The Nexus Report

First Quarter, 2022

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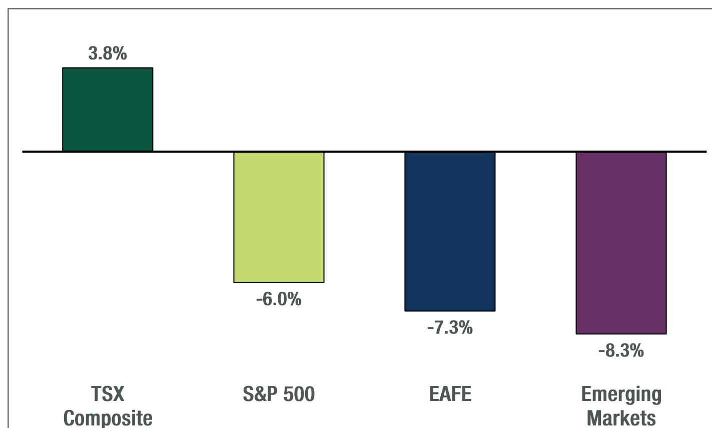
Investment Outlook

A Rocky Start to the Year

After a fantastic stock market run in 2021, investors have found the first three months of 2022 to be considerably more challenging. A myriad of concerns, some old and some new, undermined the confidence that characterized 2021. Most ominously, inflationary pressures continued to build such that central banks, who previously insisted that price pressures were transitory, were forced to admit that they misjudged. Interest rates climbed sharply higher in anticipation of more aggressive rate hikes than previously expected.

On February 24, Russia invaded Ukraine, which further unnerved investors and added fuel to the inflationary fire. Oil prices, and the prices of many other commodities, spiked higher in anticipation of disruptions in supply. Also concerning was the rapid spread of Omicron in China, and the government lockdown of tens of millions of people. Undoubtedly, this will restrain global growth in 2022. All in all, it was a tumultuous three months.



Total Returns for 3 Months ended March 31, 2022 (C$)

Battered by the turmoil, returns in financial markets over the last three months were mostly negative. The Canada Universe Bond Index had a total return of -7.0% during the quarter, one of the worst quarterly bond market returns on record.[1] Almost as bad was the principal U.S. stock market index, the S&P 500, which posted a 6.0% loss. International markets struggled as well. EAFE (international developed stock markets) fell 7.3% and Emerging Markets fell 8.3%.

The one bright spot in the investment world was Canadian stocks. The TSX Composite generated a +3.8% return during the quarter, buoyed largely by the strong performance of the commodity sectors. However, most other sectors declined significantly, and many Canadian investors have endured a difficult period.

Will History Repeat?

The economic outlook today is as uncertain as it has been for many, many years. This uncertainty arises mostly because of the inflation genie that is out of the bottle. It is driving prices higher at a rate not seen since the early 1980s. After being overly dismissive of price pressures for most of last year, central bankers in Canada, the U.S., and many other countries of the world, are now responding aggressively. The existential question is: are they too late? Will the inflationary spiral of the 1970s repeat? Will aggressive policy responses push our economies into a recession?

Many of the startling inflation numbers are widely reported. The U.S. Federal Reserve's favourite inflation barometer – the PCE deflator – was up 6.4% in February, the biggest rise since January 1982. Given the surge in energy prices, the U.S. Consumer Price Index for March was recently reported as rising 8.5% year-over-year. Inflation is also feeding into the labour market. An element of the strong U.S. labour report for

[1] Returns are total returns in Canadian dollars unless otherwise specified.

March was that wages were up 5.6% year-over-year, after escalating 5.2% in February.

In the face of this data, the Fed now realizes that it was late to act and it has become increasingly "hawkish" – meaning that interest rate hikes are likely to be numerous and come sooner than was expected even a month ago. For reference, BMO Capital Markets economists expect the Fed to hike rates by 0.50% at each of the next two meetings, and for rate hikes to pause only when the Fed Funds rate passes 2.75% some time in 2023.[2] Economists see the Bank of Canada raising rates with similar determination, although BMO thinks Canada may pause slightly sooner than the Fed.

