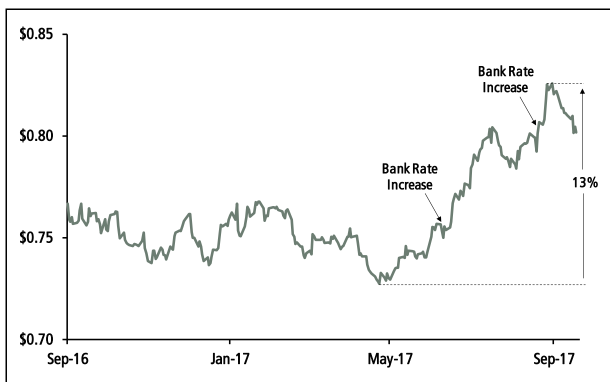
All Good Things Come to an End

The third quarter of 2017 turned out to be another fine quarter for equity investors. Canadian stocks rebounded strongly, and the TSX Composite returned 3.7%.[1] South of the border, the principal U.S. market benchmark, the S&P 500, provided a 4.5% return in U.S. dollars. Similarly, most international equity markets also provided solid positive returns to investors. A result of these gains is that the TSX Composite is near an all-time high, and many U.S. indexes are hitting new all-time highs on almost a daily basis. At the time of writing, the S&P 500 marked its 334th consecutive day without a 5% correction, surpassing the previous record set in 1994.[2] In early October, the U.S. market's principal measure of volatility, the VIX, hit an all-time low.

These achievements typically would be associated with a euphoric market phase. Instead, many Canadian investors feel a certain dismay when they consider their investment portfolios. The rain on the parade arises from the long-awaited rise in interest rates. For 35 years, relentlessly declining interest rates have resulted in excellent bond returns and a huge tailwind for stock returns. However, all good things come to an end, and it seems that a golden era for investing may be over.



Canadian Dollar vs. U.S. Dollar[3]

The Bank of Canada's decision to increase the overnight rate in July and again in September was a loud and clear statement that a new era of higher rates and lower bond prices is at hand.[4] Rising rates had a direct negative effect on the Canadian bond market – a 1.8% loss in the quarter and a 3.0% loss over the last 12 months. They also had an indirect effect on stocks as higher rates in Canada led to a sharp increase in the Canadian dollar and a reduction in value of non-Canadian investments. The 4.5% return of the S&P 500 in the last quarter was only 0.5% when translated into Canadian dollars. Over the course of 2017, the rising Canadian currency has reduced U.S. returns by 8 percentage points.

The "typical" Canadian investor who owns some bonds and has an allocation to U.S. equities is not quite so enthusiastic as the statistics may suggest. Returns were positive, but hardly exhilarating. Moreover, returns in future are likely to be lower than what many have earned over the last 35 years.

Canadian Economy is Slowing

After a surprisingly robust first half of 2017, the Canadian economy seems poised for a more modest second half. Consumer spending, housing and business investment all remain solid, and the September labour market report was strong. While the net number of new jobs created in September was only 10,000, when considered together with August, there were good jobs gains over the last two months of the summer. September's report also was notable for a sharp rise in full-time positions. As well, year-over-year wage growth of 2.2% was a welcome relief after several months of disappointing increases.

Despite these positive trends, however, there have been some more recent disappointments. Specifically, a weak July GDP report was followed by a negative surprise in the August merchandise trade account. Canada posted a $3.4 billion trade deficit in August compared to expectations for a $2.6 billion shortfall. The negative news was mostly from exports, which are down 11% in value since the peak in May. Clearly, the sharp increase in the Canadian dollar over the last 6 months is seriously hindering our export sector.

Going forward, we expect a positive but more modest pace of growth in Canada. However, we are concerned that ongoing NAFTA renegotiations – which don't seem to be going very well – and pending increases in the minimum wage in many parts of the country could provide additional brakes on an economy that is already slowing.

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1 All returns referred to in this section are total returns.

2 *Barron's*, October 7, 2017.

