The Nexus Report

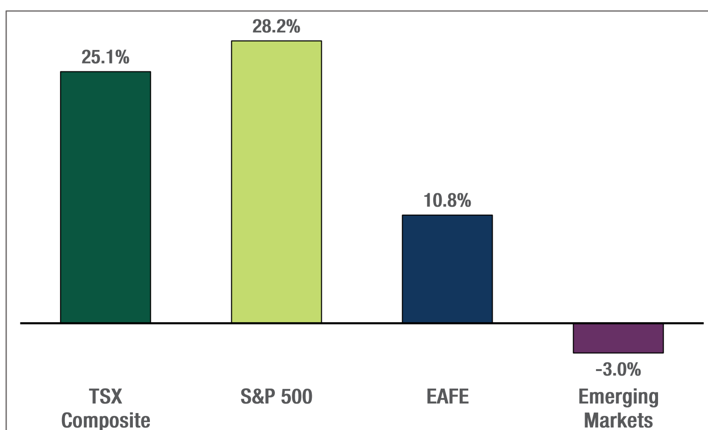
Fourth Quarter, 2021

Investment Outlook 1
Asset Class Review 3
Pooled Fund Reports 5

Investment Outlook

A Year to Remember

2021 was a remarkable year. Investors enjoyed generous investment returns despite the myriad of public health difficulties and the challenges in our daily lives. In particular, stocks in Canada and the U.S. soared as investors celebrated the strong rebound in corporate profits and implicitly agreed that it was time to focus on the post-pandemic world. The TSX Composite Index in Canada generated a total return of 25.1% in 2021.[1] Over the last three years it is up 17.5% per year. In the U.S., the S&P 500 provided an even higher 28.2% return in 2021. Its 3-year return is 23.0% per year. As we have commented before, it is like COVID-19 never happened. International stock markets performed more modestly by comparison. The index of developed countries outside of North America (EAFE) gained 10.8% in 2021. Emerging markets suffered a small loss (-3.0%), largely based on the weakness in Chinese equities.



Total Returns for 12 Months ended December 31, 2021 (C$)

While stock investors cheered, bond investors had less to celebrate. Modestly higher interest rates in Canada led to a loss of 2.5% for the Universe Bond Index over the last year.

Clear Skies in the Forecast

By almost any measure, the Canadian and U.S. economies are performing well and the outlook is strong. In Canada, the closely-watched employment report showed sustained strength in December. 54,700 net new jobs were created, exceeding expectations. This followed the remarkably strong 153,700 job gain in November. The unemployment rate fell to 5.9% in December and the workforce participation rate for the most important demographic – those 25-54 years old – rose to a record high. There are now 240,000 more Canadians employed than there were in February 2020.

Other Canadian economic measures also are encouraging. Housing, the biggest asset for most Canadians, remains strong, particularly in cities like Toronto. The November trade report was good, notwithstanding the flooding in B.C. that hampered the movement of goods. Fourth quarter GDP growth may well top 4.5%. There is great economic momentum as we start 2022.

Of course, Omicron will throw a monkey wrench into economic conditions early in the new year. Canada has implemented some of the most onerous restrictions outside of China in response to Omicron, largely on account of our limited hospital capacity even in the best of times. The strong employment report cited above was based on data collected between December 5th and 11th. Clearly, the situation has deteriorated since then and economic growth will be weak in the early days of 2022. However, evidence from other countries where Omicron is more advanced suggests that it may well recede as

[1] Returns in this paragraph are total returns expressed in Canadian dollars.

quickly as it came upon us. While 2022 may start slowly, we are optimistic that the year will be another one of solid growth.