While aggressive central bank action is necessary, investors are worried about the possibility of recession. "Soft landings" for the economy are possible, but not easy to achieve. Moreover, just as the quarter came to a close, the U.S. yield curve "inverted" for a brief period – the yield on 2-year treasuries was higher than that on 10-year treasuries. Such a circumstance, when ongoing, has typically foreshadowed a recession.

While there is no shortage of serious concerns, there is also a more positive perspective on the economic outlook. Despite inflationary pressures, the economies of both Canada and the U.S. remain in good shape, largely because of the strength of labour markets. In the U.S., for example, the 431,000 job gain in March marked the 11th consecutive month of job growth greater than 400,000 – the first time this has happened since 1939. The U.S. unemployment rate of 3.6% is almost back to the 3.5% recorded in February 2020, which was a 50-year low at the time. Job openings in the U.S. are at a record high. In Canada, job growth also remained strong in March after a blockbuster February. The unemployment rate in our country is 5.3%, a modern day low. One has to go back to the early 1970s, when unemployment was counted differently, to find a comparable period.

With such a strong labour market in both countries, the optimists believe that consumers can withstand the financial burden that higher interest rates and higher prices present. Not only do consumers have jobs, they have savings. A recent survey concluded that 60% of U.S. households still have excess savings from the pandemic. Household net worth was 37% higher at the end of 2021 than it was in the first quarter of 2020.[3] Just as the brave and surprisingly tough Ukrainian resistance surprised the world, so might the Canadian and American consumer be more resilient than many expect.

Market Outlook

The tumultuous conditions of the past quarter may well continue for a while longer. We all hope that the drag from the COVID pandemic is largely behind us in North America, but there is no denying that the latest BA.2 variant is spreading rapidly in our midst. So far it seems mild and it appears that health care capacity is sufficient, but one cannot rule out yet another economic and financial market setback.

The war in Ukraine is heartbreaking, but financial markets seem willing to look beyond it. There is no doubt about its contribution to inflationary pressures and supply chain interruptions, but the direct economic impact on Canada and the U.S. seems less than investors originally feared.

The big issue is inflation. Interest rates have climbed sharply as policy makers have jumped into action. It seems certain that rates will continue to climb for the foreseeable future. How high will depend on how effective higher rates are at cooling things off. Nexus has expected higher interest rates for several years. A polite description of this stance was that we were early. However, our short-duration bonds have protected client portfolios from the worst effects of the last three months. We think that short duration positioning continues to be appropriate in the period ahead.

Inflation affects equities in different ways than it affects bonds. Whereas higher interest rates are unequivocally bad for bonds in the short term, the effect of inflation and higher interest rates is more nuanced for stocks.[4] For commodity stocks – like energy and mining – inflation is immediately positive as companies make windfall profits from higher prices. Many other companies – whether they be banks or grocers – can pass through their rising costs to consumers. Sometimes they even end up better off. But the adjustment takes time to work its way through. Typically, higher inflation is toughest on the most speculative stocks. The present value of these businesses, whose profits lie far in the future, declines in a higher interest rate environment. A bird in hand is worth more than one in the bush. Nexus equity portfolios emphasize companies that are not speculative in nature. We've carefully analyzed each of our holdings for their resilience to higher prices and higher interest rates and are comfortable that they are well positioned to succeed. The last quarter was a tough one for some of our companies – this is detailed in the equity section of this report. But we remain confident that no matter which way this uncertain environment turns out, our investments are positioned to prosper over time.

[2] "Focus", BMO Capital Markets Economics, April 1, 2022.
[3] *Barron's*, April 4, 2022.

