clear acceleration in U.S. economic growth. Second, with the election of Mr. Trump, changes to economic policy seem likely to stoke both growth and inflation. Thus, with growth accelerating and the labour market in excellent condition, the U.S. Federal Reserve could no longer delay moving the fed funds rate higher, which it did with an increase of 0.25%, on December 14th. Since the crisis in 2008, the thinking of central bankers and bond market strategists has been dominated by a "low for longer" mentality. Financial instability, economic uncertainty, and a reluctance to use fiscal measures to jumpstart growth meant that interest rate policy had to be incredibly stimulative. Part of getting that message across was an understanding, sometimes stated explicitly, that rates would be low, and stay low, for a long time. However, better U.S. economic fundamentals and the prospect of a change in approach from the new administration appear to have broken the "low for longer" mentality.

The pressure from rising rates in the U.S. lifted rates in Canada. But the economic fundamentals of the two countries have diverged significantly. In the U.S., there is a sound argument to suggest that the economy is at capacity and that bottlenecks that might generate inflation are beginning to appear. But in Canada, economic growth remains challenged and inflation has been declining.[6] Historically, U.S. economic performance has explained a lot of what drives economic activity in Canada. The economies of both countries have moved through regular economic cycles of growth and recession in a synchronised fashion. However, due to more protectionist trade policies, impending reductions of corporate tax rates, and more relaxed regulation of energy production, it is likely that Canada's economic performance may well lag any recovery south of the border. In such a case, it is doubtful that the Bank of Canada will feel the need to follow the Fed and raise interest rates.

It is our opinion that interest rates in Canada will drift higher but that a sharp increase is unlikely and unwarranted. We have maintained a maturity profile in our bond portfolio that is shorter than the FTSE TMX Universe Bond Index (the Bond Universe). This approach was very helpful in the fourth quarter. In the last quarter of the year the Bond Universe lost 3.4% and over the course of 2016 it earned 1.7%. Our returns, using the bonds in our Income Fund as a proxy, lost 1.9% and earned 1.7% over the same periods.



Government of Canada Yield Curve

Equities

The fourth quarter added strongly to a very good year for equity investors. As an indicator, the Equity Fund was up 6.3% in the quarter and up 13.3% in 2016.[7] In the quarter, North American equities, and especially our U.S. holdings, did very well. It was a weak quarter for international equities, which were down in Canadian dollar terms.

[6] In December, Statscan reported GDP growth decelerated to 1.5% (YoY) and headline CPI inflation fell to 1.2% (YoY).

[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.

The Canadian dollar experienced big swings in 2016. It strengthened in the first six months and then weakened again in the second half of the year. For the full year, the Canadian dollar strengthened 3.0% against the US dollar, thereby reducing the return from our non-Canadian holdings.[8] Currency changes can be substantial in the short term but over longer time periods, the impact on a diversified equity investor is typically not material.

For equity investors around the world, the fourth quarter was all about the U.S. election. Investors feverishly repositioned their portfolios repeatedly as events unfolded, with different sectors bouncing up and down seemingly daily. Picking and patiently sticking with a quality, reasonably valued portfolio is a characteristic of our long-term oriented investment philosophy. There were no substantial trades in our equity portfolio in the quarter.

Canadian Equities

Nexus's Canadian stocks were up 4.6% in the quarter and largely in line with the TSX Composite's 4.5% return. For 2016, our Canadian stocks had an exceptional year, up 27.1%, and well ahead of the TSX Composite's very strong 21.1% return.

Within Canada, the quarter was a mixed bag. Our direct energy holdings (Suncor, Encana, and Cenovus) and bank stocks did well, due to hopes that OPEC will limit production and an expectation that the banks will fare better in a rising rate environment. Not owning any Materials or Healthcare stocks in Canada was also an assist relative to the TSX Composite. On the other hand, rising interest rates are a negative for our interest-sensitive holdings, such as our Pipeline, REITS and Utility holdings. Finally, our two consumer holdings, Alimentation Couche-Tard and Metro, had a negative quarter as top-down investors rolled out of staples and into "growthier" sectors.

U.S. Equities

Nexus's U.S. equities had another very strong quarter, up 11.1% in the quarter and well ahead of the S&P 500 index's 6.3% return. Our substantial allocations in Financials and Technology, which had been a headwind early in 2016, provided the biggest beneficial impact. Also, CarMax had a great quarter, up 21%, and a big turnaround from earlier in the year. This was pleasant vindication for our patience, as shorter-term investors had driven the stock down in early 2016. Our longer-term U.S. equity returns remain strong on an absolute basis and ahead of the S&P 500.

Other Equity Investments

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

The weak area of our equity portfolio in the fourth quarter was our non-North American holdings. EQIT was up only 0.2% and had a disappointing 1.1% loss in 2016. EMEC was also weak, down 3.0% in the quarter, but, nonetheless, still managed to return an attractive 11.6% in 2016. Multiple related factors conspired to cause investors to switch out of non-North American equities in the last 3 months of the year. This partly stemmed from Trump's negative international trade sentiment that may harm the U.S.'s international trading partners, but also just general international policy uncertainty and a concern that rising interest rates may dampen the growth of emerging markets.

