The Nexus Report

First Quarter, 2021

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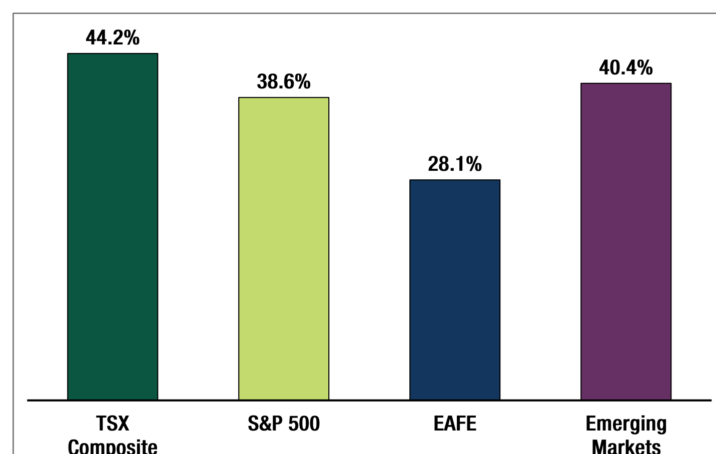
Investment Outlook

What a Difference a Year Makes

The first quarter of 2021 was fabulous for stock market investors. Commentators on business television squealed with delight as indexes hit one all-time high after another. Over the last three months, the TSX Composite generated a total return of 8.1% and the S&P 500 gained 4.9%.[1] Except for the strengthening Canadian dollar, the U.S. return would have been even better – the S&P was up 6.2% in U.S. dollar terms.



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

Stock market returns over the last 12 months are even more astounding. March 23, 2020 marked the bottom of the COVID-related bear market for many stock indexes around the world. Accordingly, the 12-month returns to March 31 chart the stock market recovery from close to its worst levels. Patient investors who stuck with the TSX Composite over the last 12 months enjoyed a 44.2% return. The S&P 500 generated a 38.6% return (56.4% in USD) over the same period. International stock markets were similarly rewarding.

Of course, these returns are from a bear market low, so many might not find the strong recovery surprising. Consider this however: the two-year TSX return is 11.2% per year. The two-year S&P 500 return is 17.0% per year. Pandemic? What pandemic? It is like the once-in-a-century crisis we have endured never happened.

The only caveat to this happy circumstance in which investors find themselves is that it was a tough period in the bond market. The fixed income section later in *The Nexus Report* explains the rise in interest rates in more detail. Suffice it to say here that the first quarter of 2021 was the worst quarter in the U.S. Treasury bond market since 1980. It was similarly tough in Canada.

A Goldilocks Moment

In his annual letter to shareholders, JPMorgan CEO, Jamie Dimon, recently suggested that conditions were such that the U.S. economy could experience a "goldilocks moment".[2] He cited the successful vaccine rollout, strong consumer savings, and the Biden administration's $2.3 trillion infrastructure plan as the basis for significant and sustained growth through to at least 2023. This view is a stark contrast to his letter a year ago, in which he worried that the U.S. faced the prospect of a catastrophic recession in which GDP could fall by up to 35%.

Dimon's comments reflect a widespread feeling of optimism about U.S. economic prospects as the quarter drew to a close. Not only is this optimism very different from the feelings of despair a year ago, but it also is very different from the troubling situation at the start of this year. 2021 opened with a heinous attack on the U.S. Capitol, together with a widespread

[1] Returns are total returns in Canadian dollars, except where indicated.