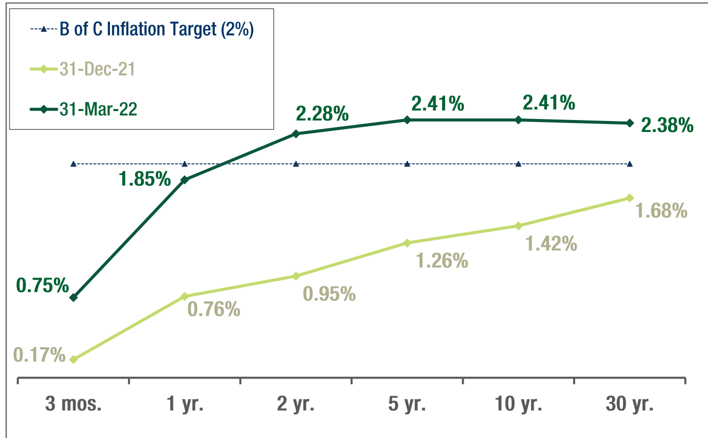
[4] Over time, however, higher interest rates will lead to a larger income stream for bond investments. It's the transition that is difficult.

Asset Class Review

Fixed Income

The first quarter of 2022 saw a pronounced shift in central bank tone and market expectations for the course of future monetary policy. Globally, central banks accepted that current inflationary pressures are problematic and that an aggressive policy about-face was necessary, resulting in one of the worst quarterly returns in history. The yield on 2-year Government of Canada bonds jumped 1.33%, ending the quarter at 2.28%, while 30-year bond yields were up 0.70% and finished the quarter at 2.38%. In addition to the dramatic shift in absolute yields, the other trend worth noting is that rates on bonds with maturities from 2 to 30 years converged within a range of less than 0.15% as the yield curve flattened.

Both the Federal Reserve and the Bank of Canada took action, hiking rates 0.25% each, and communicating that we can expect significantly more policy tightening ahead. Tightening will come in the form of both ongoing rate hikes and a reduction in bonds held on the balance sheet (quantitative tightening).



Government of Canada Yield Curve

Most clients know that we do not like to spend our time trying to predict the future. But looking ahead we believe that it would be naïve to suggest that the big moves in the bond market are done for now. There is still a meaningful gap between where rates are today and the current pace of inflation, which has resulted in painfully negative real yields. Recall that "real yields" are nominal yields, less the prevailing rate of inflation. In February, the consumer price index increased by 5.9% in Canada and 7.9% in the U.S. Until the gap between inflation rates and bond yields closes, fixed income markets will continue to feel dislocated. The economic consensus expects inflation to peak at some point in the second quarter with a slow journey back towards target levels by the end of 2023. Despite significantly pushing out the time it will take for inflation to get back to target, these projections remain riddled with uncertainty and risk. To quote the Governor of the Bank of Canada on March 3rd:

"This broadening in price pressures is a big concern. It is making it more difficult for Canadians to avoid inflation, no matter how patient or prudent they are as shoppers. This is affecting more vulnerable members of society the most. It also increases the risk that households and businesses will begin to expect large price increases to continue and that this becomes embedded in long-term inflation expectations. The lesson from history is that if inflation expectations become unmoored, it becomes much more costly to get inflation back to target…."

Central banks now face the daunting challenge of acting swiftly in order to quell inflation, but not so swiftly that they squash any and all economic growth and, in turn, the consumer strength that we are currently experiencing.

In credit markets, corporate bonds fared worse than government bonds as the extra spread that investors demanded over government bonds increased. This is not surprising given the broad negative sentiment that prevailed throughout the quarter. What is a little bit surprising, however, is that the higher yields didn't deter companies from issuing new debt. In the first quarter, the "big 6" banks have issued almost $30 billion in Canadian dollar debt, compared to only $28 billion in all of 2021[5]. It is evidence that sophisticated borrowers fear that this spike in yields is just the beginning, and they are eager to raise capital before rates move even higher.