We continue to like the diversification benefit of our non-North American holdings and their longer-term return prospects. Both funds have better dividend yields and substantially lower valuations than the S&P 500 and TSX Composite. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this 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 6.3% in the fourth quarter. This return compares to the 5.1% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 13.3%, but lagged the benchmark return of 14.4%. From a longer-term perspective, our returns for 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

In Canada, the equity market advanced 4.5% in the quarter. Our Canadian holdings modestly outperformed, delivering a 4.6% return. The principal influences on relative performance this quarter came from sector allocations rather than the returns on any individual stocks. The main positive contributors were our avoidance of the Materials and Health Care sectors, each of which fared poorly in the fourth quarter. However, on the negative side was our lack of exposure to Life Insurance companies, several of which had strong quarterly returns.

In the U.S., the equity market advanced 6.3% in the quarter. Our U.S. holdings outperformed, generating an 11.1% return. Our U.S. returns mainly benefitted from our exposure to the Financial sector, which rose 21% in U.S. dollar terms during the quarter. In this sector, all of our holdings, M&T Bank, JPMorgan, Citigroup, and PRA performed very well. We also benefitted from strong recoveries in CarMax and Western Digital. Western Digital presented a positive outlook at its December investor event.

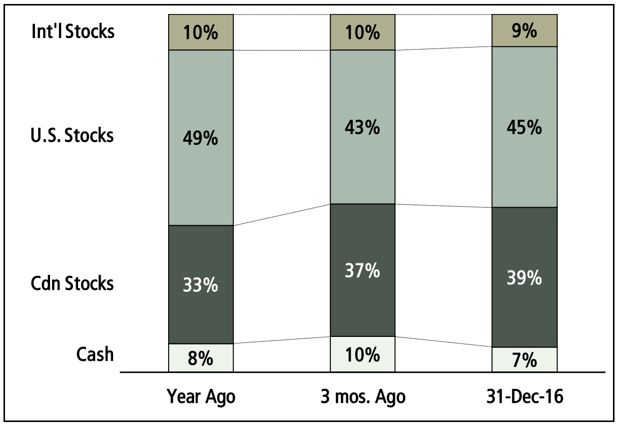
Our international holdings delivered mixed performance in the fourth quarter. The developed markets fund, EQIT, was up a modest 0.2% this quarter and the emerging markets fund, EMEC, fell 3%.

At the end of the quarter, the Fund's cash position was 7%. Our allocation to Canadian stocks was 39%, while U.S. stocks represented 45% of the mix. We have maintained a 9% allocation to markets outside North America and remain confident that this will provide important diversification to our North American investments.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	6.3%	4.6%	11.1%	-1.0%
Benchmark	*5.1%*	*4.5%*	*6.3%*	
One Year				
Fund	13.3%	27.1%	10.1%	3.5%
Benchmark	*14.4%*	*21.1%*	*8.6%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day 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 December 31, 2016



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 3.9% in the fourth quarter. This return compares well with the 2.3% total return of the Fund's benchmark for the same period. In the last 12 months, the Fund has returned 9.7%, but lagged the benchmark return of 11.0%. Taking a longer-term view, our returns for the 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

Our bond holdings lost 1.6% in the quarter, significantly better than the return of the bond benchmark, which declined 3.4%. This relative outperformance is the result of our maintaining a maturity profile of our bonds that is shorter than the bond benchmark during a quarter when yields rose and the yield curve steepened.

In equities, our Canadian stocks performed in line with their benchmark, while our U.S. stocks outperformed by a sizable margin. The strength in the U.S. was in large part due to our holdings of U.S. Financials, which benefitted not only from the rise in interest rates but also expectations of a more accommodating regulatory environment for the Financial sector under the Trump administration.

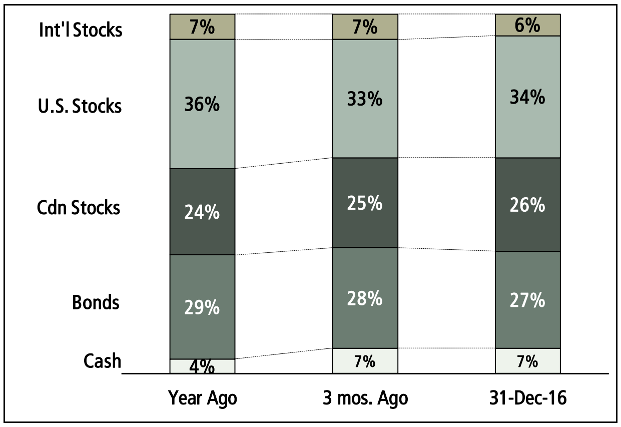
Our international holdings delivered mixed performance in the fourth quarter. The developed markets fund, EQIT, was up a modest 0.2% this quarter and the emerging markets fund, EMEC, fell 3%.