3 C$ strength is mostly against the U.S. dollar. It has not been especially strong against other currencies.

4 While the Bank of Canada was most aggressive in raising rates, the U.S. Federal Reserve and European Central Bank also signaled less accommodative monetary policies going forward.

An Expanding Global Economy

While Canadian growth may be slowing from its vigorous first half, U.S. economic growth remains strong. In particular, the September purchasing managers' manufacturing survey from the Institute of Supply Management reached a level of 60.8, well ahead of the expectation for 58.0, and the strongest reading since May, 2004. Any reading above 50 suggests an expanding economy, and a reading above 60 is unusual. It reflects high levels of optimism in the U.S. industrial sector for the period ahead. U.S. light vehicle sales also are booming, having reached an annual rate of 18.5 million units in September. This was also much higher than expected and suggests consumers are also feeling confident.

Given the devastation wrought by hurricanes Harvey and Irma, investors were a little unsure what to expect in the monthly labour report for September. While it turned out that 33,000 jobs were lost, compared to an expectation for 80,000 jobs created, it was readily apparent that weather was responsible for the shortfall. In fact, the official unemployment rate dropped to 4.2%, a new low for the current expansion. Equally important, average hourly earnings grew at a 2.9% pace year-over-year, further evidence that the U.S. consumer is in good shape.

Last quarter we remarked on the growing momentum of the global economy. The last three months saw purchasing manager surveys strengthen in every major economy in the world. Both in North America and abroad, the fundamental economic backdrop for investors has not been so positive for a while.

Investment Outlook

Those who attended our recent investment review sessions, or who looked at the presentation online, will know that we believe that the most likely outcome for markets in the period ahead is for modestly positive returns. As described above, the prospects for ongoing economic growth are good, and this likely will translate into higher corporate profits and higher stock prices.

However, there are many real and growing risks to the most likely outcome. Geopolitical risks, such as the tensions with North Korea and Iran, and the Brexit negotiation between the UK and EU are near the top of the list. Canadians need to pay special attention to the NAFTA talks, as a failure to reach agreement with the U.S. and Mexico could be a serious hit to our economy. And within the U.S., political dysfunction rarely has been more acute. Optimism lingers that tax reform can be achieved, but we think skepticism is warranted, considering the Trump Administration's failure on healthcare reform and some controversial aspects of the tax proposals. In particular, the new tax regime is expected to generate massive budget deficits for which there is no obvious solution.

At this confusing moment in financial markets, we believe it is more important than ever to stick to one's long-term financial plan and asset mix. Some may think current circumstances warrant caution and wish to lower their exposure to equities. Since the most likely scenario is for further gains in markets, these investors would miss out.

Others have questioned the logic of owning bonds, particularly given the recent decline. Over time, bond returns will be positive, but low. Their principal purpose is to provide stability to portfolios in times of distress. To be sure, some investors have the luxury of eschewing bonds. But these are investors with long time horizons and who need little or no income from their portfolio. The majority of us need some measure of safety when the next downdraft occurs. It is picking the right balance that is crucial.

As we wrote last quarter, properly structured portfolios are meant to address what *could* happen rather than anticipate what *will* happen. No one can know the latter. But thoughtful investors should always be prepared for the former. A sensible asset mix and investment in high quality companies allow one to prosper during good times and sleep well at night knowing they are also prepared for the unexpected, whenever it may occur.

Asset Class Investment Review

Fixed Income

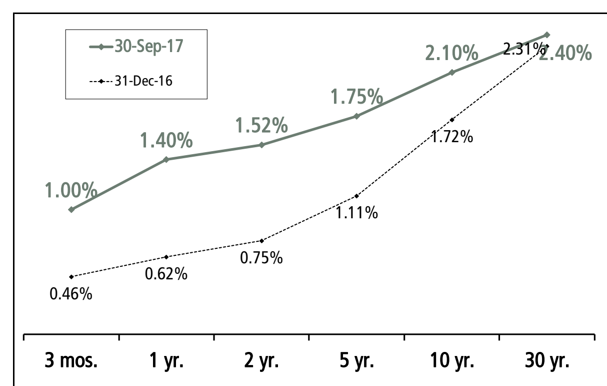
It was a busy summer in bond markets, continuing a more active trend that began late in the second quarter. Activity was driven by a growing belief that the multi-decade trend of successively lower Canadian interest rates ended in the summer of 2016 when 10-year Canada bonds yielded less than 1.0%. Since then, a gradual retracement to higher yields has been underway. Over the course of this past quarter yields began to rise more quickly, propelled by two Bank Rate increases – in July and September. The Bank of Canada's changed approach to monetary policy came on the back of strong economic growth which obviated the need for the "emergency" rates that had been instituted in early 2015 to address the effect of collapsing oil prices. In the quarter just ended, 1-year rates jumped from 0.97% to 1.40% and 10-year rates moved from 1.76% to 2.10%.