In the U.S., the December labour market report seemed disappointing at first glance. However, a more thorough analysis suggests that labour market conditions there are just as strong as in Canada. The headline gain of 199,000 new jobs fell far short of the 400,000 expected. The unemployment rate, however, tumbled to 3.9% from 4.2%, even as more people entered the workforce. The disconnect between the two reports is rooted in the fact that the numbers derive from different surveys. According to the so-called "household survey", which is the source of the unemployment rate, the U.S. economy generated 651,000 new jobs in December.[2] Moreover, other measures of the U.S. labour market are exceptionally strong. A record 6.4 million new jobs were created over the course of 2021. Average hourly earnings climbed 4.7% year-over-year in December after a 5.1% increase in November. A record number of people (4.5 million) quit their jobs in December – something that happens only when people have high confidence in finding a new one. And there are 10.4 million job openings in the U.S., whereas there are only 6.3 million unemployed people.

Some economists expect that once full-year 2021 economic growth is tallied in the U.S., it will be the best year since 1984. As in Canada, we expect this momentum to continue in 2022.

A Nagging Dark Cloud

As we detailed last quarter, the one persistent dark cloud in the sky is inflation. As this year-end report went to press the U.S. Consumer Price Index for December was released. As was widely expected, U.S. prices increased 7% in December compared to a year earlier. This is up from the 6.8% year-over-year increase in November and is the highest inflation reading in the U.S. since 1982. It's the third consecutive month that the CPI registered an increase of more than 6%. For certain, some of the increase relates to price spikes in both food and energy. Nonetheless, the core index, excluding food and energy, increased 5.5% in December, the biggest rise since 1991.

What is driving the headline inflation numbers in both Canada and the U.S. is the surge in the price of goods. For the last couple of decades, services prices have increased at a fairly consistent annual rate of 3%. The average annual increase in goods prices was close to zero. Through the pandemic, little has changed to affect the steady increase in services prices. Goods, however, have endured both a positive demand shock as well as a negative supply shock. Consumers are flush with cash, have been frequently stuck at home, and have been limited in the services they can consume (such as travel). They have been keen to buy "stuff". Because of the supply chain issues that are widely known, that "stuff" is in short supply. Goods prices have skyrocketed.

Of course, most important for investors is not what inflation is now, but what it will be over the coming months and years. For most of the last year, central banks have been dismissive of the threat, declaring that inflationary pressures are "transitory". Their tune has changed markedly in recent months. The Bank of Canada was one of the first to publicly recognize that price pressures were likely to be more persistent than previously expected. When the minutes of the U.S. Federal Reserve meeting in December were released in early January, it became clear that the Fed is now on high alert. Investors were taken by surprise by how quickly the Fed may start withdrawing stimulus from the economy. Inflation – and central banks actions – are factors that we will monitor carefully.

Market Outlook

Given the inflationary pressures at hand, we expect interest rates to move higher from their historic lows. Higher rates are unequivocally bad for bonds and our bond portfolio has maintained short average maturities to manage this risk.

Inflation's effect on stocks is more nuanced. The value of a stock is the net present value of its future cash flows. As interest rates go higher, this puts downward pressure on the net present value – a dollar tomorrow, or 10 years from now, is not worth as much in a higher interest rate environment. On the other hand, higher rates reflect higher economic growth. Many companies can pass price increases through to consumers and are able to generate higher cash flows. These kinds of companies may actually benefit from inflation. In fact, investors are positioning for this shift in the early days of 2022. Formerly high-flying technology companies, many of which are unproven and unprofitable, have been under pressure. With higher interest rates, the promise of profits far in the future is not as valuable as it was before. In contrast, the stock prices of traditional manufacturing companies, commodity producers and banks have been strong. They have strong cash flows today and typically perform well in an environment of rising prices and interest rates.

