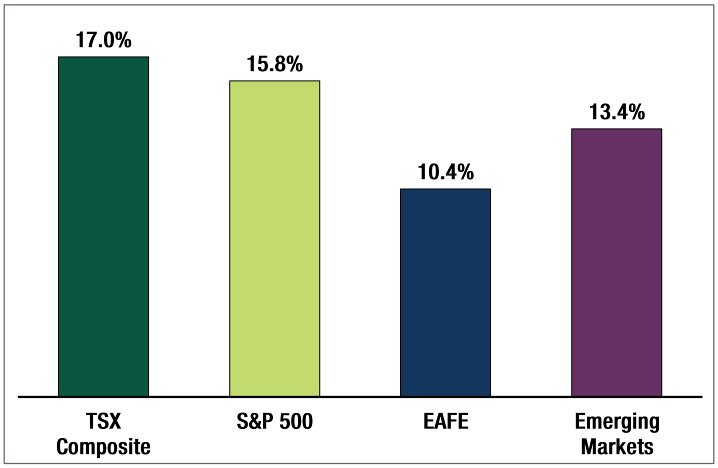
The Nexus Report

Second Quarter, 2020

Investment Outlook

A New Bull Market?

The longest bull market in history ended abruptly in mid-February. Stock markets around the world collapsed in the face of the COVID-19 pandemic. However, the stock market rebound investors have enjoyed over the last three months has been almost as dramatic. Could the COVID-19 bear market be the shortest in history?



Second Quarter 2020 Stock Market Total Returns (C$)

In the U.S., the S&P 500 rose 20% during the quarter, its biggest quarterly gain since the final quarter of 1998.[1] Technology stocks were among the biggest contributors, as evidenced by the technology-heavy NASDAQ's 30% gain. While virtually every market index around the world remains in negative territory in the year-to-date period, the NASDAQ is up a remarkable 16%.

Canada's TSX Composite Index surged 16% over the course of the last quarter. Almost every sector of the market had a meaningful recovery, but the Canadian market was particularly dominated by gold and technology stocks.[2] Moreover, the market darling above all else remains technology company, Shopify, which continued its dizzying ascent. Shopify's gains led it to finish the quarter as the largest company in Canada, measured by market capitalization.[3]

As nice as it would be to think we are at the dawn of a new bull market, investor sentiment became increasingly wary as the quarter drew to a close. Perhaps the rally in stocks is just a little too good to be sustainable?

The Great Re-Opening

One of the few things that is certain in this period of uncertainty is the disastrous performance of the U.S. economy in the second quarter. For all of April, and much of May, COVID-19 lockdowns and shelter-in-place orders virtually closed the economy. GDP is expected to contract at the fastest rate since the Great Depression. More than 20 million Americans lost their jobs, and the official unemployment rate climbed to 14.7% at its peak, a breathtaking change from the 3.5% rate in February. A broader measure of unemployment – known as U-6 – peaked at 22.8% in April.[4] Many household-name retailers have filed for bankruptcy, including J.C. Penny, Neiman Marcus, and J. Crew. As this report went to press, 200-year-old Brooks Brothers also threw in the towel.

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[1] Returns in this section exclude dividends and are expressed in local currency.

[2] While the overall TSX return is still -9.1% YTD, the gold sector is +34.2% and the technology sector is +61.8%, excluding dividends.

[3] We pointed out in our recent investment review presentation that Shopify is the 4th company over the last several decades to surpass the Royal Bank in value. None of the previous three, Nortel Networks, Blackberry, and Valeant Pharmaceuticals, stayed in that position for long or had a bright future.

[4] Seasonally adjusted figure. U-6 adds to the unemployed those workers who are marginally attached to the labour force.

