The Nexus Report

Third Quarter, 2022

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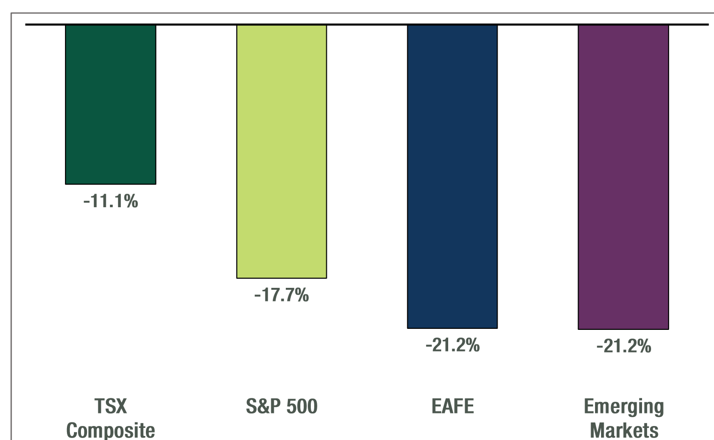
Investment Outlook

A Summer of Discontent

The dark clouds over financial markets remained in place during the last three months. Portfolio values are down sharply in 2022. Using our Balanced Fund as a proxy, client portfolios have been down in every quarter this year – the third quarter was not as bad as the second, but a bit worse than the first. Moreover, as we have reported previously, there is nowhere to hide. In the lifetime of most investors, bonds have provided a safe haven with modest gains whenever stocks hit the skids. Not so in 2022. Amidst the stock market sell-off, Canadian bonds are believed to have had the worst first 9 months ever.[1] The U.S. bond market is in a bear market worse than any since the aftermath of the two World Wars.[2] In the U.S., the S&P 500's loss of about 24% year-to-date and the Bank of America Treasury bond index decline of approximately 13% make 2022 the toughest year for the combined returns of these two asset classes since 1938.[3]



Total Returns – 9 Months ended September 30, 2022 (C$)

There are a myriad of reasons for the stock market's struggles this year, but Public Enemy #1 is inflation. As we have written about before, governments and central banks were universally dismissive of the inflationary threat a year ago. Their favourite term was that it was "transitory". In hindsight, however, inflation potential was badly underestimated and fiscal and monetary policy remained too stimulative for too long. After almost 40 years when inflation was well controlled, central banks find themselves in the position of having to raise interest rates aggressively in order to put the genie back in the bottle. The Bank of Canada has hiked short-term rates from 0.25% to 3.25% in the most rapid monetary tightening cycle ever. Even so, Governor Macklem recently insisted that they are not done raising interest rates yet. Investors worry that such aggressive actions, in Canada and elsewhere, will plunge the global economy into a recession.

Of course, inflation in Canada and the U.S. is only part of the worry. Europe is a mess, with inflation similarly hot, and the risk of energy shortages is a clear and present danger. Continental Europe (particularly Germany) is dependent on Russia for oil and gas and Putin is using energy supply as a weapon. Energy prices are high and the prospect of rationing natural gas supplies to industrial companies is real. It could be a long, cold winter. There have also been some self-inflicted wounds, the most notable of which is in the U.K. The new government of Liz Truss moved rapidly to announce tax cuts and increase spending, thereby throwing gasoline on the inflation fire. Investors responded by sending the British pound and U.K. government bonds tumbling. Investors remain concerned about how the Russia-Ukraine war will play out, particularly Russia's nuclear threat. Tensions with China over Taiwan persist. Turbulent financial markets are clearly reflecting investor angst over this wide range of concerns.

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[1] As an over-the-counter market, the bond market does not have the same meticulous records as the stock market.

[2] *Barron's*, October 1, 2022.

[3] *The Globe and Mail,* October 3, 2022. Returns are total returns expressed in U.S. dollars.

Good News is Bad News

The doom and gloom of September faded in the first two days of October, as financial markets staged a vigorous rally. There was a sense that the worst may be over. Perhaps the aggressive interest rate increases by central banks were close to running their course? The word “pivot” was everywhere in the media as observers speculated that central banks might shift gears – from aggressive tightening to a more neutral, “wait and see” approach. Maybe central banks can achieve the elusive soft landing?