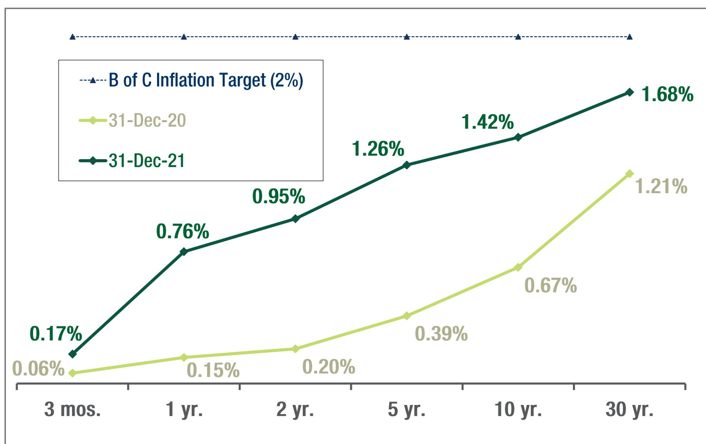
As always, we don't offer any predictions of how the market might evolve. But we do feel good about the companies we own. We think they stand to benefit from a period of strong economic growth and we believe they are well positioned to succeed in a period of more persistent inflation. We are optimistic about our portfolios in 2022 and are confident that they will prosper over time. Nonetheless, risk is unavoidable when investing and any number of events could undermine stock prices in the months ahead – typically, these events are ones that no one is talking about.

[2] The headline monthly jobs creation number is derived from the "establishment survey"; i.e., a survey of employers.

Asset Class Review

Fixed Income

To properly describe the fourth quarter, one needs to break it into two parts: "pre-Omicron", and "post-Omicron". The "pre-Omicron" period ran up until Black Friday of the U.S. Thanksgiving holidays, and "post Omicron" captures the time from then until the end of the year. During the first part of the quarter, the trend of lower bond prices and higher yields was in full force, bringing the highest yields of the year in both 2- and 10-year Government of Canada bonds, while 30-year bond yields were very close to 2021 highs. In the second part of the quarter, investor concerns that the latest COVID variant would derail an economic recovery sent yields on longer-dated bonds move swiftly lower. For the quarter, yields on 2-, 10- and 30-year bonds were 0.42% higher, 0.08% lower and 0.31% lower respectively. Despite this year-end pull-back, the trend of higher yields over the course of 2021 remained intact and yields on Government of Canada bonds ended the year 0.40% to 0.90% higher across all the different bond maturities.



Government of Canada Yield Curve

By most measures the Canadian economy ended 2021 in a strong position. A contributor to this strength has been the extremely stimulative monetary policy measures in place since the beginning of the pandemic. Likewise, in other parts of the globe, economic recovery continued to progress. As a result, central banks are beginning the transition away from extreme monetary stimulus. The degree to which the tone has shifted varies from "not very much" (European Central Bank), to "purchasing fewer bonds, but not quite hiking rates yet" (Federal Reserve), all the way to "worried we are late, and already hiking" (Bank of England). The Bank of Canada (BoC) is around the middle of this spectrum. The BoC is no longer purchasing bonds and has indicated that it is on track to begin hikes in the coming months. In our opinion, this transition is happening more slowly and later than it should, but we are pleased that it is underway.

Embedded in this shift of tone has been an acknowledgement that inflationary pressures are expected to be longer lasting than initially thought. Recall that central banks had been holding onto the view that higher inflation would be short lived or "transitory", as we worked through various temporary factors, such as supply chain disruptions and labour market shortages.

As we start 2022, absolute yields remain extremely low. Using current Consumer Price Index levels, real yields (nominal interest rates minus inflation) are negative. Low interest rates were not lost on corporate borrowers. 2021 was a record-setting year for corporate debt issuance. In Canada, we saw $133 billion of debt issued (topping the previous highwater mark of $114 billion set in 2017) and the average coupon on that debt, at 2.63%, marked a 5-year low.[3] Despite all this supply at terms that were very attractive to issuers, corporate bonds held up well during the year and outperformed government bonds.