[2] *The Wall Street Journal*, April 7, 2021. By "goldilocks moment", Dimon means a state of affairs that are perfect. Not too hot, and not too cold…

acceleration in COVID infections following the holidays. Vaccines were promising, and starting to be offered, but many were frustrated with the slow pace of the rollout. To its credit, however, the U.S. ramped up vaccine distribution rapidly. Together with the U.K., the U.S. leads the pack among large countries at immunizing its population. The benefit has been palpable. Despite some lingering hot spots in various states, the nationwide trend in COVID infections and hospitalizations is decidedly lower. This has allowed states to relax restrictions (some more rapidly than health authorities think is wise) and consumers have started to shop, dine, and travel again. As *The Wall Street Journal* recently wrote: “Fear is subsiding, and U.S. households are sitting on a lot of cash.”[3]

The blockbuster U.S. employment report for March provided clear evidence that economic momentum is improving. 916,000 new jobs were created, and the unemployment rate fell to 6.0% from 6.2%. There remain 8.4 million fewer jobs in America than existed before the pandemic, but the labour market appears to be improving rapidly. It seems likely that job growth over the next 12 months could be the best in decades. In addition, the closely watched ISM manufacturing survey hit a remarkably strong level of 64.7 in March, the best in 37 years. There are booming auto sales, and the residential housing market is hot. A consequence of this positive momentum is that GDP is expected to expand at a brisk pace. The U.S. Federal Reserve’s current forecast is for 6.5% growth in 2021. Many private economists see 2021 growth above 7.0% – the strongest since the 7.2% expansion in 1984. There is good reason for the feeling of optimism south of the border.

Vaccines vs. Variants

As COVID’s second wave subsided early in the winter, the Canadian economy showed remarkable signs of resilience. The jobs market boomed in February as 260,000 new jobs were created. Economists expected another solid gain of 100,000 jobs in March and were stunned to learn the extent to which the boom continued. March saw the creation of another 303,000 new jobs and the unemployment rate plunged from 8.2% to 7.5%, even as more workers entered the workforce. Jobs were largely private sector and full-time (both good) and were focused on the hardest hit sectors: retail, recreation, accommodation and food service. Canada is now closer to achieving pre-pandemic employment levels than is the U.S. Other measures of economic momentum have also been strong. For example, the Markit Manufacturing Purchasing Managers Index – a good indicator of future economic activity – hit 58.5, the best reading in the history of the data series.

Despite this positive news about the Canadian recovery over the last several months, investors are concerned about the period ahead. A COVID third wave has arrived and lockdowns have been reimposed in Ontario and several other regions. “Variants of concern” are spreading rapidly. Hospitals are filled with more COVID patients than at any point in the pandemic. Canada’s rollout of mass immunization has been considerably slower than that in the U.S. or the U.K. and the country now finds itself in a race against these variants. Some of the job gains in March are likely to reverse in April. The performance of our economy over the balance of the year will depend on the outcome of this race. While we remain optimistic about the prospects for economic growth in the second half of the year, it seems likely that our recovery will trail that which is underway in the U.S.

Market Outlook

Some investors are concerned about the outlook for the market. Inflation fears could drive interest rates even higher and this could undermine confidence in the stock market. As well, stocks have reached all-time highs based on the expectation that COVID will be defeated in short order. What if it isn’t? Perhaps there will be a fourth wave led by the variants. Certainly, the synchronized global recovery that was once expected seems less likely to happen as several countries remain mired in the battle with the virus.

Moreover, many of the speculative forces we described last quarter continue to boil. The VIX, a measure of volatility in the stock market, has dropped to pre-pandemic levels, signalling growing complacency among investors. Many are familiar with the bizarre saga of Gamestop, and other weak companies whose stock prices were bid up by a cabal of retail investors. Bitcoin has doubled year-to-date and is up eight-fold over the last year. Many electric vehicle stocks have soared to dizzying levels. SPACs – the blind investment vehicles in which investors fund acquisitions not yet imagined – continue to successfully attract capital.

Without doubt, there are elements of the stock market that are risky and asset prices that are inflated. Investments in many of these assets will end badly. However, we do believe that the pandemic will subside, and that strong economic growth and better corporate earnings lie ahead. The stocks that Nexus owns are valued at reasonable levels and we are optimistic that they will perform well over time. We are not immune from the vicissitudes of the market. But we are confident that client portfolios are well-positioned for the period ahead and will earn good investment returns over the long term.