Ultra-low rates were justified when the global economy was dealing with the fallout from the Great Recession. But it is now clear that global growth is improving and emergency monetary policies are no longer required – especially in the U.S. and Canada, where both economies have moved well beyond the fallout from the credit crisis.

One notable development this year is the unusually active new-issue bond market. Corporate bond issuance in the first 9 months of the year was $93 billion, an increase of 14% over the same period in 2016.[5] Unsurprisingly, considering their budgetary positions, provincial government issuance has also been high. Between domestic and foreign markets, the provinces have issued almost $64 billion of new debt. That's an 11% increase over the same period last year.[6] Despite the record amount of issuance, corporate and provincial spreads have tightened. In fact, in the year-to-date an index of single-A corporate bond yields has narrowed from 1.41% over Canada bond yields to 1.24%.[7]

The motivation of issuers is straightforward. Corporate borrowers want to lock-in abnormally low borrowing rates while they still can. However, the appeal of these low rates to bond buyers is less clear. We know that capital markets are global in nature and that money generally flows freely across borders. We suspect that a portion of the demand for Canadian bonds yielding not much more than 2% or 3% emanates from yield-starved investors in Europe and Asia where official monetary policies are still fully committed to quantitative easing and the desire for zero or even negative interest rates. From our perspective here in Toronto, the rates available in the bond market remain unappealing and are made even less so by the tightening of spreads. But for the short-term stability that bonds provide in a dangerous world (and it is a dangerous world) we remain wary of committing client capital to an asset class offering such meagre prospective returns.

Notwithstanding the recent increase in yields, our strategy remains unchanged. We have maintained a concentration in shorter-maturity bonds, and emphasized higher-quality credits. In the third quarter we outperformed our benchmark, the FTSE TMX Bond Universe Index (the Bond Universe). Our bond portfolio lost 0.8% while the Bond Universe gave up 1.8%. In the last year our return has been negative 1.8%, while the Bond Universe declined 3.0%.



Government of Canada Yield Curve

Equities

The third quarter of 2017 didn't *feel* great for equity investors. But it was actually a decent quarter. To illustrate, the market benchmark return for the Equity Fund in the quarter was 2.3%, which on an annualised basis is better than the long-term average return for the equity markets. The Equity Fund's actual return was 2.2% and approximately in line with the Fund's benchmark. Over the past 12 months, the Fund returned 13.5%, which is nicely ahead of the benchmark's 10.4% return.[8] As we

[5] Barry Critchley *Off the Record* Financial Post October 3rd, 2017.
[6] Casgrain and Co.
[7] BMO Capital Markets.

[8] All the return data in the Equities section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar.

have pointed out before, we expect that future equity returns will be lower than recent returns.

For the quarter, all asset classes held by the Fund generated positive returns. Our Canadian stocks returned 3.6% and our international equity holdings did well, with EQIT returning 2.5% and EMEC up a strong 4.3%.[9] The laggard was U.S. equities. Our U.S. portfolio increased a modest 0.6%, which was in line with the S&P 500.

After awakening in the second quarter, the Canadian dollar continued to strengthen last quarter, such that it "robbed" investors of 4.0 percentage points of the S&P 500's third quarter return. For the year-to-date, our currency's strength had the effect of reducing the Canadian dollar return on our U.S. equity holdings by 8.0 percentage points.