Negative returns are nothing to celebrate, but Nexus bond investors fared much better than most. After an extended period in which we have held the view that stimulus is overdone and central banks are dragging their feet, our short duration positioning – our portfolio has a duration of 3.3 years, the FTSE Canada Universe Bond Index is at 7.8 years – has been rewarded. In the quarter, our bonds outperformed the Universe benchmark, falling 4.1%, while the Universe declined 7.0%.

[5] BMO FICC macro strategy "Bank Bond Bonanza", April 11, 2022.

Equities

After a strong 2021, the first quarter of 2022 has been sobering – Omicron, war in Ukraine, more enduring supply chain disruptions, rising inflation, and increasing interest rates. The Equity Fund lost 2.7% in the quarter, and is up 11.2% over the past 12 months.[6]

Equity markets around the world fell in the quarter. The U.S. S&P 500 (in C$) fell 6%, and international markets fell more than this. The TSX Composite in Canada, with its strong commodity orientation, was an outlier – returning a positive 3.8%.

Our equity portfolio underperformed in the quarter. The blended benchmark return for the Equity Fund was -0.8%. This was driven by the negative return in our U.S. and International holdings. Partly offsetting this was the particularly strong performance of our Canadian stocks. Our overall equity portfolio has an economic recovery bias. While this hurt us in the quarter, this positioning should be an assist in a global growth recovery.

Our Canadian and U.S holdings continue to carry valuations that are well below the indices, a key differentiator, and one which should be beneficial over longer time periods.

Canadian Equities

Nexus's Canadian stocks returned 9.9% in the quarter and had a very strong return of 27.8% for the full year, both well ahead of the TSX Composite. For the quarter, the strong performance stemmed from our Energy sector holdings and from not holding Shopify, which has a sizeable weight in the TSX and experienced a 51% decline. Assisting were Finning (a Caterpillar dealer) and a partial recovery in our REIT holdings. The partial negative offset was Magna, our auto parts holding, which is experiencing a significant supply chain disruption that is restricting production levels.

During the quarter, we added to some of our energy holdings – ARC Resources, Cenovus and Suncor. Our energy holdings are benefitting from higher oil and gas demand in the post-COVID recovery, as well as constrained supply due to years of underinvestment in production capacity. Added to this longer-term backdrop, the West's preference to limit the use of Russian oil and gas has added to price increases.

A new name in the portfolio is Primaris REIT. This is a shopping mall REIT that was spun out of H&R REIT. We added to the holding during the quarter, as the negative sentiment towards shopping malls seems extreme and Primaris's prospects are solid. For all of our REIT holdings, rising interest rates are a shorter-term negative, but in time, these holdings – unlike bonds – will adjust to inflation

U.S. Equities

Our U.S. equity portfolio had a tough quarter, falling 12.8%[7] in the first three months of 2022. It is up 2.3% over the last 12 months. Our U.S. portfolio was well behind the S&P 500 for these periods, with the U.S. S&P 500 declining 6.0% in the quarter.

As can sometimes happen, very little went well for our U.S. portfolio this past quarter. Recall that we hold an integrated North American portfolio, so we have a small number of U.S. holdings relative to the S&P 500. In the quarter, the only two sectors in the S&P 500 index that had a positive return were Energy and Utilities. We have several holdings in these sectors, but they are all on the Canadian side. This contributed to our relative outperformance in Canada and underperformance on the U.S. side. In addition, we hold three automotive stocks, GM, BMW and CarMax, and all experienced double-digit share price declines in the quarter due to automotive supply chain issues and negative sentiment. These holdings trade at attractive valuations and should recover over time. Our bank holdings (JPMorgan and Citigroup) also fell – typically banks stocks fall in the early phase of a rising interest rate cycle, until better net interest margins and loan growth lead to higher earnings. Finally, Meta Platforms (Facebook) was the weakest stock in our portfolio in the first quarter. Notwithstanding its ongoing issues, we think Meta Platforms has strong prospects and we took the opportunity to add to our holding in the quarter.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure and (typically) diversification to our Funds.[8] The first quarter was particularly tough for our international holdings – largely driven by the points in the opening paragraph of this Equity section, as well a pro-growth bias by the manager, JPMorgan. EQIT (international developed market equities) fell 12.7% and EMEC (emerging market equities) fell 10.7%. In a typical quarter, our international holdings add some diversification to North America. This did not happen in the most recent quarter, as the negative international performance added to the decline in the overall equity portfolio. Still, over the 2-year and longer periods, these holdings have performed well. They 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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[6] 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.