Most investors are not focused on how bad the current quarter will be, but on the trajectory for economic growth in the future. To start, we believe that a truly permanent recovery can only come when a COVID-19 vaccine is widely available, or when treatments become highly effective. On that front, there has been a lot of encouraging news. Never in the course of human history has so much scientific know-how and so many economic resources been dedicated to a single objective. There is no way to know for sure how quickly a vaccine can be produced or how effective it will be. But much is being accomplished and the developments we see every week form a reasonable basis for optimism.

As well, certain U.S economic statistics are trending in an encouraging direction. The June labour market report revealed that 4.8 million jobs were created during the month, far in excess of the 3.2 million expectation and the biggest monthly job gain since data collection began in 1939. May's employment gain also was revised higher, to 2.7 million new jobs created, from the previous estimate of 2.5 million. The official unemployment rate dropped to 11.1% from 13.3%. Stores began to re-open in May and retail sales were 17.7% higher than in April, more than twice expectations.

Despite some glimmers of hope, however, there is real reason to be cautious about the path of the U.S. recovery. The June labour market report was based on data gathered in early June, at a time when many regions were pursuing an aggressive re-opening strategy. Since then, a surge of infections in the south and southwest has caused re-opening plans to be put on hold in some areas and reversed in others. As well, despite the strong job growth, there are still 14.7 million fewer jobs today than in the pre-pandemic period. The 11.1% unemployment rate suggests that 17.75 million Americans are "officially" unemployed. Yet 31.5 million continue to claim unemployment benefits. There is no doubt that conditions today are better than in April, but significant risk remains, and the road back to a solid economy is long and uncertain.

Green Shoots in Canada

Second quarter GDP in Canada is expected to be similarly disastrous. In April, it declined 11.6%, the largest drop on record. This was on top of the 7.5% decline in March. As in the U.S., Canada's economic setback will be the most profound since the Great Depression.

Early in July, the Bank of Canada's quarterly Business Outlook Survey also painted a fairly dire picture of the Canadian economy. It highlighted that expectations for employment, business investment, and household spending were strongly negative in all regions of the country. Its indicator dropped sharply, close to the trough experienced in the 2008-2009 global financial crisis. While this report is based on surveys from mid-May until early June – prior to lockdowns beginning to ease – updated commentary from the Bank indicates that it still sees the recovery in aggregate demand being gradual and drawn-out, despite the excitement around re-opening. Not all jobs will come back quickly.

However, there are also signs of light at the end of the tunnel in Canada. One of the most watched economic data series, the Ivey purchasing managers' survey, jumped 19 points to 58.2 in June. This is not only a huge improvement, but its level above 50 is historically a reliable indicator that positive economic growth lies ahead. The housing market has also rebounded sharply. Toronto home sales surged in June, with prices rising 12% over the same period in 2019. Volume rose 84% from May and was about the same as last year. Active listings are still lower than a year ago, but there is clear improvement. Our May merchandise trade report also revealed a strong increase in exports, as the auto and energy sectors enjoyed a recovery from very low levels. In most areas of the economy there is much ground to make up to reach pre-pandemic levels, but there is clear progress being made.

Market Outlook

The great debate among investors at present is whether the market rally we've enjoyed is out of synch with the more somber outlook for the economy and corporate profits. For certain, current stock market levels are not sensible compared to likely profits in 2020, and maybe not sensible relative to 2021 profits. Investors appear to be looking out to 2022 as a time when things get back to "normal". It seems likely that by 2022 a vaccine will be available and economic growth should be back on track. While current stock market levels are not cheap relative to forecast 2022 earnings, they are not extreme, particularly compared to the low level of interest rates.

Investors also seem to be banking on the success of economic stimulus coming from both governments and central banks. This stimulus is meant to bridge the gap from the period of economic lockdown to the time when natural economic momentum returns. To be sure, there are real concerns over who will eventually pay for this. There is no easy and obvious answer. We must keep it in mind as we make investment decisions in the years ahead. Today, the stimulus is necessary, but a heavy debt burden will remain.