Canadian Equities

Nexus's Canadian stocks were up 3.6% in the quarter and 12.8% over the last 12 months. This was in line with the TSX Composite's return in the quarter and well exceeded the index's 9.2% return for the 12 months.

For the quarter, the highlights of our Canadian portfolio were our energy (up 13.2%) and industrial (up 9.8%) holdings. Cenovus, Encana, and Suncor all had big recoveries after a dismal first half of 2017. In the industrial sector, one of our long-term holdings, Toromont, announced the $1 billion acquisition of Hewitt Group, which was very well received by the market. Hewitt is the Caterpillar dealer in Quebec, the Maritimes and western Labrador. Finning, our other Caterpillar dealer, also traded up. These two holdings returned 20% and 13% respectively in the quarter.

U.S. Equities

Nexus's U.S. equities were up 0.6% in the third quarter, approximately in line with the S&P 500's return of 0.5%. Over the twelve months, our U.S. holdings have done well, up 17.2% and well ahead of the S&P 500's 12.8% return.

Our consumer discretionary stocks added the most value in the quarter, with CarMax and Dollar General both up by double digit percentages. Both are doing well in a strengthening U.S. economy. Gilead and HP Inc. also had great quarters. Gilead announced the acquisition of Kite Pharma, which will broaden and strengthen its drug portfolio. At the other end of the spectrum, PRA Group traded down last quarter, largely on a re-assessment by some analysts of its future profitability, which we think is an over-reaction.

During the quarter we sold J.M. Smucker, a successful investment we had held since 2009. The company owns many well-known brands, such as Folgers, Jif, Crisco, Kibbles 'n Bits, as well as Smucker's, of course. This stable business had served us very well since the credit crisis and during the subsequent recovery. Looking ahead, we see cloudier skies for consumer brands in general, as the internet provides consumers with plenty of current information on emerging brands, such that the value of long-established and sometimes "faded" brands is being eroded. Similarly, the big box chains are prioritizing their private label brands ahead of the established consumer brands.

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).[10]

Both funds had a good quarter, as one might expect in a period of global economic growth. EQIT was up 2.5% last quarter and up 15.4% over the last 12 months. EMEC was up 4.3% in the quarter and up 16.8% for the 12 months. These holdings have added useful diversification to our core North American equity portfolio over the long term and have also been value-additive to returns over the quarter and past 12 months. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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

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

[10] 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 1.9% 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 13.5%, better than the benchmark return of 10.4%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or 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 gained 3.7% in the quarter. Our Canadian holdings captured most of those returns, gaining 3.6% in the quarter. The main positive contributors were stocks in the industrials sector, particularly Toromont, which announced a significant acquisition. We also benefitted from a rebound in the stock prices of several energy companies.

In the U.S., the equity market advanced 0.5% in the quarter in Canadian dollar terms. Our U.S. holdings modestly outperformed, generating a 0.6% return. This quarter, our U.S. returns benefitted from owning CarMax, Dollar General and Gilead. However, these positives were partially offset by weak returns from PRA Group, GE and Western Digital.

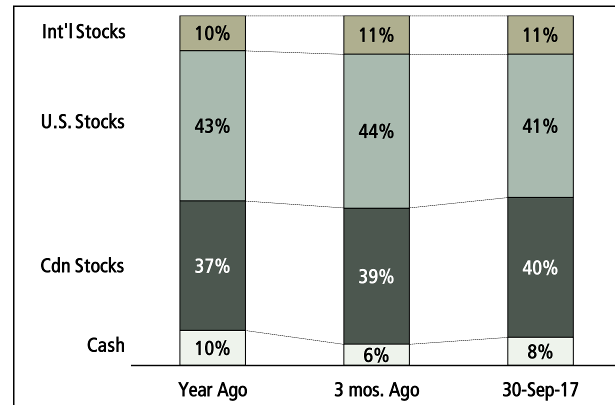
Our international holdings delivered positive returns in the quarter. The developed markets fund, EQIT, was up 2.5% this quarter, and the emerging markets fund, EMEC, rose 4.3%.