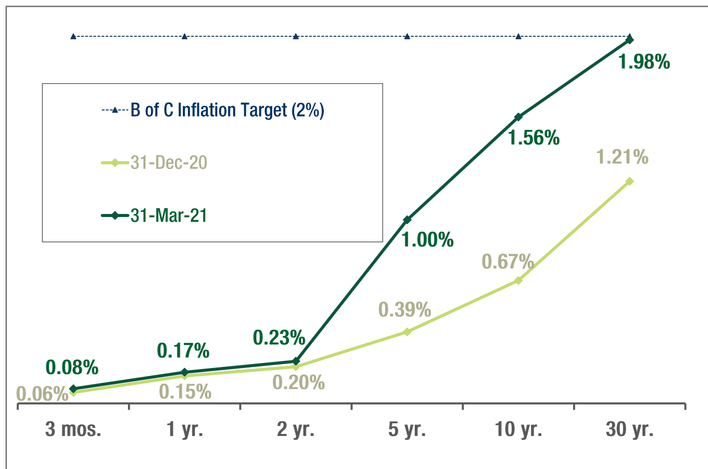
[3] *The Wall Street Journal*, April 3, 2021.

Asset Class Review

Fixed Income

Interest rates made a major move higher in the first quarter, producing large negative returns. In fact, the U.S. Treasury market had its worst quarter since 1980.[4] Despite the increase, Canadian interest rates remain below the target rate of inflation (see chart). The change came despite strong and consistent messaging from global central banks that easy monetary conditions and aggressive quantitative easing policies were not likely to change for some considerable period.

There is a uniformity of messaging from the U.S. Federal Reserve, the Bank of Canada and the European Central Bank that inflation is not a concern and that economies still need extraordinary interest rate support. The Fed has specifically said it would welcome inflation above 2% for an extended period while the economy recovers and until the U.S. achieves full employment. In Canada, in the press release which accompanied its March 10th interest rate decision, the Bank of Canada kept the target rate for overnight financing at 0.25% (what it describes as the effective lower bound) and maintained "*its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program, which continues at its current pace of at least $4 billion per week.*"



Government of Canada Yield Curve

Rates moved higher, not due to suspicion that central banks are on the cusp of backing away from stimulus policies, but because of a growing confidence that the rollout of vaccines will lead to a global economic expansion. This transition from contraction to growth will unfold sooner in some regions (the U.S.) than in others (Europe). But conventionally, a vibrant recovery removes the need for extraordinary monetary support and, potentially, causes inflation as demand runs ahead of supply. With central banks vowing to keep monetary conditions easy for some time yet, there is worry that inflation will accelerate more than expected. We share this concern because there is a great deal of pent-up savings in the hands of consumers, and fiscal support is at levels not seen since the Second World War. We all want the pandemic to be behind us and the global economy to re-open. But as bond investors, we should be careful what we wish for!

This quarter, we took advantage of new bond supply to make some refinements to our holdings, including investing in newly issued bonds at a price of $100 and selling bonds that trade at a premium to their par value. This improves the tax profile of our investment returns because we capture returns as capital gains rather than as interest income.

The new issue market continues to feature activity in a relatively new bond structure: Limited Recourse Capital Notes (LRCN). Initially issued last year, these bonds pay tax-deductible interest, yet qualify as "permanent capital" (a regulatory requirement). Issued primarily by banks and insurance companies, LRCNs are subordinate in the capital structure to the bonds and debentures typically issued by these borrowers, so LRCN bonds pay a higher coupon. But, should the issuer face insolvency, LRCNs convert to common equity. Nexus bought LRCNs last year, as the initial deals offered a generous yield premium over traditional debt. We haven't bought recent issues, which offered less of a premium.