Most of our holdings are high quality corporate bonds, which strike an attractive balance between providing additional yield (compared to government bonds), while avoiding the price swings and potential liquidity hurdles that come with lower-quality corporate debt. During the quarter we participated in some of the new issues that came to the market, opting to crystalize capital gains in favour of lower priced bonds where possible. Additionally, we have reduced our preferred share holdings, taking advantage of a strong price recovery in this relatively illiquid part of the capital markets. Finally, consistent with our view that interest rates will rise, we added some exposure to floating rate notes. Floating rate notes offer a yield superior to that on short-term money market securities, along with protection from interest rate increases.

Our portfolio has a duration of 3.6 years – much shorter than our benchmark, the FTSE Canada Universe Bond Index (Universe) at 8.4 years. This positioning served us well in 2021 and we think it will continue to do so, as we expect rates will continue to rise. In the quarter, our bonds trailed the Universe benchmark, generating a 0.6% loss, while the Universe returned 1.5%. Over the last 12 months, our bonds holdings lost 1.6%, better than the 2.5% loss for the Universe.

[3] TD Securities Credit Research.

Equities

The last quarter of 2021 was a very strong finish to an exceptional year for equity investors. The Equity Fund returned 7.3% in the final three months alone, and 25.0% for the full year, just a snick behind the Fund's benchmark.[4]

The equity markets for the quarter and year were strong in Canada, the US, and international markets. (Even though international was not as strong as North America, it was above the long-term average return.) Only emerging markets had a poor quarter and year. Then again, it is rare for all geographies to have a blow-out year at the same time. Although the currency markets moved noticeably during the year, for the full year, the Canadian dollar was more or less unchanged against the US dollar, and somewhat stronger against other international currencies.

In short, our Canadian and U.S. portfolios both outperformed their respective benchmarks for the year, but the overall Equity Fund was in line with the blended benchmark as our allocation to international equities returned less than the North American market. As the equity themes for the last quarter were similar to those for the year, we have focussed the details of this quarterly comment more on the year than the quarter.

Canadian Equities

Nexus's Canadian stocks returned 7.5% in the quarter and had a very strong return of 29.4% for the full year.

It was a strong, broad recovery year in Canada and all of our stocks, but one, had double-digit returns for the year. A key driver of the Canadian market in 2021 was a strong recovery in energy prices, with oil and gas commodity prices rising about 58% during 2021. Our two core Canadian oil and gas holdings, Cenovus and Suncor, returned 102% and 54% respectively for the year. It was also a big year for the banks, with our three bank holdings all enjoying better returns than the TSX for the year. George Weston, a typically defensive stock, returned 57% for the year as it implemented its corporate streamlining plan, including the sale of Weston Foods. We benefitted from not holding any Canadian materials stocks.

The laggard in Canada for the full year was CAE, as its main customers, the airlines, are recovering more slowly than was anticipated at the start of 2021.

U.S. Equities

Our U.S. equity portfolio increased 8.4% in the fourth quarter and 31.5% for the year.[5]

Similarly to Canada, 2021 was an economic recovery year. All but two of our U.S. holdings had double-digit returns. Strong sectors were Communication Services (mainly Alphabet), Health Care (Pfizer and CVS) and Industrials (UPS). For the year, while we outperformed the overall U.S. index, the main laggards in our portfolio were the banks and Medtronic. Citigroup returned about 0% for the year and JPMorgan, with a strong 27% return, returned less than the U.S. financial sector average. Our one negative return stock in the U.S. was Medtronic, a medical devices and technology supplier, which suffered as many elective surgeries were deferred for longer than expected due to COVID, and the company experienced product issues with an insulin pump. These factors have deferred our investment thesis for Medtronic, rather than negated it.