This optimism was short-lived, however, as it was undermined by good economic news. The paradox of our current situation is that investors are hoping that signs of economic weakness will send the central banks to the sidelines. Perversely, good economic news is bad news to investors and bad news is good!

The big events of the first week of October were the labour market reports in both the U.S. and Canada. In the U.S., 263,000 new jobs were created in September compared to expectations for 255,000. The unemployment rate dropped to 3.5%, its lowest level since the 1960s. While the pace of job growth has decelerated through the third quarter, the U.S. labour market remains strong. Its economy lost 22 million jobs in the first two months of the pandemic. It has now gained them all back, as well as an additional 500,000. In the recession triggered by the Global Financial Crisis it took five years to regain all the lost jobs. And even at a more moderate 263,000 new-jobs-per-month rate, job growth remains stronger than it was in the years prior to the pandemic.

While not quite as robust as in the U.S., Canada’s labour market remains similarly resilient. After three consecutive months of job losses, Canada’s labour market generated 21,000 net new jobs in September. The unemployment rate ticked down to 5.2%, a low level by historic standards.

While the strong labour market and resilient consumer spending have caused investors to worry that inflation will remain high, the headline inflation data has, in fact, fallen slightly over the summer in Canada. In the U.S., August inflation was higher than expectations, but lower than July. Some observers, like widely-followed economist David Rosenberg, believe that inflation may have peaked. He points out that many commodities have declined significantly from their highs. For example, lumber is down 70%, aluminum is down 40%, and iron ore is down 35%. Even oil is down 23% from its high, notwithstanding OPEC’s recent announcement of a 2 million barrel per day output cut. Moreover, shipping costs have begun to decline and supply chain bottlenecks are easing. These are all good signs for the inflation outlook.

Of course, not all bad news is actually good news. Sharply higher interest rates will put a strain on households carrying high debt levels, and these strains will not dissipate quickly. Higher interest rates have also led to weakness in house prices that may only be just beginning. As the largest asset on most household balance sheets, lower house prices could have profound repercussions for the economy. Many consumers still have excess savings from the pandemic to blunt some of these headwinds, but the savings won’t last forever.

The Glass is Half Full

We can’t forecast what will happen in markets in the coming weeks or months. It’s quite possible – perhaps even likely – that, as companies report third quarter earnings over the coming weeks, they will provide a disappointing outlook for their businesses. Some think that there is more downside ahead. Perhaps there is. However, we do think that stock and bond markets are priced for a lot of the bad news that concerns investors. Moreover, the American Association of Individual Investors reported that 61% of survey respondents were bearish in the week of September 21st. This is the most bearish reading in this survey since 2009 – a survey that has been a fairly reliable contrary indicator (bad news is good!).

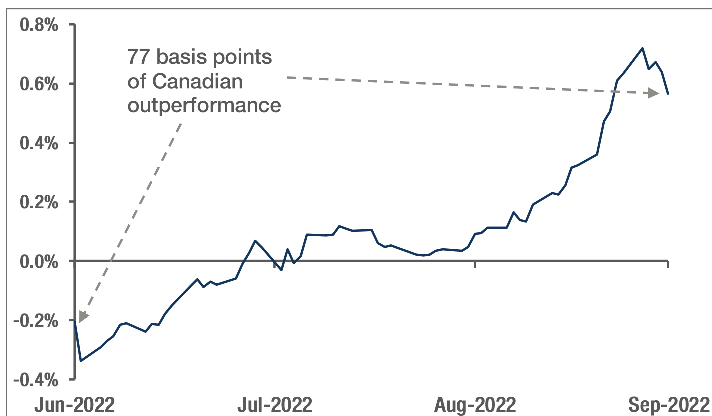
We don’t want to sugar coat the tough times that investors have endured this year. But a positive consequence of this is that valuations in the stock market have declined to levels where they are attractive in an historical context. One can now invest in many great companies at extremely attractive valuations. Those who participated in our investment review last month will remember the Warren Buffett perspective we offered on hamburgers and the stock market. Warren loves hamburgers. When they go down in price, he is happy because he can buy more. He points out that when stocks go down in price, people like them less. In his mind, it makes no sense. We agree with Buffett’s way of thinking and see the current investment environment as a glass very much half full.