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

[8] Both pooled funds are managed by teams from JPMorgan 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 declined 2.7% in what was a tumultuous first quarter. Russia's invasion of Ukraine and the humanitarian crisis that followed quickly became the focal point for markets. The conflict roiled energy markets, exacerbated the disruption to already-strained supply chains, and sent stocks sharply lower. Adding to the challenges, inflation has reared its head in both Europe and North America. In an effort to rein in inflation, the Fed raised its benchmark federal funds rate for the first time since 2018 and opened the door to more aggressive interest rate increases in the period ahead.

In the last 12 months, the Fund has delivered a total return of 11.2%. The gain was driven by an improvement in the economic outlook as the pandemic receded, but this good news was partly offset by more recent concerns about inflation, rising rates and the war in Europe.

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

In this environment, Canada proved to be a relative safe haven for equity investors. The TSX Composite, which has a heavy commodity orientation, gained 3.8% in the quarter, led by gains in the Energy sector (up 29%) and the Materials sector (up 20%). Our core Energy holdings, Suncor and Cenovus, continued their run of strong performance, advancing 30% and 35% respectively. The largest detractor in the quarter was Magna, our auto parts holding, which is experiencing a significant supply chain disruption that is restricting production levels.

The U.S. market did not fare as well, with the S&P 500 falling 6.0%, measured in Canadian dollars. The only two sectors that delivered positive returns were Energy and Utilities. We have several holdings in these sectors, but they are all on the Canadian side. This contributed to our relative outperformance in Canada and underperformance on the U.S. side. In addition, our automotive holdings (GM, BMW and CarMax) all experienced double-digit declines due to the supply chain disruption.

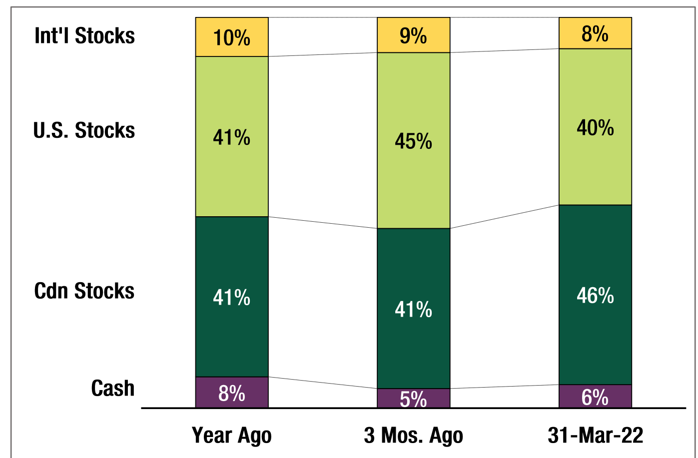
Outside of North America, our international holdings experienced a particularly difficult quarter. A combination of factors – Omicron, war in Ukraine, inflation, and rising interest rates – pressured both developed and emerging international markets. The developed markets fund, EQIT, fell 12.7% in the quarter while the emerging markets fund, EMEC, declined 10.7%.

At the end of the first quarter, the Fund's cash position was 6%. Our allocation to Canadian stocks was 46%, while U.S. stocks represented 40% of the mix. We have maintained an allocation of 8% to markets outside North America which we expect will recover as international economies re-open.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	-2.7%	9.9%	-12.8%	-11.8%
Benchmark	*-0.8%*	*3.8%*	*-6.0%*	
One Year				
Fund	11.2%	27.8%	2.3%	-9.0%
Benchmark	*16.9%*	*20.2%*	*14.9%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Canada 91Day 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 March 31, 2022



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund retreated 2.9% in the first quarter. Our Canadian stocks produced strong gains, but this was more than offset by weakness in our U.S. and International stock holdings as well as a decline in our bond holdings.