Of course, another elephant in the room is the upcoming U.S. election. We think many Canadians hope for a Biden victory, and recent polls suggest this is possible. But a Biden victory is not necessarily good for investors, as his platform promises higher corporate taxes and more burdensome regulation. Of course, the incumbent President has proven himself totally unpredictable; there is much uncertainty over how the election will play out and what surprises may be in store.

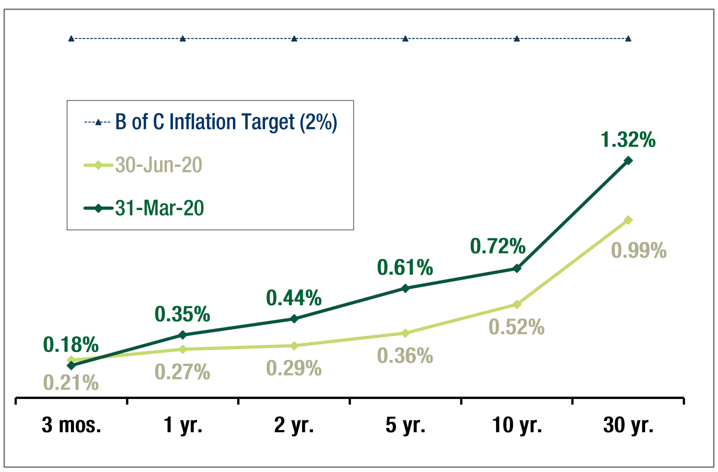
Despite significant short-term uncertainty, we remain confident that good long-term opportunity remains for patient investors. Well-run businesses will prosper over time. As always, our job is to find them and stick with them.

Asset Class Review

Fixed Income

Interest rates continued to decline substantially last quarter, guided lower by continued extraordinary monetary easing and financial intervention from central banks. While the key Bank of Canada Policy Rate was left unchanged at 0.25%, short of the Bank adopting a policy of negative interest rates, there is not much lower for it to go. More on that later.

In the second quarter the effect of Bank of Canada support to credit markets was on full display. Corporate and Provincial Bond buying programs facilitated a record period of bond issuance as borrowers raced to raise liquidity in preparation for coping with the pandemic. Fortified by the knowledge that the central bank was there as a buyer in support of the bond markets, investors had the confidence to take down record amounts of new bond supply. Despite the flood of issuance, dismal economic results, and deteriorating credit metrics (e.g. interest coverage), credit spreads narrowed dramatically. An index of investment grade corporate bond spreads narrowed from +3.49% at the end of March to +2.32% at the end of June, evidence that corporate solvency concerns, so worrying only 3 months ago, were much less of an issue.[5]



Government of Canada Yield Curve

Also in the quarter, the general level of interest rates continued to decline. As shown in the chart, two-year yields fell 15 basis points (from 0.44% to 0.29%), while ten-year yields fell 20 basis points (from 0.72% to 0.52%).[6] We are closing in on what economists call the lower bound for interest rates. Unless one thinks rates will fall below zero, further small cuts will have marginal, if any, effect on the creation of credit. In fact, they might only compound a problem that was already a pressing issue before the pandemic – the extent of household debt in Canada in proportion to incomes, and the potentially destabilizing effect that a period of economic weakness might have on the functioning of the banking system. Neither outgoing Governor Poloz nor new Governor Macklem has expressed much support for a negative interest rate approach. We concur with this sentiment. It is our belief that ultra-easy monetary policy has been an effective response to the present crisis, but it is a blunt instrument at best. Instead, fiscal policy targeted at specific areas of acute economic weakness is far more likely to prove effective in leading the economy back to a more stable footing. We will have very low interest rates for some time yet, but our belief is that falling rates are largely behind us.