Asset Class Review

Fixed Income

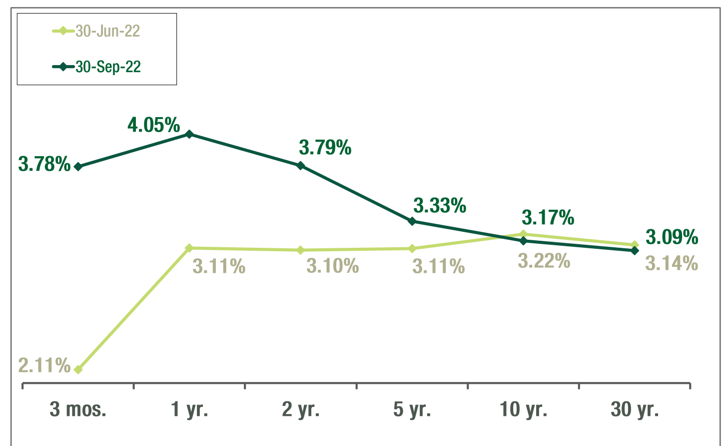
The first half of 2022 was a period of record weakness in the bond market, marked by an increase in interest rates across the entire yield curve and a widening of credit spreads. However, in the third quarter there was no such clear trend. In Canada, 2-year yields rose steadily over this period from 3.10% to 3.79%, while 10-year yields actually declined slightly. That said, although there was not much change in value, the pathway to the small decline was extraordinarily volatile. Recall that in mid-June, 10-year Canada bonds traded at a yield of 3.62% before declining at quarter-end to 3.22%. That sharp rally continued in early in the third quarter, and by late July, the yield had fallen to 2.60%. In a world where reported inflation was more than 8%, such low interest rates proved unsustainable. Over the remainder of the quarter, rates moved back higher, with the 10-year rate finally closing the quarter at 3.17%.

Contributing to a sense of dislocation and unease in bond markets was the staggering difference in performance between the bond markets in Canada and the U.S. Normally, due to the close integration of the two economies, these markets follow similar trends and move in the same direction. However, in the third quarter, Canadian bonds hugely out-performed their U.S. counterparts (see graph). While Canada 10-year bonds declined slightly in yield, the U.S. 10-year treasury rate rose sharply.



10-Year Yield Differential (U.S. Treasury minus Canada)

This volatility is a by-product of confusion about the state of the economy, uncertainty about the willingness of central bankers to keep monetary policy tight in the face of an economic slowdown, and less liquid markets during the summer. To some degree, the confusion is justified. The leaders of the Bank of Canada, the ECB and the Federal Reserve have made a dramatic about-face with their monetary policies this year. This sudden shift has undermined the confidence of investors who worry that another about-face might be at hand. Hence, at almost any sign of slowing growth or the release of soft economic data, the expectation that the bankers will "pivot" to easier monetary conditions washes through the market. Pundits and strategists parse the press releases of the central banks carefully for signs of "hawkishness" or "dovishness". Central bankers have been frequently massaging their message in speaking engagements. This activity reached a crescendo in late August with a policy speech given in Jackson Hole, Wyoming by Federal Reserve Chair Jerome Powell. In short, stern and direct remarks, Powell reiterated the Fed's intention to get inflation back to 2% and maintain a restrictive policy for some time. Based on those remarks and other data released from the Fed's meetings, bond markets weakened considerably.



Government of Canada Yield Curve

We believe the resolve of central bankers to rein in inflation is strong. We expect the economy in Canada to slow and believe that a moderation in aggregate demand is what the Canadian economy needs right now. While headline inflation has declined on the back of lower energy prices, core inflation is rising more than 5% per year. It's an environment in which we see little appeal to longer-dated bonds. Our duration (3.5 years) remains short as compared to the Universe Bond Index (7.4 years). If there is a silver lining to the bond market, it is that after such a sharp decline, a period of positive returns ahead is far more likely. While we await a period of higher rates where we can invest at more attractive levels, we are now earning more than 4.5% on our holdings.