In the last 12 months, the Fund has returned 7.2% driven primarily by gains in our Canadian stocks.

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

The first quarter was a difficult period for bonds, as both the Federal Reserve and the Bank of Canada began raising rates and communicating that we can expect significantly more policy tightening ahead. This shift in central bank tone reflects an acknowledgement that inflationary pressures will likely persist, and more aggressive policy changes are required. While negative returns are nothing to celebrate, Nexus's bond holdings outperformed their benchmark, falling 3.9% as compared to the 7.0% decline of the FTSE Canada Universe Bond Index.

Our equity holdings produced mixed results in the quarter. On the positive side, our Canadian equities performed well, led by several of our core Energy holdings. Cenovus and Suncor, for example, gained more than 30% during the quarter. On the negative side, our U.S. holdings underperformed, hurt by automotive supply chain disruptions (GM, BMW and CarMax declined) and temporary weakness in our bank holdings (JPMorgan and Citigroup). Bank stocks typically decline in the early phase of a rising interest rate cycle, until better net interest margins and loan growth lead to higher earnings.

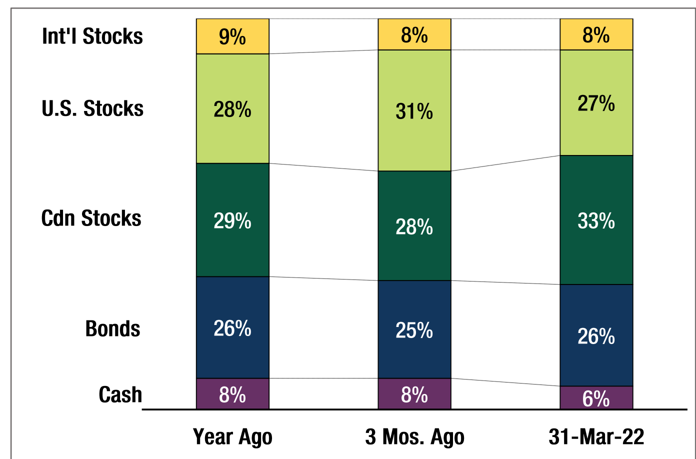
Outside of North America, our International holdings experienced a particularly difficult quarter. A combination of factors – Omicron, war in Ukraine, inflation, and rising interest rates – pressured both developed and emerging international markets. The developed markets fund, EQIT, fell 12.7% in the quarter while the emerging markets fund, EMEC, declined 10.7%.

At the end of the quarter, cash represented 6% of the Fund's asset mix, bonds were 26% and stocks accounted for the remaining 68%. 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	-2.9%	-3.9%	10.5%	-12.6%	-11.9%
Benchmark	*-2.1%*	*-7.0%*	*3.8%*	*-6.0%*	
One Year					
Fund	7.2%	-3.8%	29.7%	3.5%	-8.9%
Benchmark	*10.1%*	*-4.5%*	*20.2%*	*14.9%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE Cda 91 Day T Bill, 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 March 31, 2022



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund fell 2.4% in the first quarter. Our bonds and U.S. stocks declined in the period, and this was only partly offset by the strong performance of our Canadian stocks. Over the past 12 months, the Fund has returned 0.8%, outperforming the benchmark which has declined 4.5%.

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

The first quarter was a difficult period for bonds, as both the Federal Reserve and the Bank of Canada began raising rates and communicating that we can expect significantly more policy tightening ahead. This shift in central bank tone reflects an acknowledgement that inflationary pressures will likely persist, and more aggressive policy changes are required. While negative returns are nothing to celebrate, Nexus's bond holdings outperformed their benchmark, falling 4.1% as compared to the 7.0% decline of the FTSE Canada Universe Bond Index.

