The Nexus Report

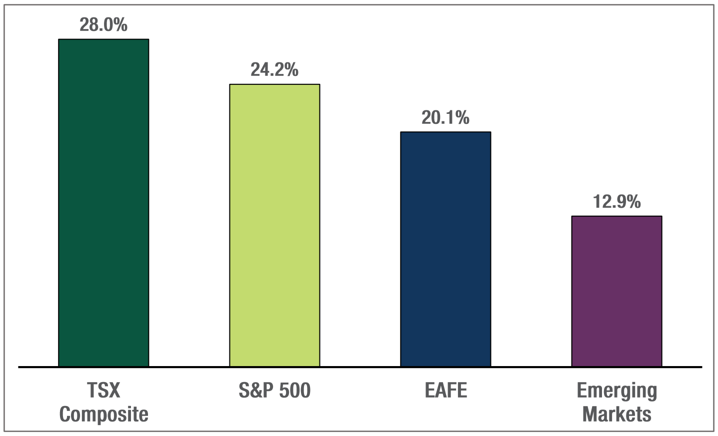
Third Quarter, 2021

Investment Outlook

A Sombre September

The string of successful months in the stock market had to end some time. Perhaps it was predictable that it would end during September, historically the market's most difficult month. After hitting an all-time high on September 2, the S&P 500 – the principal U.S. stock market index – stumbled. The S&P fell 4.8% in September, the worst month for the index since the onset of the pandemic caused stocks to get crushed in March 2020. Similarly, the Dow Jones dropped 4.3% and the NASDAQ slumped 5.3%.[1] The TSX Composite in Canada also declined, although not quite so significantly.

While this setback interrupted the stock market's ascent, returns overall remained modestly positive for the quarter. Most important, year-to-date and 12-month returns for all major stock market indexes are outstanding.



Total Returns for 12 Months ended September 30, 2021 (C$)

There is a myriad of reasons for the stock market's struggles in September. Perhaps the most important is the growing concern about inflation, which we will discuss again below.

Suffice it to say that an energy price spike, supply chain disruptions, and difficulty finding labour in many sectors have pushed prices higher. Reflecting this dynamic, bond yields rose during the month – 10-year U.S. Treasuries rose from 1.3% to 1.5% and the 10-year Canada bond rose from 1.2% to 1.5%. Inflation is unequivocally bad for bonds, but the long-run effect on stocks is more nuanced. The problem in September was that equity investors were caught off guard by the extent and the persistence of recent price pressures.

A few other factors also undermined confidence in stocks. The U.S. Government faced the prospect of a debt default before Democrats and Republicans agreed to raise the debt ceiling. While that risk has been kicked down the road to December, whenever it raises its head, investors get nervous. A U.S. Government default would be catastrophic. Also rattling investor nerves was news of several missed debt payments by Chinese real estate behemoth, Evergrande. Evergrande is the second largest real estate company in the world. A default on its massive debts risks financial contagion throughout the global financial system. As of writing, there has been no resolution to the Evergrande situation other than the hope that it is so big that the Chinese Government will step in to stop it from failing.

The Beat of Growth Goes On

Despite the issues that rattled investors in September, economic growth in both Canada and the U.S. remains solid. In fact, the economic recovery from the depths of the COVID crisis is remarkable. Real U.S. GDP is now 0.9% higher than it was pre-pandemic. As well, forward earnings estimates for U.S. companies are now 21% higher than pre-pandemic levels, stock prices are 27% higher, unemployment has fallen from a high of 14.8% to 5.2%, and the most recent Institute of Supply Management survey result of 61.1 compares to a pre-pandemic level of 51.1 and signals that robust economic

[1] U.S. returns cited here are in U.S. dollars and exclude dividends.

growth lies ahead.[2] It's true that estimates of third quarter U.S. GDP have moderated, but they remain at strong levels.

Even what seemed at first like a disappointing labour market report for September was interpreted as confirmation that U.S. economic momentum remains on track. In September, 194,000 new jobs were created in the U.S. compared to expectations for 500,000. However, this significant headline "miss" was overshadowed by the strong details in the report. Significant revisions higher were made to previous months, wage growth was strong at 4.6% year-over-year, and the unemployment rate fell to 4.8% compared to expectations for 5.1%. There are 10.4 million job openings in the U.S. compared to 7.7 million unemployed.