During the quarter, price declines offset interest earned, resulting in no net return for our bond portfolio. As a result, we modestly underperformed the Universe Bond benchmark, which generated a 0.5% return.

Equities

Equity markets fell in all major geographies around the world again in the third quarter. Concerns continue regarding inflation, central bank increases in policy interest rates, the risk of recession, the war in Ukraine, and energy security in Europe. In this quarter, the Equity Fund fell 3.4% and is down 7.5% over the past 12 months.[4]

Unlike the second quarter, when we outperformed relative to the benchmark, our equity portfolio in the third quarter underperformed, such that its performance is close to the benchmark for the past 12 months – trailing by less than 1 percentage point. This is atypical compared to the norm for our equity portfolio in down markets, as demonstrated by the longer-term track record for the Equity Fund. Unfortunately, "the norm" will not occur in each instance of a down market. RBC Capital Markets produces investment style indices which offer added insight into the return patterns within the equity market. The third quarter exhibited a highly unusual pattern. Normally, in a down quarter, higher growth, higher valuation, and cyclical stocks do relatively poorly. In contrast, this quarter growth stocks outperformed both low value and high predictability (i.e. earnings stable) stocks, in both the U.S. and Canadian markets. This phenomenon of unusual relative returns was also apparent from the sector-level returns. Sectors that typically do relatively better in a down quarter, such as communication services, real estate and utilities underperformed in the quarter. Additionally, more cyclical sectors (that typically underperform in a down market), such as consumer discretionary and industrials, did relatively well. Time will tell, but some of these oddities will likely normalize. As always, our equity portfolio differs from the benchmarks and we think its quality attributes and lower valuation multiple will be positive contributors in the period ahead and the portfolio will prosper longer term.

Canadian Equities

Nexus's Canadian stocks fell 6.4% in the third quarter, and were behind the TSX Composite, yet remain, over the last 12 months, up 2.2% and ahead of the TSX's negative 5.4% return. As indicated above it was an unusual quarter in the markets. As a further example, the Energy sector in Canada (where we hold almost all our energy equity exposure) fell, whereas the U.S. Energy sector was up 8.9% in the quarter (in Canadian dollars). Suncor, Cenovus, and TC Energy fell mid-teen percentages in the quarter, although they have done very well year-to-date. All of them stand to benefit after a long period of underinvestment in the sector and newfound concerns about energy security. Two of our real estate holdings (Allied Properties, H&R) were also hit, as investors reacted to inflation and higher interest rates. This short-term reaction is understandable. But in an inflationary environment real estate stands to benefit once rental contracts renew. After all, real estate has been one of the best long-term inflation hedges.

There were no significant trades in the Canadian portfolio in the quarter.

U.S. Equities

Nexus's U.S. holdings fell 1.6% last quarter and have declined 16.5% in the last year.[5] We note that the equity market can overcorrect, and it almost always starts to recover a couple of quarters before the economy does. U.S. valuation multiples have already declined almost 30% year-to-date and inflation is starting to positively flow through to earnings.[6] Normalizing valuation multiples and higher nominal earnings both will be supportive factors going forward.

A number of our U.S. holdings are being punished by investors for what we think are short-term negative factors (the post-COVID normalization for companies that did well in the last couple of years). This is masking the longer-term competitive strength and quality of these companies. These holdings include Alphabet, Meta, Western Digital, CarMax, Pfizer, and UPS. Our more cyclical auto stocks, GM and BMW, are facing challenges with higher energy prices, tighter consumer wallets, and inflation, but the longer-term electric vehicle opportunity still lies ahead.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure to our Funds.[7] The difficult environment for our international holdings continues. EQIT (international developed market equities) fell 3.2% in the quarter and EMEC (emerging market equities) fell 2.5%, for all the reasons mentioned earlier. Additionally, for emerging markets, Chinese COVID lockdowns and issues in the real estate markets continue. A less visible, but significant, effect is that a Pound, Euro, and Yen basket has weakened against the Canadian dollar in the last 12 months by about 11%. This has directly reduced the return from international holdings when measured in Canadian dollars. Historically, after a period such as this, international holdings tend to do relatively well – but the timing has varied widely and is impossible to predict. In the interim, we take comfort from the higher dividend yield and lower valuation levels of international equities relative to North America, and the high quality of the individual underlying stocks. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