After a strong year, overall U.S. equity market valuations are elevated, with some stocks and themes (such as growth and "new economy" stocks) looking positively frothy. We remain comfortable with our holdings, as the portfolio has a lower valuation multiple than the overall market, with strong cash flows and solid balance sheets.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure and diversification to our Funds.[6] Returns for our international holdings in 2021 were well below North American levels. In the fourth quarter and for the year, EQIT (international developed market equities) returned 5.5% and 11.5%, while EMEC (emerging market equities) fell 3.4% in the quarter and fell 5.6% in the full year. Longer-term annualised returns (2+ years) for these holdings remain double-digit. These holdings are attractively valued relative to the U.S. equity market and should benefit as international economies re-open. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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[4] All the return data in the Equities section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar. For specific performance, please refer to the Fund reports that follow or your client-specific report.

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

[6] Both pooled funds are managed by teams from J.P. Morgan Asset Management in the U.K. and are held in our Equity and Balanced Funds.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund generated a total return of 7.3% in the fourth quarter. While the net result was strong, there was considerable volatility in markets this quarter. COVID trends continue to influence investors, with this quarter's ups and downs reflecting turbulence from the Omicron variant and its disruptive effects on the economic recovery. However, COVID is no longer the singular focus of investors. Other factors are also top-of-mind, including the outlook for inflation, the duration of central bank pandemic interventions, the path of consumer spending, and corporate earnings growth.

In the last 12 months, the Fund has delivered a total return of 25%. The gains reflect the significant progress economies have made towards recovery, as well as the improvement in the outlook for the companies we own in the Fund.

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

The Canadian market gained 6.5% in the quarter, with most sectors participating in the gains. The financial sector was particularly strong and our holdings of Bank of Nova Scotia and Toronto-Dominion Bank both rose 17%. In addition, we saw significant gains in our core energy holdings, Suncor and Cenovus, which both gained 22%. The largest detractor in the quarter was CAE, which declined 16% as Omicron created disruption for its airline customers.

The U.S. market finished the year with a 10.5% gain in the quarter. Among our U.S. holdings, in US$ terms we had nine companies that delivered double-digit gains in the quarter, including Pfizer (39%), CVS Health (22%) and Microsoft (20%). The largest detractor in the quarter was Medtronic, which fell 17% as management struggled with manufacturing challenges in their insulin pump business, as well as the rise of Omicron, which led to continued delays in the elective medical procedures in which many of its products are used.

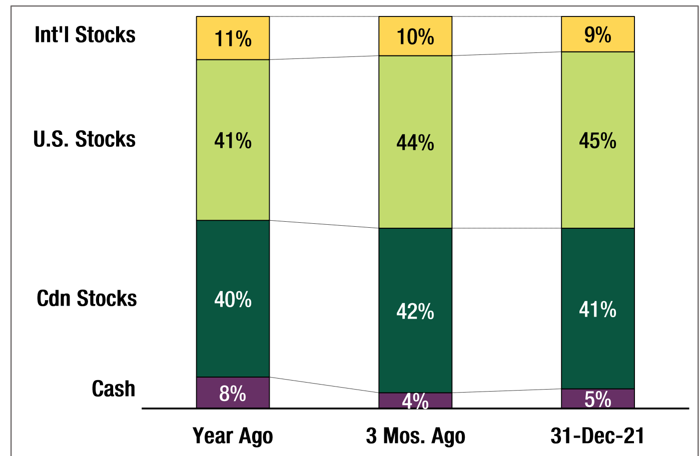
Outside of North America, our international holdings delivered mixed results. The developed markets fund, EQIT, gained 5.5% in the quarter, while the emerging markets fund, EMEC, declined 3.4%.

At the end of the fourth quarter, the Fund's cash position was 5%. Our allocation to Canadian stocks was 41%, while U.S. stocks represented 45% of the mix. We have maintained an allocation of 9% to markets outside North America, as we feel this geographic diversification provides an important complement to our core North American holdings.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	7.3%	7.5%	8.4%	1.6%
Benchmark	*8.0%*	*6.5%*	*10.5%*	
One Year				
Fund	25.0%	29.4%	31.5%	3.6%
Benchmark	*25.2%*	*25.1%*	*28.2%*	

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 December 31, 2021



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 4.8% in the fourth quarter. The gain was driven by our Canadian and U.S. stocks which rose 7.8% and 8.3% respectively. These gains were slightly offset by the 0.6% decline in our bond holdings during the quarter.