For some time, we have worried that meagre bond yields could easily be swamped by an erosion of capital value when rates rise to more normal levels, and we positioned our bond portfolio accordingly. During the pandemic, when central bank intervention has been so extreme, it has been a frustrating stance. Last year, as rates collapsed to the lowest levels in many generations (10-year bonds traded at 0.43% in August), our returns suffered. Thankfully, we kept our positioning, making the portfolio only slightly exposed to the recent increase in interest rates. In the first quarter, 10-year yields rose 89 basis points, from 0.67% to 1.56% and the FTSE Canada Universe Bond Index (Universe) lost 5.0%.[5] Our portfolio also had a negative return, falling 1.7%. In the last year, our bond holdings returned 3.9%, ahead of the 1.6% return of the Universe.

[4] U.S. Treasuries Worst Quarter Since 1980 Upended Global Markets, Greg Ritchie et al., *Bloomberg Markets*, March 31, 2021.

[5] A basis point is one one-hundredth of one percent.

Equities

The markets continued to soar in the first quarter. The Equity Fund was up 9.4% in the quarter and returned a blistering 42.1% for the last 12 months.[6] Recall that the COVID-driven market free-fall occurred in the same quarter of 2020 (the Equity Fund lost 17.8% then), so a portion of the 12-month return is from the recovery, but mainly comes from the markets gaining new ground. In turn, this stems from the unprecedented amount of government fiscal and monetary stimulus that has been shovelled everywhere. As we had already enjoyed 11 years of strong markets prior to COVID (the Global Financial Crisis market low was in March 2009), recent equity returns are simply extraordinary.

The first 9 months of 2020 was a period that heavily favoured high-valuation growth stocks over value stocks and was a continuation of a cycle that had been going on for a number of years. These market circumstances don't align well with our investment approach. Since last Fall, there has been a partial comeback for quality and value stocks and our investment approach has fared well. The Equity Fund outperformed the blended benchmark in the quarter and over the full 12-month period (the benchmark was up 6.2%, and up 39.2%, respectively). Nexus's investment approach emphasizes quality companies with attractive valuations. The overall portfolio has both growth and value characteristics, but our approach is closer to value than growth. The growth vs. value struggle will continue, but we remain confident in our disciplined approach. High-growth stocks may perform relatively well for some time, but history shows that quality and lower-valuation stocks provide better long-term risk-return characteristics.

Canadian Equities

Nexus's Canadian stocks returned 11.3% in the quarter and 42.9% for the 12 months.

Our portfolio benefitted as investors looked beyond COVID to a cyclical recovery. Our energy, bank, and consumer discretionary (Magna) holdings did particularly well. George Weston (consumer staples and not a typical beneficiary in a cyclical recovery) was up 17% in the quarter after announcing the intended sale of Weston Foods and some management changes. The relative laggards in the quarter were our other consumer staple (Alimentation Couche-Tard and Metro) and communication services (Telus) holdings – all of which have strong long-term records of shareholder value creation. After a difficult 2020, our two REIT holdings each returned 7% in the quarter. We think they both have good potential ahead as workers eventually return to offices.

U.S. Equities

Our U.S. equity portfolio increased 12.1% in the quarter and 52.3% for the 12 months – an extraordinary period and well ahead of the S&P 500.[7] This return is all the more startling due to the material strengthening of the Canadian dollar over the 12 months – measured in U.S. dollars, our U.S. portfolio was up 71.8%.

As occurred in Canada, it was a pro-cyclical quarter in the U.S. Our U.S. automotive (consumer discretionary) stocks, CarMax and GM did particularly well. Our banks (JPMorgan and Citigroup) and value tech holdings (Western Digital and Cisco) had big recoveries after a difficult 2020. UPS and Dollar General, after a stellar 2020, were somewhat inevitable laggards in the quarter. Our Healthcare holdings did little – typical in a pro-cyclical quarter, but also due to concerns about the Biden administration targeting drug companies.

In the first quarter, we sold our small holding of Ovintiv. This energy stock has had a good recovery from its 2020 low, but its management team has made some poor strategic decisions and the company has weaker governance than we would like. We redeployed the funds by adding to our Suncor holding in Canada.