Economic conditions in Canada are also strong. Our employment report for September was a blockbuster. 157,100 new jobs were created compared to an expectation of 60,000. There are now as many employed Canadians as there were before the pandemic began and the workforce participation rate is also back to February 2020 levels, just shy of the all-time high. GDP growth has been softer in Canada than the U.S. as we were affected more by fourth-wave lockdowns. Second quarter growth was modestly negative, and the negative trend continued in July, with a disappointing 0.1% month-over-month decline. However, August is expected to be positive relative to July, and most economists expect a nice rebound in the third quarter. Hospitality, recreation and air travel are each staging a strong rebound at the same time that there has been a drop in goods consumption.

As has been the case for the last 18 months, the future path of economic growth will be influenced by the ongoing battle with COVID-19. As vaccinations in North America reach high levels, there is every reason to be optimistic. Moreover, U.S. investment dealer, Alliance Bernstein, wrote recently that Merck's new therapy to treat diagnosed COVID infections could be the gamechanger that finally defeats the virus.[3] Its efficacy in reducing serious illness is good, it is a pill which can be easily distributed and administered, and it appears to be an excellent way to manage those who are not yet vaccinated. Bernstein believes that this pill could be what converts COVID from a pandemic to an illness no more concerning than the seasonal flu.

The Spectre of Inflation

In August, the U.S. Personal Consumption Expenditures Index, the Federal Reserve's favourite inflation barometer, rose by 4.3%, the highest rate in 30 years. In Canada, the August Consumer Price Index rose 4.1%, the highest since 2003. Everywhere one looks inflation is evident. Yet the Bank of Canada and the U.S Federal Reserve both dismiss these price pressures as transitory and not a reason to change the course of monetary policy. The Fed believes U.S. inflation will moderate to 2.2% in 2022.

Many investors worry that central bankers are taking the inflation threat too lightly. They see so much fiscal and monetary stimulus in the economy that demand for goods and services has overwhelmed the ability to supply. Moreover, the rising cost of energy and housing, combined with ongoing supply chain disruptions, has raised inflation expectations, which could ultimately translate into demands for higher wages and start a vicious cycle of inflation.

Recently, Bank of Canada Governor, Tiff Macklem, conceded that inflationary pressures have been more acute and likely will persist longer than expected. Still, the Bank of Canada and some other economists believe most of the price pressures stem from pandemic distortions. There is confidence in many quarters that these forces are temporary and will abate with time. While we certainly don't see a repeat of the 1970s, we do believe that caution is required and we will be carefully monitoring inflationary trends.

Market Outlook

Given the incredible stock market run over the last 18 months, it seems reasonable to expect a little more turbulence in the near term. In particular, it seems likely there may be some corporate profit disappointments as the result of some or all the factors mentioned above: rising input costs, supply chain disruptions, and labour shortages. While we are optimistic that the fight against COVID-19 is on a positive trajectory, one cannot rule out the possibility of a fifth wave and more economic disruption. Nonetheless, we think the medium- and longer-term outlook for economic growth, corporate profitability and higher stock prices remains bright.

Where we are most cautious is with regard to interest rates. For some time, we have been anticipating that the era of abnormally low interest rates would end. There have been a couple of false starts on this reversal and maybe the bond market dynamic in September is another example. However, our bond portfolio maintains its defensive positioning – it is designed to protect capital during the period when interest rates normalize.

We remain focused on the most important factor for long-term investment success: time. It is a fool's errand to try guessing what will happen in the coming weeks or months. We devote all of our energy to constructing a diversified portfolio of securities designed to succeed over the coming years. With diligence and consistency we hope that author Morgan Housel might describe Nexus in the same way he described Warren Buffett: "His skill is investing, but his secret is time."[4]

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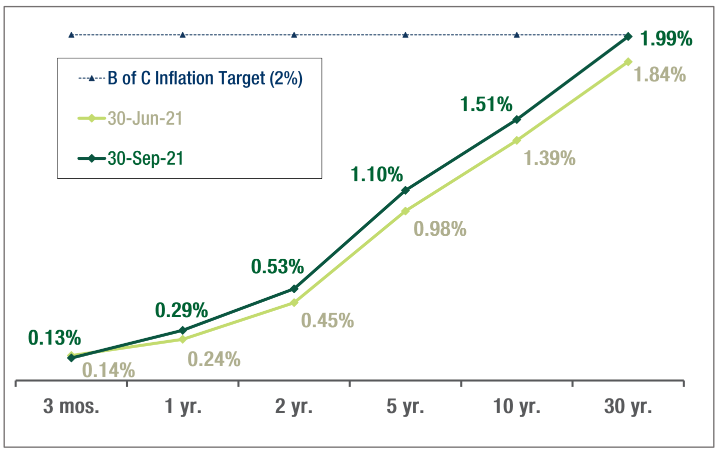
[2] Jonathan Golub, Credit Suisse, October 7, 2021.
[3] Ronny Gal, Alliance Bernstein, October 6, 2021.
[4] Morgan Housel, *The Psychology of Money*.