In the last 12 months, the Fund has returned 16.9% which reflects large gains in our Canadian and U.S. stocks, offset by a 1.6% decline in our bond holdings.

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

Q4 proved to be another volatile quarter for bonds. Nexus's holdings underperformed the benchmark, due to the strong performance of longer-dated bonds which we do not own. We maintain our longer-term view that interest rates will continue their move higher, as occurred in 2021 overall, which drives our preference for bonds with shorter-dated maturities.

Our equity holdings had a strong quarter. In Canada, two of our bank holdings — Toronto-Dominion Bank and Bank of

Nova Scotia — each rose 17%. We also had significant gains in our core energy holdings, Suncor and Cenovus, which both gained 22%. The largest detractor in the quarter was CAE, which declined 16% as Omicron created disruption for its airline customers. Among our U.S. holdings, in US$ terms we had nine companies that delivered double-digit gains in the quarter, including Pfizer (39%), CVS Health (22%) and Microsoft (20%).

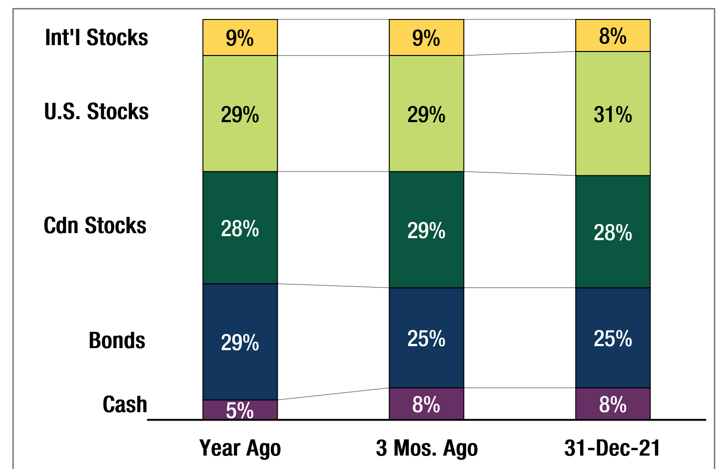
Outside of North America, our international holdings delivered mixed results. The developed markets fund, EQIT, gained 5.5% in the quarter while the emerging markets fund, EMEC, declined 3.4%.

At the end of the quarter, cash represented 8% of the Fund's asset mix, bonds were 25% and stocks accounted for the remaining 67%. These asset allocations remain close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	4.8%	-0.6%	7.8%	8.3%	1.7%
Benchmark	*5.6%*	*1.5%*	*6.5%*	*10.5%*	
One Year					
Fund	16.9%	-1.6%	30.2%	31.7%	3.8%
Benchmark	*15.7%*	*-2.5%*	*25.1%*	*28.2%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Cda 91Day 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 December 31, 2021



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 1.2% in the fourth quarter. Although our bonds fell 0.6% in the period, this was more than offset by the 7.5% gain in our Canadian stocks and the 9.9% gain in our U.S. stocks. Over the past 12 months, the Fund has returned 4.3%, outpacing the benchmark which declined 2.5%.

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

The quarter proved to be another volatile one for bonds. Nexus's holdings underperformed the benchmark, due to the strong performance of longer-dated bonds, which we do not own. We maintain our longer-term view that interest rates will continue to move higher, as occurred in 2021 overall, which drives our preference for bonds with shorter-dated maturities.