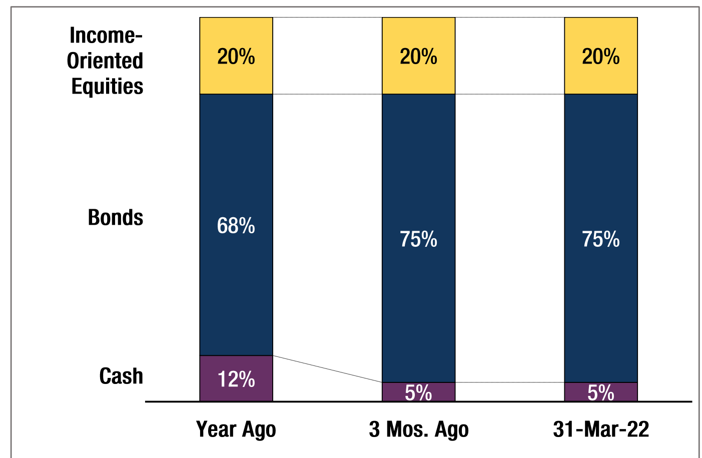
The income-oriented equities we hold in the Fund produced mixed results in the quarter. Our Canadian stocks rose 7.4%, driven primarily by the strong performance of our Energy sector holdings. Our U.S. stocks, however, fell 3.5%. Over the last 12 months, our Canadian and U.S. stocks have gained 25.9% and 14.3% respectively, benefiting from gradual economic re-opening as COVID-19 has receded.

At the end of the first 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	-2.4%	-4.1%	7.4%	-3.5%
Benchmark	*-7.0%*	*-7.0%*		
One Year				
Fund	0.8%	-4.0%	25.9%	14.3%
Benchmark	*-4.5%*	*-4.5%*		

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 March 31, 2022



Income Fund Asset Mix

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).[9]

NIEF declined 11.9% in the first quarter. EQIT fell 12.7% in the period and EMEC fell 10.7%.

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

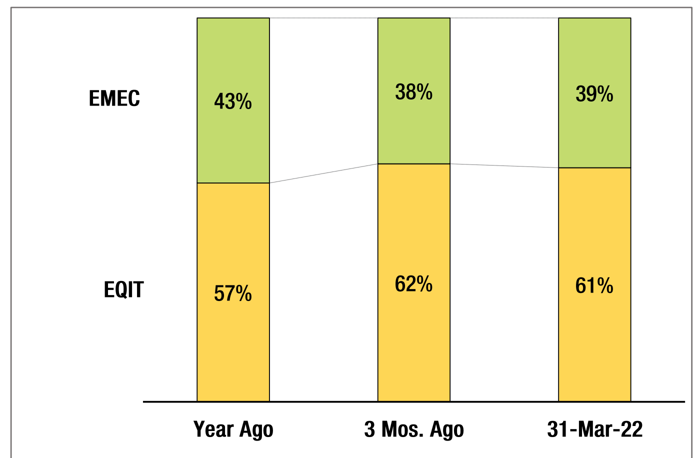
International markets encountered significant near-term challenges in the first quarter. In Europe, the tragic developments in Ukraine rippled through all of the continent's markets, causing concern about both near-term supply chain problems and longer-term disruptions to important continental trade relationships. Emerging markets also fell, primarily due to concerns about China, which is grappling with a surge in COVID cases, renewed lockdowns and instability in the Chinese property market. Despite the difficulties encountered in the first quarter, we expect many of these problems will eventually be resolved and we remain confident in the long-term opportunities that international markets present.

At the close of the first quarter, the International Equity Fund's investment in EQIT accounted for 61%, while EMEC accounted for 39%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-11.9%	-12.7%	-10.7%
Benchmark	*-7.5%*	*-7.3%*	*-8.3%*
One Year			
Fund	-8.5%	-2.6%	-16.4%
Benchmark	*-2.7%*	*0.5%*	*-11.9%*

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 March 31, 2022



International Equity Fund Asset Mix

[9] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 24 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.