As we mentioned in our report last quarter, concerningly, the overall U.S. equity market now carries a high valuation. We reiterate that most of our U.S. holdings have valuations below that of the S&P 500. Our "growthier" stocks (Microsoft, Alphabet, Facebook, Boston Scientific) have reasonable valuations after factoring in excess cash on their balance sheets and their solid attributes and growth prospects.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure and diversification to our Funds.[8] Both have had strong multi-year periods of returns. But in this most recent quarter, both hit the pause button, as the rest of the world grapples with COVID-driven economic fallout. In the quarter, EQIT (international developed market equities) returned 0.0% and EMEC (emerging market equities) 0.8%. For the 12 months, their returns were 32.0% and 54.5% respectively. These holdings remain attractively valued relative to the overall U.S. equity market. 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 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 9.4% in the first quarter. This strong performance marks a continuation of the gains achieved over the past several quarters, underpinned by the brightening economic outlook. The key drivers for the better outlook are government stimulus programs and progress on vaccination rollouts. Although much remains to be accomplished, markets are responding to the positive indicators of progress against COVID.

Over the last 12 months, the Fund gained 42.1%. This remarkable figure reflects the fact that a year ago marked the market low during the COVID crisis. Since that point, markets have recovered swiftly in an almost unbroken pattern that anticipates improved economic conditions ahead.

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

In Canada, the equity market continued its rise, gaining 8.1% in the quarter. Although our country's response to COVID leaves much to be desired, many of Canada's listed companies have performed well and are poised to benefit from a global reopening. Several of our cyclical holdings, including Magna, Suncor, Cenovus and Finning are well positioned for reopening and, as a result, delivered strong price gains in the quarter.

The U.S. market gained 4.9% (in Canadian dollars), a robust result, although not quite as strong as the Canadian market. The gains were broad-based, with particular strength in Energy, Financials and Industrials, which are primed to do well in a reopening scenario. Our U.S. holdings outperformed in the quarter, led by CarMax and General Motors, which both rose about 40% (in U.S. dollar terms). Our bank holdings – JPMorgan and Citigroup – performed well, as did Western Digital, Alphabet and Cisco.

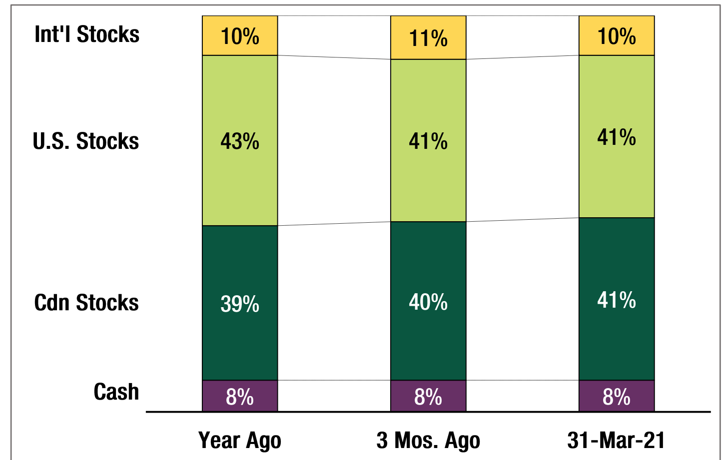
Gains in our international holdings moderated after several quarters of strong performance. The developed markets fund, EQIT, was flat in the quarter, and the emerging markets fund, EMEC, rose 0.8%.

At the end of the first quarter, the Fund's cash position was 8%. Our allocation to Canadian stocks was 41% and our allocation to U.S. stocks was also 41%. The remaining 10% is invested in markets outside North America, which have attractive growth and valuation characteristics and also add important diversification benefits to our North American investments.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	9.4%	11.3%	12.1%	0.4%
Benchmark	*6.2%*	*8.1%*	*4.9%*	
One Year				
Fund	42.1%	42.9%	52.3%	41.5%
Benchmark	*39.2%*	*44.2%*	*38.6%*	

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 March 31, 2021



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 5.9% in the first quarter, driven by gains in our Canadian and U.S. stocks. Government stimulus programs and progress on vaccination rollouts were the main tailwinds driving stock gains in the period.