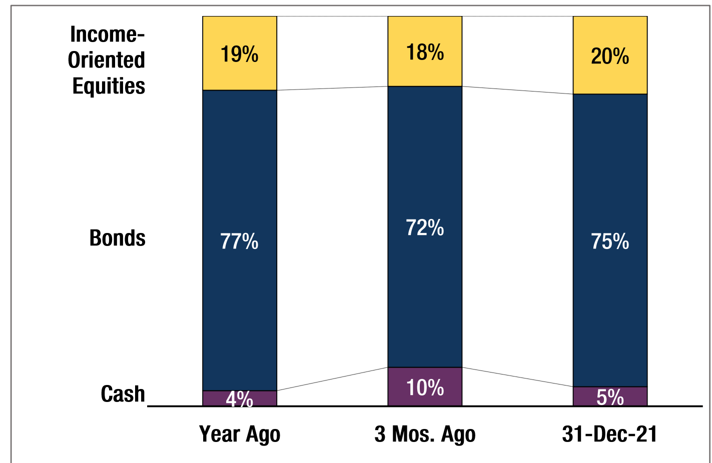
The income-oriented equities we hold in the Fund performed well in the quarter, with both our Canadian and U.S. stocks advancing. Over the last 12-months, the income-oriented stocks have performed remarkably well, with the Canadian holdings up 30.4% and the U.S. holdings up 29.9%. The gains reflect the significant progress economies have made towards recovery, as well as the improvement in the outlook for the companies we own in the Fund.

At the end of the fourth quarter, the Fund's cash position was 5%, income-oriented equities accounted for 20% and the balance, 75%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.2%	-0.6%	7.5%	9.9%
Benchmark	*1.5%*	*1.5%*		
One Year				
Fund	4.3%	-1.6%	30.4%	29.9%
Benchmark	*-2.5%*	*-2.5%*		

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 December 31, 2021



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).[7]

The Fund delivered a total return of 1.9% in the fourth quarter. EQIT performed well, gaining 5.5% in the period, but EMEC fell 3.4%.

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

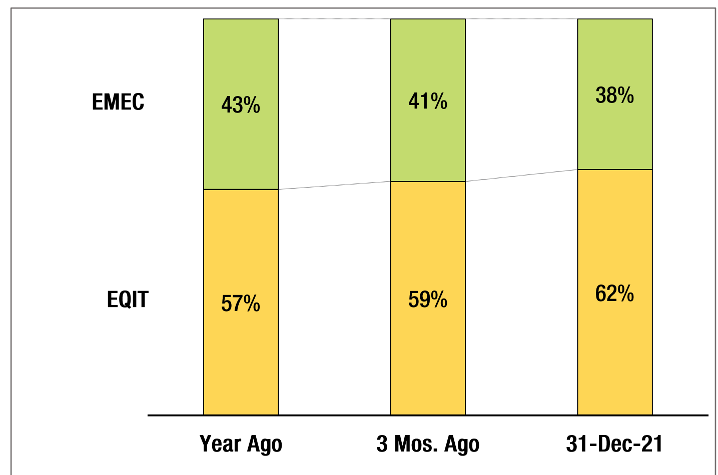
While gains in international developed markets reflect optimism for economic recovery, the outlook for emerging markets remains challenged. Investors are concerned that pandemic uncertainties linger — vaccination progress remains sluggish and Omicron threatens to disrupt supply chains — all of which are tamping down emerging market economic activity, at least in the near term. We remain positive regarding the long-term growth outlook in international markets, but accept that the unpredictable course of COVID may cause further bouts of volatility before a continuation of economic expansion resumes in earnest.

At the close of the fourth quarter, the International Equity Fund's investment in EQIT accounted for 62%, while EMEC accounted for 38%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	1.9%	5.5%	-3.4%
Benchmark	*1.2%*	*2.2%*	*-1.8%*
One Year			
Fund	4.2%	11.5%	-5.6%
Benchmark	*7.3%*	*10.8%*	*-3.0%*

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, 2021



International Equity Fund Asset Mix

[7] 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.