[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] Credit Suisse, October 4, 2022.

[7] 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 declined 3.4% in the third quarter. Markets in most parts of the world retreated, reflecting concerns regarding inflation, higher rates and the potential for recession. In addition, geopolitical tensions increased in response to Putin's "partial mobilization" of military reservists, risks to energy security across Europe, and new unrest in Iran. In short, there was little to allay investor concerns in the quarter and this was reflected in markets worldwide.

In the last 12 months, the Fund has declined 7.5%. Early in the third quarter there were indications that economies were improving as the pandemic receded. However, these positive signals have been drowned out by the confluence of factors described above.

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

In Canada, our stocks fell 6.4% in the third quarter. A key factor was the decline in the Energy sector, which fell alongside the retreat in oil prices, as investors responded to the risk of recession and its potential dampening effect on energy demand. Our holdings of Suncor, Cenovus and TC Energy fell mid-teen percentages during the quarter, although they have performed well year-to-date. Over time, we expect these holdings to benefit from newfound interest in ensuring energy security, as well as the lack of supply that has resulted from an extended period of underinvestment in the sector.

Our results were also impacted by our two real estate holdings (Allied Properties, H&R REIT), which fell on concerns regarding the impact of inflation and higher interest rates. While there will be near-term pressures on these firms in an inflationary environment, over time real estate stands to benefit as rental contracts renew at higher prices.

In the U.S., our holdings fell 1.6% in the quarter. A number of our U.S. holdings are being punished by investors for what we think are short-term negative factors (the post-COVID normalization for companies that did well in the last couple of years). This is masking the longer-term competitive strength and quality of these companies. These holdings include Alphabet, Meta, Western Digital, CarMax, Pfizer, and UPS. Our more cyclical auto stocks, GM and BMW, are facing challenges with higher energy prices, tighter consumer wallets, and inflation, but the longer-term electric vehicle opportunity still lies ahead.

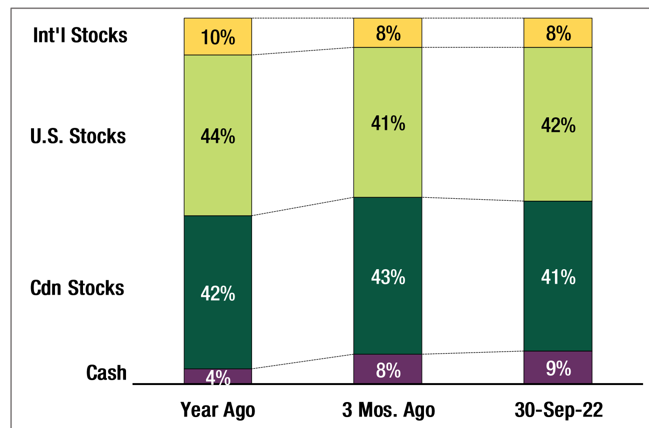
Inflation, rising interest rates and geopolitical tensions have combined to create a challenging environment for our international holdings. The developed markets fund, EQIT, fell 3.2% in the quarter, while the emerging markets fund, EMEC, declined 2.5%.

At the end of the third quarter, the Fund's cash position was 9%. Our allocation to Canadian stocks was 41%, while U.S. stocks represented 42% of the mix. We have maintained an allocation of 8% to markets outside North America which have strong long-term growth potential.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	-3.4%	-6.4%	-1.6%	-2.9%
Benchmark	*-0.1%*	*-1.4%*	*1.2%*	
One Year				
Fund	-7.5%	2.2%	-16.5%	-22.4%
Benchmark	*-6.6%*	*-5.4%*	*-9.1%*	

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 September 30, 2022



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund declined 2.2% in the third quarter. Our Canadian stocks fell 6.6%, yet remain in positive territory over the last year. Our bond holdings, U.S. stocks and international holdings also declined over the quarter.