For now, economic weakness is keeping inflation pressures at bay, and this will be the case until there are signs of a substantial recovery in economic activity, particularly employment. But even at low levels of inflation, bonds offer meagre future returns. As we have been positioned for some time, our holdings are concentrated in shorter-maturity securities and higher-quality issuers. The duration of our portfolio is 3.6 years as compared to the FTSE Canada Universe Bond Index of 8.2 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.[7] It is a portfolio designed to hold up during difficult markets. Due to our shorter-maturity profile, we missed some of the benefit from this quarter's decline in interest rates. As well, our high-quality emphasis meant that we benefitted less than strategies that focus on lower-quality credits. The bond return in our Income Fund was 3.7% for the quarter, while the FTSE Canada Universe Bond Index returned 5.9%. Over the last 12 months, our bond holdings returned 5.4%, which trailed the 7.9% return of the FTSE Canada Universe Bond Index.

[5] Bloomberg Barclay Canadian IG Credit Spread Index.
[6] A basis point is one-hundredth of one percent.
[7] Returns and credit information are for the bond portion of the Nexus North American Income Fund, which serves as the model for all bond portfolios at the firm.

Equities

COVID-19 has made for an unpleasant period for equity investors. An abrupt, late quarter decline in the first quarter was followed by a rapid recovery in the second. But this has still left the equity markets down for the year-to-date and the outlook remains uncertain. The Equity Fund was up 13.2% in the quarter, trailing the 15.6% recovery for the Fund's market benchmark. For the past 12 months, the Equity Fund had a total return of 0.8%, trailing the 4.4% gain for its benchmark.[8]

The equity portfolio performed well in the quarter. Our Canadian stocks returned 9.5%, our U.S. stocks 19.8%, and our international holdings were up 14.8%.[9] The underperformance relative to the benchmark, as explained more fully below, is driven by 6 stocks that we don't own in Canada: Shopify and the gold stocks.

Canadian Equities

Nexus's Canadian stocks returned 9.5% in the quarter, but are down 12.5% for the last 12 months. By comparison, the TSX was up 17.0% and down 2.2% over the same periods.

For perspective on the 12-month return, recall that the year-ago starting point (June 30, 2019) was a strong one. The TSX had experienced a major swoon in December 2018, but by mid-2019 had recovered strongly, such that it was up 16.2% for the first half of 2019, and continued to drift higher over the remainder of 2019. In the first quarter of 2020, the TSX declined 20.9%, setting up well for the partial recovery of 17.0% in the second.

Behind the returns for the overall TSX Index, an unusual story has been unfolding. Shopify, a software company that provides services to online merchants, rocketed up 150% in the first 6 months of 2020 to become the largest company in the TSX by market capitalization. Shopify's return meant that this single stock contributed a positive 577 points to the TSX Index year-to-date, whereas the TSX Index as a whole lost 1,548 points over the same period. Shopify has done a remarkable job, but it has yet to turn a profit. Given our investment philosophy of buying quality stocks at a reasonable valuation, Shopify doesn't fit our investment criteria for either profitability or valuation.

Similarly, the top five gold stocks in the TSX each had year-to-date returns in the 40% to 60% range and contributed a further 356 points to the Index for the year-to-date. While the gold stocks can have shorter periods of strong performance, they have been uneven performers over longer time periods. Without these 6 stocks, the return on the TSX Index would have been dramatically lower.

Last quarter several Canadian holdings, Cenovus, Magna, CAE and Finning, had strong bounce backs, but are still down on the year-to-date. Our other top performer, Alimentation Couche-Tard, has been resilient in a COVID world and was one of the few stocks on the TSX that are up year-to-date.

During the quarter, we purchased George Weston for the portfolio. It has solid profitability and a positive outlook in a COVID-stressed world. Weston's has three businesses: several grocery banners, including Loblaw and No Frills; Choice Property REIT; and Weston Bakery.

U.S. Equities

Our U.S. equity portfolio increased 19.8% in the second quarter and 16.6% over the past 12 months, outperforming the S&P 500, which rose 15.8% and 11.9% for the respective periods. The quarterly performance of our U.S. portfolio in U.S. dollars was even stronger – around 24% – but the stronger Canadian dollar in the second quarter reduced returns when measured in Canadian dollars.