Over the past 12 months, the Fund has gained 28.0%. Recall that one year ago marked the low point for markets during the COVID crisis. Since then, markets have recovered swiftly in an almost unbroken pattern that anticipates improved economic conditions ahead.

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

Fixed income markets were the lone negative in the quarter, with the FTSE Canada Universe Bond Index declining 5.0% due to the sharp move higher in interest rates. Our bond holdings, which are positioned with minimal exposure to rising rates, declined only 1.8%. For a more detailed discussion of our bond performance this quarter, please refer to the Fixed Income section earlier in this report.

In contrast to bond markets, equity markets staged a strong rally in the quarter. Our Canadian stocks rose 11.0% and our U.S. stocks rose 11.3% (in Canadian dollars). In Canada, several of our cyclical holdings, including Magna, Suncor, Cenovus and Finning are well positioned for economic reopening and, as a result, delivered strong price gains in the quarter. In the U.S., the prospects for an easing of the pandemic also drove strong gains for several of our U.S. holdings. CarMax and General Motors both rose about 40% (in U.S. dollar term), our bank holdings – JPMorgan and Citigroup – performed well, as did Western Digital, Alphabet and Cisco.

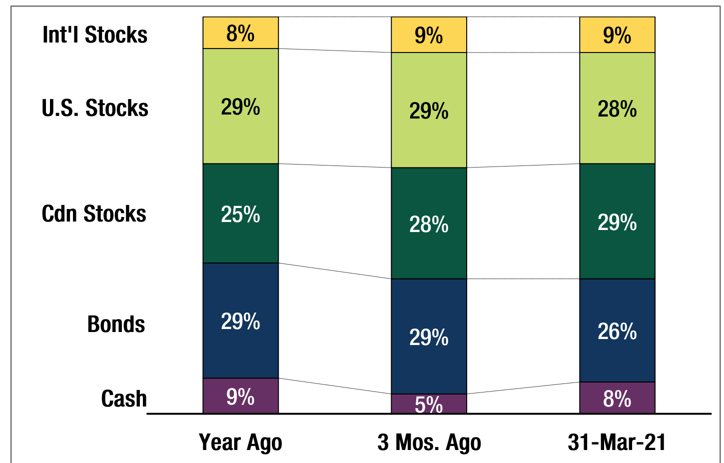
Gains in our international holdings moderated after several quarters of strong performance. The developed markets fund, EQIT, was flat in the quarter, and the emerging markets fund, EMEC, rose 0.8%.

At the end of the quarter, cash represented 8% of the Fund's asset mix, bonds were 26% and stocks accounted for the remaining 66%. 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	5.9%	-1.8%	11.0%	11.3%	0.4%
Benchmark	*2.8%*	*-5.0%*	*8.1%*	*4.9%*	
One Year					
Fund	28.0%	4.1%	40.4%	48.2%	41.4%
Benchmark	*26.6%*	*1.6%*	*44.2%*	*38.6%*	

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 March 31, 2021



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 1.0% in the first quarter. Though our fixed income holdings declined 1.7%, our income-oriented equity investments offset this decline with strength in both our Canadian and U.S. stocks. In the last 12 months, the Fund has delivered a total return of 8.8%.

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

During the quarter, the Canadian bond market, as measured by the FTSE Canada Universe Bond Index, declined 5.0% due to the sharp move higher in interest rates. Our bond holdings declined 1.7%, outperforming the benchmark. Our conservative fixed income positioning provided some protection during this recent move lower as our bond holdings have a relatively short duration and we do not own the longer-dated bonds that experienced the biggest losses. For a more detailed discussion of our bond performance this quarter, please refer to the Fixed Income section earlier in this report.