At the end of the third quarter, the Fund's cash position was 8%. Our allocation to Canadian stocks was 40%, while U.S. stocks represented 41% of the mix. We have maintained an allocation of 11% 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	1.9%	3.6%	0.6%	3.2%
Benchmark	*2.1%*	*3.7%*	*0.5%*	
One Year				
Fund	13.5%	12.8%	17.2%	16.0%
Benchmark	*10.4%*	*9.2%*	*12.8%*	

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 September 30, 2017



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 0.8% in the third quarter. This return compares to the 1.0% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 8.3%, surpassing the benchmark return of 5.9%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or 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 0.8% in the quarter, but fared better than the FTSE TMX Universe Bond Index, which lost 1.8%. The duration (weighted maturity) of our fixed income portfolio remains shorter than the bond index. This positioning helped by limiting our exposure to the negative effects of rising interest rates.

As a reminder, when interest rates rise, bond prices decline, which can produce a negative return for that time period. The total return to maturity ("yield-to-maturity") from each bond's purchase date doesn't change and remains positive. Assuming no trading, this means that, after a period of negative returns, the bond returns in future periods go up.[11]

In equities, our Canadian stocks returned 3.0% in the quarter. Our U.S. equities also delivered positive returns, up 1.0%, despite strong headwinds from the strengthening Canadian dollar.

Our international holdings also generated positive returns in the quarter. The developed markets fund, EQIT, was up 2.5% and the emerging markets fund, EMEC, rose 4.3%.

At the end of the quarter, cash represented 6% of the Fund's assets, 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	0.8%	-0.8%	3.0%	1.0%	3.2%
Benchmark	*1.0%*	*-1.8%*	*3.7%*	*0.5%*	
One Year					
Fund	8.3%	-1.6%	11.7%	17.1%	15.7%
Benchmark	*5.9%*	*-3.0%*	*9.2%*	*12.8%*	

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 September 30, 2017

	Year Ago	3 mos. Ago	30-Sep-17
Int'l Stocks	7%	8%	8%
U.S. Stocks	33%	31%	31%
Cdn Stocks	25%	25%	26%
Bonds	28%	29%	29%
Cash	7%	7%	6%

Balanced Fund Asset Mix

[11] As fixed income managers, our role is to anticipate these interest rate changes and position (or re-position) the bond portfolio accordingly. This trading however, could potentially have the effect of worsening, rather than improving returns.

Nexus North American Income Fund

The Nexus North American Income Fund lost 0.6% in the third quarter. This return compares to the 1.8% loss of the Fund's market benchmark during the same period. In the last 12 months, the Fund has generated a *positive* total return of 0.9%, materially better than the benchmark's 3.0% *loss*. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or above the benchmark and are very attractive on an outright basis. More detail on the Fund's performance is displayed in the table below.

Our bond holdings gave up 0.8% in the quarter, outperforming the FTSE TMX Universe Bond Index which lost 1.8%. This relative outperformance is a consequence of our choice to maintain a bond portfolio comprised of shorter-maturity bonds, which helped by limiting our exposure to the negative effects of rising interest rates.

As a reminder, when interest rates rise, bond prices decline, which can produce a negative return for that time period. The total return to maturity ("yield-to-maturity") from each bond's purchase date doesn't change and remains positive. Assuming no trading, this means that, after a period of negative returns, the returns in future periods go up.[12]

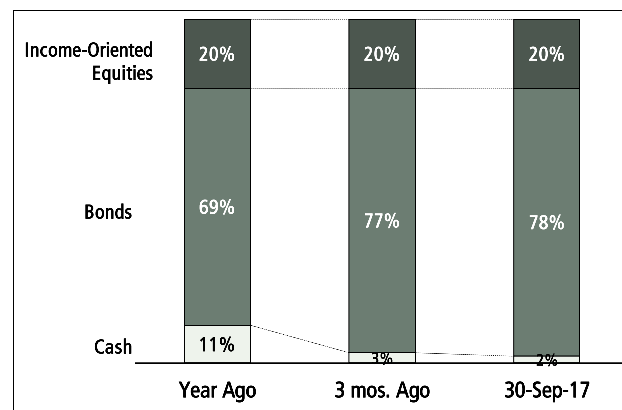
The Fund continued to benefit from tailwinds provided by our investment in income-oriented equities, although the few U.S. equities we hold were negatively affected by the stronger Canadian dollar.