In the quarter we had several strong performers that are also up for the year-to-date, such as Microsoft, Apple and Dollar General. Ovintiv, an oil and gas stock, had a strong bounce back, but is still down on the year.

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).[10]

Much like in North America, both funds had strong bounce-backs in the second quarter and are up for the past 12 months. For the quarter, EQIT returned 13.2% and EMEC 17.1%. Over the previous 12 months, their returns were 1.4% and 4.4% respectively. The manager of both funds, JPMorgan Asset Management, delivered better returns than for comparable market indices. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

[8] 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.

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

[10] 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 rose 13.2% in the quarter, marking a strong rebound from the steep first quarter decline. The gains reflect the equity market's increasing optimism for an economic recovery, some success in COVID-19 containment in certain regions and record central bank stimulus. Performance over the last 12 months is modestly positive, with strength in our U.S. stocks outweighing a difficult period for our Canadian holdings. From a longer-term perspective, our returns remain near the benchmark and have been healthy on an absolute basis.

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

In Canada, our holdings generated a 9.5% gain with several of the more cyclical companies (such as Magna, CAE and Finning) advancing between 20 and 35% in anticipation of improving economic conditions. While the overall gain was solid on an absolute basis, it trailed the TSX Composite, which rose 17% due to large gains in the gold mining stocks and several Canadian information technology companies.

Our U.S. holdings produced much stronger gains, rising 19.8% in the quarter. None of our stocks declined during the period. CarMax, a large retailer of used cars, stood out with a 66% gain (in U.S. dollars) in the quarter as it re-opened stores and rolled out new digital selling capabilities. Several of our U.S. technology stocks also performed well, including Alphabet, Apple, Facebook and Microsoft.

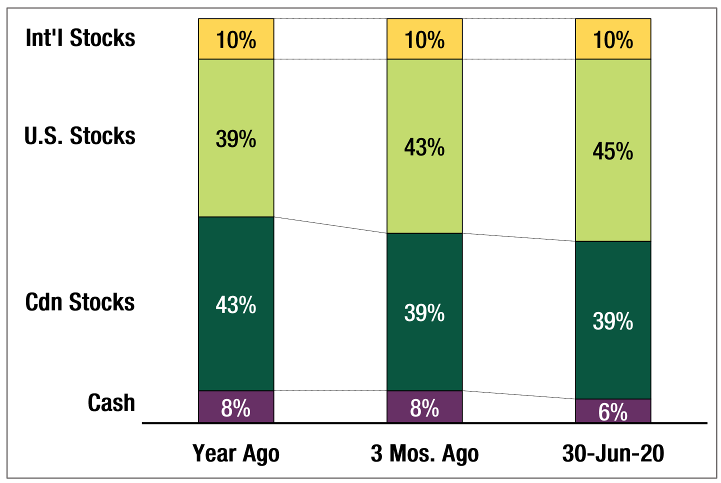
Our international holdings also participated in the equity market rally. The developed markets fund, EQIT, rose 13.2% in the quarter and the emerging markets fund, EMEC, rose 17.1%.

At the end of the second quarter, the Fund's cash position was 6%. Our allocation to Canadian stocks was 39%, while U.S. stocks represented 45% of the mix. We have maintained an allocation of 10% 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	13.2%	9.5%	19.8%	14.9%
Benchmark	*15.6%*	*17.0%*	*15.8%*	
One Year				
Fund	0.8%	-12.5%	16.6%	3.1%
Benchmark	*4.4%*	*-2.2%*	*11.9%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Canada 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 June 30, 2020



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 9.8% in the second quarter. Performance over the last 12 months was also positive, with the Fund rising 3.3% during this period. From a longer-term perspective, our returns remain healthy on an absolute basis, delivering gains of 6.7% per year over 5 years and 9.0% per year over 10 years.