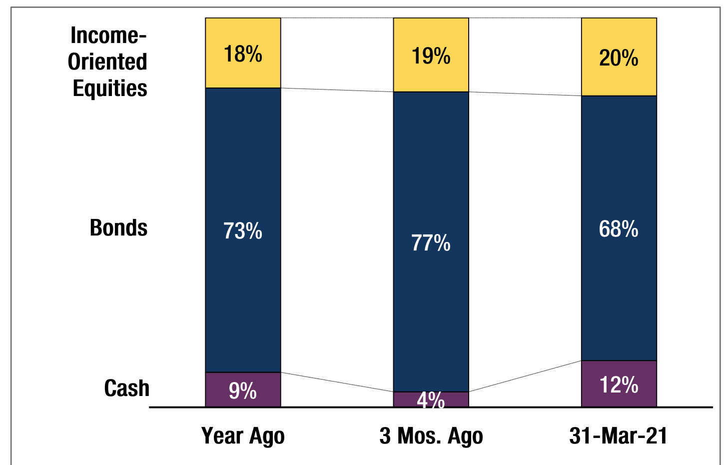
The income-oriented equities we hold in the Fund had a strong quarter, with our Canadian stocks rising 11.5% and our U.S. stocks rising 9.7%. Results over the 12-month period have been particularly strong, reflecting the steep recovery since stock markets bottomed in March of 2020.

At the end of the first quarter, the Fund's cash position was 12%, Income-Oriented Equities accounted for 20%, and the balance, 68%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.0%	-1.7%	11.5%	9.7%
Benchmark	*-5.0%*	*-5.0%*		
One Year				
Fund	8.8%	3.9%	25.2%	37.9%
Benchmark	*1.6%*	*1.6%*		

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, 2021



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]

Following three consecutive quarters of large gains for the International Fund, returns in the most recent quarter moderated. Despite this moderation, the medium-term backdrop for international markets has become more positive as global economic activity looks set to recover to a more "normal" level. The key factors underpinning a global reacceleration will be successful vaccine rollouts, re-opening of economies, and the release of pent-up demand from consumers worldwide. The pace of progress is difficult to predict and will vary from region to region. However, as the pandemic eases, we expect improving economic conditions in most parts of the world. In the longer term, we expect the companies held in the International Fund to benefit from positive demographic tailwinds and the continuing rise of the middle class that characterizes many international markets.

With this backdrop, NIEF gained 0.4% in the quarter, comprised of flat performance for EQIT and a 0.8% gain for EMEC.

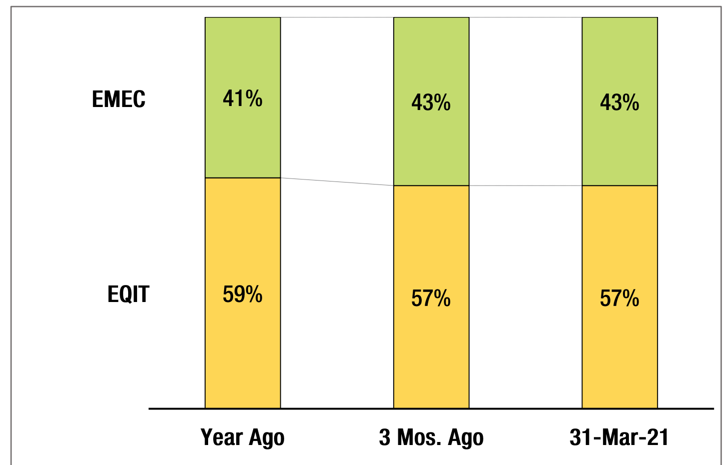
More detail on the Fund's performance is presented in the table below.

At the close of the first quarter, the International Equity Fund's investment in EQIT accounted for 57%, while EMEC accounted for 43%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	0.4%	0.0%	0.8%
Benchmark	*1.9%*	*2.2%*	*1.0%*
One Year			
Fund	41.1%	32.0%	54.5%
Benchmark	*31.3%*	*28.1%*	*40.4%*

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, 2021



International Equity Fund Asset Mix

[9] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 26 developing countries. EQIT and EMEC are managed by J.P. Morgan 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.