In the last 12 months, the Fund has retreated 6.5% in a difficult environment in which only our Canadian stocks have managed to produce positive returns.

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

After a first half marked by record weakness, the bond market endured significant volatility in the third quarter. Capital markets wrestled with conflicting signals regarding the state of the economy, uncertainty about central bank resolve to keep monetary policy tight in the face of economic slowdown, and a reduction in trading liquidity over the summer months. Amidst the volatility, Nexus's bond holdings were largely unchanged, gaining 0.1% during the quarter.

Equity markets were no less volatile, and our Canadian equities fell 6.6%, while our U.S. holdings declined 0.9%. In Canada, the downturn in oil prices pressured our Energy sector holdings, while rising interest rates and inflation pressured our REIT holdings. We expect both to be temporary headwinds that will resolve in time. Similarly, several of our U.S. holdings (including Alphabet, Meta, Western Digital, CarMax, Pfizer and UPS) were punished by investors for what we think are short-term negative factors. We expect that, despite the current pressures, these companies have outstanding competitive strengths and will thrive in the longer term.

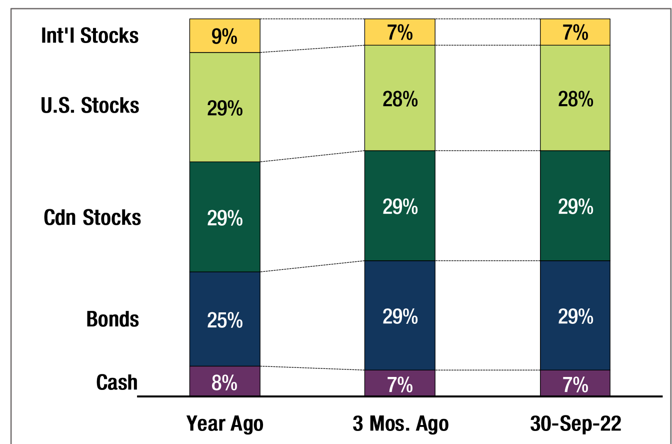
Inflation, rising interest rates and geopolitical tensions have combined to create a challenging environment for our international holdings. The developed markets fund, EQIT, fell 3.2% in the quarter, while the emerging markets fund, EMEC, declined 2.5%.

At the end of the quarter, cash represented 7% of the Fund's asset mix, bonds were 29%, and stocks accounted for the remaining 64%. 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	-2.2%	0.1%	-6.6%	-0.9%	-2.9%
Benchmark	*0.0%*	*0.5%*	*-1.4%*	*1.2%*	
One Year					
Fund	-6.5%	-6.3%	3.8%	-15.2%	-22.3%
Benchmark	*-7.3%*	*-10.5%*	*-5.4%*	*-9.1%*	

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 September 30, 2022



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund declined 1.0% in the third quarter. These results continue a difficult period in which the Fund has retreated 5.4% over the last 12 months which, while not comforting on an absolute basis, is superior to the return of its benchmark, which has fallen 10.5%.

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

After a first half marked by record weakness, the bond market endured significant volatility in the third quarter. Capital markets wrestled with conflicting signals regarding the state of the economy, uncertainty about central bank resolve to keep monetary policy tight in the face of economic slowdown, and a reduction in trading liquidity over the summer months. Amidst the volatility, we generated a 0.0% return from our bond holdings, as a decline in bond prices offset the interest earned in the period.