At the end of the third quarter, the Fund's cash position was 2%, income-oriented equities accounted for 20% and the balance, 78%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-0.6%	-0.8%	1.2%	-0.7%
Benchmark	*-1.8%*	*-1.8%*		
One Year				
Fund	0.9%	-1.8%	12.0%	11.4%
Benchmark	*-3.0%*	*-3.0%*		

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 September 30, 2017



Income Fund Asset Mix

[12] As fixed income managers, our role is to anticipate these interest rate changes and position (or re-position) the bond portfolio accordingly. This trading however, could potentially have the effect of worsening, rather than improving returns.

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).[13]

In third quarter, NIEF had a good return of 3.2% and was ahead of its blended benchmark return of 2.0%. Both EQIT (up 2.5%) and EMEC (up 4.3%) did well and were ahead of their respective benchmarks. Over the past twelve months, EQIT returned 15.4% and EMEC 16.8%. These returns are well in excess of the long-term annual average returns from equities, so things, by definition, will not always be this good!

In the first phase of the post-credit crisis recovery, the U.S. was the engine pulling the rest of the world along. Now, the global economy is expanding in a synchronized way, but with the non-U.S. world outpacing the U.S. in GDP growth. This has inevitably led to an acceleration in corporate earnings growth around the globe. In turn, international equity markets have done well in general and some have had very strong year-to-date returns: China is up 33% and each of France, Germany, India and Brazil have had better than 15% year-to-date returns (all expressed in Canadian dollars). Collectively, as emerging market economic growth continues to far outstrip the developed world, emerging market countries become less dependent on the developed world as a source of export-driven demand.

Rather, these countries' domestic economies are becoming powerful growth engines in their own right, driven by increasing standards of living and urbanization. As a quick anecdote, Chinese tourist spending around the globe has "gone vertical" and in total is now more than double that of U.S. tourists, whereas in 2005 it was around 25% of the U.S. level.[14]

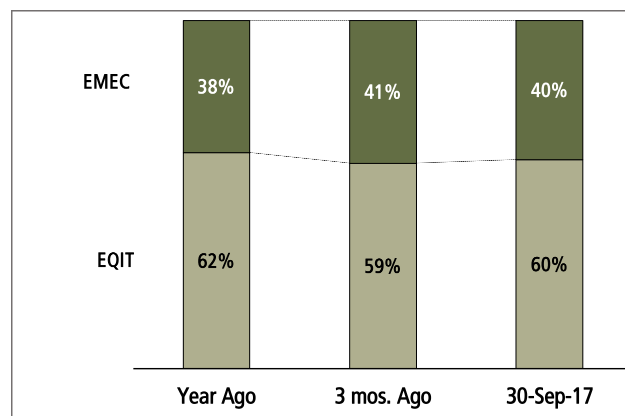
Whilst the U.S. dollar continued its recent weakening trend against the Canadian dollar, it has also been weakening against other global currencies. As a result, on a year-to-date basis, the Canadian dollar has not changed much in value against the basket of international currencies underlying our international equity holdings. Consequently, the Canadian dollar has not been a drag on our recent international returns. One implication is that the natural shifts in currencies that occur at different rates and at different times is one of the reasons that international equity exposure adds diversification to our North American holdings and reduces volatility of our entire equity portfolio relative to a pure North American portfolio.

The Fund's proportional exposure of developed markets to emerging markets is about 60:40, whereas the Fund's benchmark is 75:25.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	3.2%	2.5%	4.3%
Benchmark	*2.0%*	*1.4%*	*3.8%*
One Year			
Fund	16.0%	15.4%	16.8%
Benchmark	*14.2%*	*13.3%*	*16.5%*

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, 2017



International Equity Fund Asset Mix

[13] 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.

[14] Avery Shenfeld, CIBC Economic Insights, September 21, 2017.