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

Fixed income markets rose during the quarter, reflecting the intervention of the Bank of Canada, as well as the reduction of uncertainty regarding the liquidity, and even solvency, of corporate and provincial bond issuers. Our bonds rose 3.9% in the period.

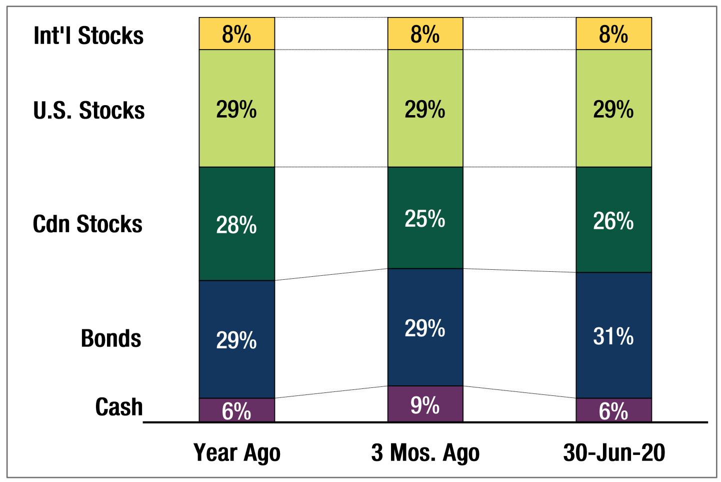
Our equity holdings in the Balanced Fund participated in the risk-on rally that characterized Q2. Our Canadian holdings rose 8.8% and our U.S. holdings rebounded 19.3% (in C$ terms). While our Canadian performance was good on an absolute basis, we lagged the index due to our lack of holdings in the gold and information technology sectors, which were among the best-performing sectors in Q2. Our international holdings also rebounded, with the developed markets fund, EQIT, rising 13.2% and the emerging markets fund, EMEC, rising 17.1%.

At the end of the quarter, cash represented 6% of the Fund's asset mix, bonds accounted for another 31%, and stocks were 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	9.8%	3.9%	8.8%	19.3%	14.8%
Benchmark	*12.4%*	*5.9%*	*17.0%*	*15.8%*	
One Year					
Fund	3.3%	5.6%	-11.5%	17.5%	2.7%
Benchmark	*4.9%*	*7.9%*	*-2.2%*	*11.9%*	

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

Investment Returns – As at June 30, 2020



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund rose 3.8% in the second quarter. In the last 12 months, the Fund has generated a total return of 3.3%. Over longer periods, our returns remain healthy on an absolute basis, delivering gains of 3.8% per year over 5 years and 5.2% per year over 10 years.

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

With a large allocation to high-quality corporate securities, our holdings benefitted from a reduction in credit spreads that was engineered by the Bank of Canada's intervention in the bond markets. However, our focus on shorter-maturity bonds meant that we participated less in the capital appreciation that arose from the further decline in the general level of interest rates.

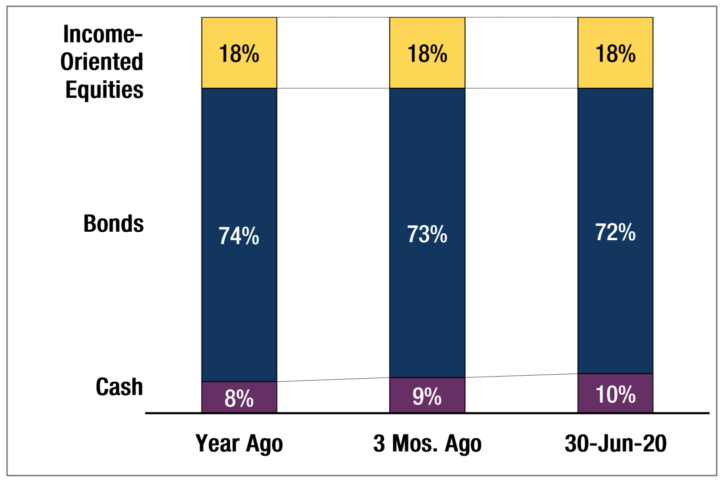
Our holdings of income-oriented Canadian and U.S. equities detracted from performance this quarter, after an extended period in which they had added to the returns of the Income Fund.