At the end of the quarter, cash represented 7% of the Fund's asset mix, bonds were 27% and stocks accounted for the remaining 66%. Our asset allocation remains close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	3.9%	-1.6%	4.5%	10.6%	-0.9%
Benchmark	*2.3%*	*-3.4%*	*4.5%*	*6.3%*	
One Year					
Fund	9.7%	1.9%	26.1%	9.3%	3.1%
Benchmark	*11.0%*	*1.7%*	*21.1%*	*8.6%*	

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 December 31, 2016



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of negative 0.2% in the fourth quarter. This return compares to the 3.4% loss of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 5.4%, significantly better than its benchmark return of 1.7%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

Our bond holdings produced a loss 1.9% in the quarter, outperforming the bond benchmark which lost 3.4%. This relative outperformance is the result of our maintaining a maturity profile of our bonds that is shorter than the bond benchmark, during a quarter when yields rose and the yield curve steepened.

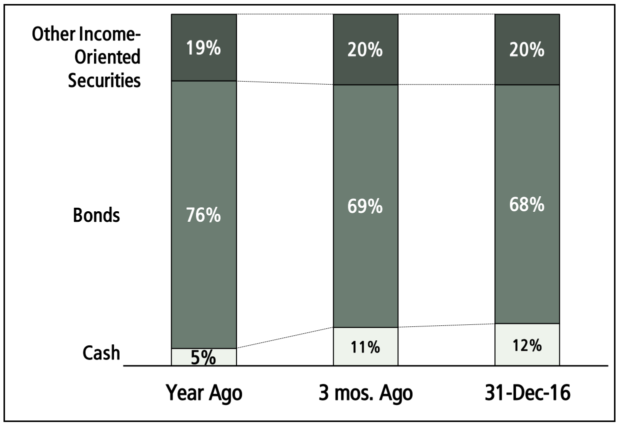
In addition, the Fund benefitted from tailwinds provided by our "Other Income-Oriented Securities": both our Canadian stocks (up 3.3%) and U.S. stocks (up 13.3%) delivered strong quarterly results.

At the end of the fourth quarter, the Fund's cash position was 12%, "Other Income-Oriented Securities" accounted for 20% and the balance, 68%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-0.2%	-1.9%	3.3%	13.3%
Benchmark	*-3.4%*	*-3.4%*		
One Year				
Fund	5.4%	1.7%	27.7%	10.9%
Benchmark	*1.7%*	*1.7%*		

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 December 31, 2016



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund ("NIEF") lost 1.0% in the fourth quarter. This return compares to the 0.8% total return of the Fund's blended benchmark during the same period. Despite the underperformance in the final quarter, over the past year, the Fund returned 3.2%, significantly outperforming the benchmark return of 0.5%. Longer-term returns for both EQIT and EMEC remain solid, with EQIT up 6.2% per year and EMEC up 7.4% per year over the past three years.

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

NIEF holds two underlying funds – EQIT (invested in international developed market equities) and EMEC (invested in emerging market equities) – both of which are managed by JPMorgan Asset Management in the United Kingdom. EQIT and EMEC complement Nexus's North American equity exposure and offer additional diversification. The Nexus Balanced and Equity Funds continue to hold EQIT and EMEC directly.

The most prominent event on the international stage this quarter was the U.S. election. Although it is notionally a North American event, the change in government is expect to ripple through international markets. International investors have numerous concerns related to foreign policy "unknowns", including future U.S. relations with Russia and China, the potential for renegotiation of the U.S.'s international trade treaties and, more broadly, the implications of more protectionist economic policies from the world's major economies. Adding to the uncertainty is the expectation that interest rates are headed higher, which will have far-ranging implications for Europe, Japan and emerging markets.

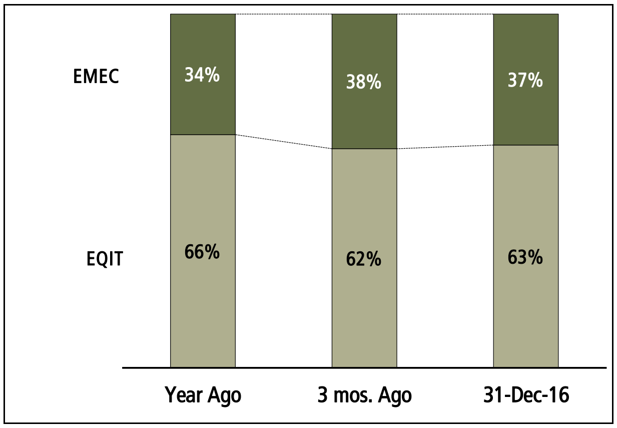
It has been quite common for international and emerging markets to be affected by short-term changes in sentiment – the fundamentals rarely change as much as the market implies. Our longer-term outlook for both EQIT and EMEC remains positive, as we consider both to offer attractive valuations and exposure to a range of well-managed companies with solid growth prospects.

At the close of the fourth quarter, the International Equity Fund's investment in EQIT accounted for 63%, while EMEC accounted for 37%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-1.0%	0.2%	-3.0%
Benchmark	*0.8%*	*1.6%*	*-1.9%*
One Year			
Fund	3.2%	-1.1%	11.6%
Benchmark	*0.5%*	*-2.0%*	*7.9%*

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 December 31, 2016



International Equity Fund Asset Mix