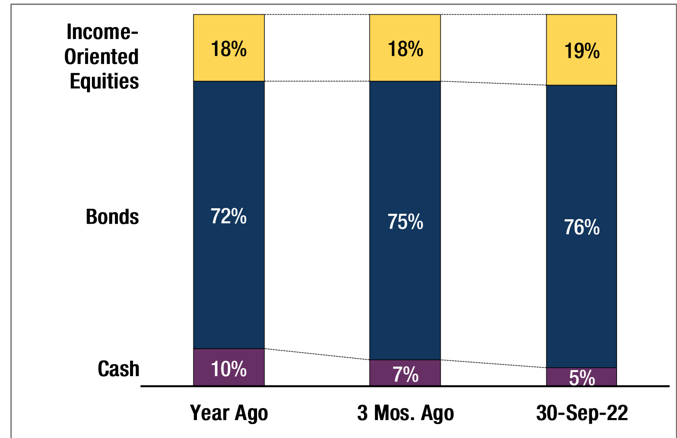
The income-oriented equities we hold in the Fund declined. Our Canadian equity holdings fell 6.0%, driven primarily by our Energy sector holdings which declined in parallel with energy prices, as well as our REIT holdings which were pressured by rising rates and inflation. We anticipate that these near-term pressures will abate in time and that the strong competitive positions of our holdings will produce good results over the long term. Similarly, our U.S. holdings fell 1.9%, as some of our stocks were punished by investors for what we think are short-term reasons.

At the end of the third quarter, the Fund's cash position was 5%, Income-Oriented Equities accounted for 19% and the balance, 76%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-1.0%	0.0%	-6.0%	-1.9%
Benchmark	*0.5%*	*0.5%*		
One Year				
Fund	-5.4%	-6.6%	-3.0%	-1.8%
Benchmark	*-10.5%*	*-10.5%*		

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 September 30, 2022



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).[8]

The Fund declined 2.9% in the third quarter. EQIT fell 3.2% in the period and EMEC fell 2.5%.

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

Overseas markets have endured a significant downturn over the past year, with the main benchmark for international developed markets and emerging markets declining 19.5% and 22.7% respectively, when measured in Canadian dollars. In international developed markets, the underlying forces driving the downturn include record-high inflation, rising interest rates, war in Europe, challenges facing U.K. policymakers to stabilize the economy, and the pan-European energy crisis.

In emerging markets, the downturn has also been driven by the corrosive effects of inflation, rising rates and – of particular relevance in the third quarter – the rise of the U.S. dollar. Given its role as the de facto currency for global trade, its rise has pressured emerging market consumers and businesses that are paying far more than a year ago for imported goods, simply because of the decline in the relative value of their currencies. What's more, a recovery in Chinese growth remains uncertain and geopolitical tensions, such as the unrest in Iran, continue to add to emerging market volatility.

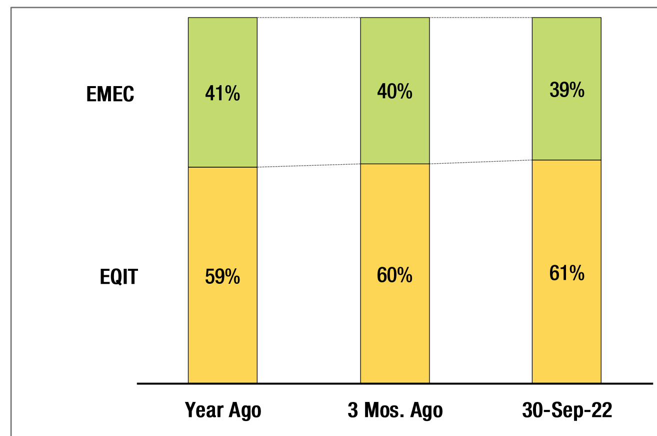
While there is no shortage of real and perceived risks in international markets, much of this has already been discounted in market valuations. The current volatility should prove the value of our emphasis on owning high-quality businesses that are able to manage through difficult periods and remain well-positioned to capture the long-term growth opportunities that are available in international markets.

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

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-2.9%	-3.2%	-2.5%
Benchmark	*-4.1%*	*-3.6%*	*-5.9%*
One Year			
Fund	-22.3%	-21.1%	-24.0%
Benchmark	*-20.2%*	*-19.5%*	*-22.7%*

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, 2022



International Equity Fund Asset Mix

[8] 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.