At the end of the second quarter, the Fund's cash position was 10%, income-oriented equities accounted for 18%, and the balance, 72%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	3.8%	3.7%	2.8%	8.1%
Benchmark	*5.9%*	*5.9%*		
One Year				
Fund	3.3%	5.4%	-7.3%	3.1%
Benchmark	*7.9%*	*7.9%*		

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 June 30, 2020



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund holds two underlying funds: EQIT, invested in international developed market equities, and EMEC, invested in emerging market equities.[11]

Returns in international equity markets rebounded strongly in the second quarter. The strength was driven by economic data that was better than expected, early evidence that COVID-19 containment efforts are having some positive effect, and unprecedented fiscal and monetary support from various central banks.

The Fund participated in these gains, rising 14.8% during the quarter, with both EQIT and EMEC rising sharply. On the back of these gains, the Fund's performance over the last 12 months, at 2.6%, is now positive. Longer-term returns for both EQIT and EMEC remain positive, with EQIT up 4.9% per year and EMEC up 9.1% per year over the past five years.

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

International markets gained ground as economic re-openings accelerated through the second quarter. Although recent localized COVID-19 outbreaks have led to reversals in some re-opening plans, the overall trend of economic recovery was positive for the quarter and international stock markets responded accordingly. Risks remain – Hong Kong, Brexit and the state of global trade relations, to name a few – but we continue to expect the key drivers for the remainder of the year to be the trajectory of the virus and the success of government responses.

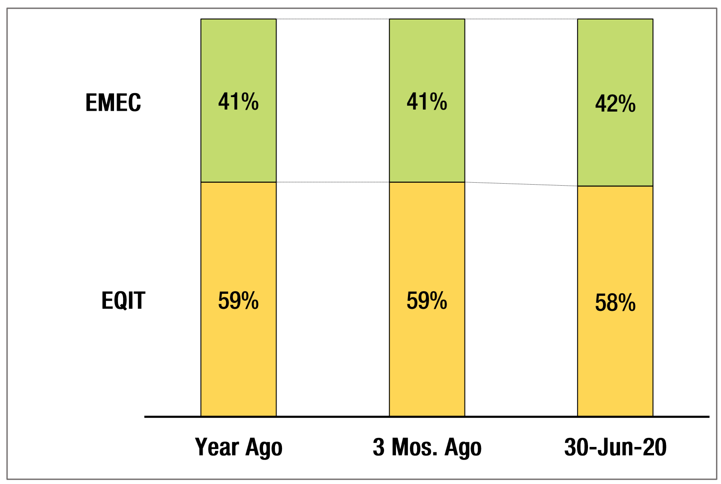
Emerging markets also participated in the second quarter rally, producing their best quarter in more than a decade. The rebound from the March lows was driven by improvements in economic data, particularly from China, which is showing signs of a rapid recovery in economic activity. Much uncertainty remains about both the path of the disease in emerging market countries as well as the staying power of the economic recovery, but the quarter delivered more positives than negatives.

At the close of the second quarter, the International Equity Fund's investment in EQIT accounted for 58%, while EMEC accounted for 42%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	14.8%	13.2%	17.1%
Benchmark	*11.1%*	*10.4%*	*13.4%*
One Year			
Fund	2.6%	1.4%	4.4%
Benchmark	*-0.7%*	*-1.2%*	*0.6%*

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

Investment Returns – As at June 30, 2020



International Equity Fund Asset Mix

[11] 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 U.K. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.