Asset Class Review

Fixed Income

For the third quarter, the bond market can be described in three parts: in July rates fell as concern grew that accelerating infections would derail the economic recovery; in August rates tracked sideways; and in September rates rose sharply, driven to their highest levels by accelerating inflation. Such market action as occurred was all in longer-maturity securities. In the quarter, 2-year Canada bonds traded in a narrow 13 basis point (bp) range. On the other hand, 10-year Canada bonds traded in a 40 bp range, making a low of 1.11% on August 3rd, before finishing the quarter at 1.51%. All maturities still yield less than the target rate of inflation (see chart).



Government of Canada Yield Curve

The current level of interest rates arises from the deliberate intentions of central bank policy and intervention. In the U.S., the federal funds rate is effectively at 0% and the Fed buys US$120 billion of Treasury and mortgage-backed securities every month. The Fed says that inflation is temporary, and that it is not yet time to end the extraordinary quantitative easing policies that were instituted to combat the pandemic. On August 27th, at the Fed's Jackson Hole Conference, Fed Chair Powell laid out the preconditions for reducing the bond buying that has pressed interest rate levels so low. Unsurprisingly, he thinks the Fed's target of 2% inflation has been met (August CPI was 5.3%). However, he was unwilling to conclude the same about employment. Worried about the effects of the Delta variant, the Fed wants a stronger labour market in order to begin reducing their asset purchasing (bond buying). It is widely expected that the Fed will begin tapering its purchases in November. But lest anyone think the minds at the Fed were changing quickly, Powell was explicit in explaining that increases to interest rates remain a late 2022 event:

"The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test. We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis." [5]

The Bank of Canada is further along in preparing to shift away from an ultra-easy monetary policy. It has already reduced its weekly purchases of bonds from $5 billion to $2 billion. But it certainly isn't in a big hurry. In the press release that followed the September meeting of the Bank of Canada's Governing Council, it left the Bank Rate unchanged and made the case for little change to monetary policy. The premise for not moving to more normal monetary conditions rests on a belief that Delta-variant concerns and supply chain disruptions present risks to economic growth. In the opinion of the Bank, slack in the economy is significant and will not be absorbed until late in 2022. Most importantly, like the Fed, it views current elevated inflation to be temporary.[6] (Canadian CPI was 4.1% in August.)

Even if central bankers are proven right that inflation is temporary, expected returns from the bond market are unappealing as a means of protecting future purchasing power. If there is opportunity in the bond markets, it is for a borrower, not an investor. Government yields are low and credit spreads, the extra yield demanded by investors for the additional risk of lending to a company and not the government, are also very low.

Our portfolio has a duration of 3.8 years – much shorter than the FTSE Canada Universe Bond Index (Universe). It will be less affected by changes to the general level of interest rates, which we expect will rise. In the quarter, our portfolio generated a 0.5% return, while the Universe gave up 0.5%. Over the last 12 months, our bond returns were flat, which was substantially better than the 3.3% loss for the Universe.

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[5] "Monetary Policy in the Time of COVID." Speech by Jerome Powell August 27th, 2021.

[6] "…factors pushing up inflation are expected to be transitory, but their persistence and magnitude are uncertain and will be monitored closely" Press release from the Bank of Canada, September 8th, 2021.

Equities

After a strong run of recent returns, third quarter performance was mixed. The Equity Fund eked out a gain of 0.3% in the quarter, but is up 29.3% for the last 12 months.[7]

Index returns in the quarter were anemic in Canada and the U.S. (both up less than 1% in their home currencies) and international markets were down (measured in US dollars). This outcome was largely driven by a poor month in September – in the U.S. and Canada all sectors of the indices were down in September except for Energy. One benefit in the quarter was the weaker Canadian dollar, which improved our U.S. and international returns from what they were in their native currencies. To illustrate, the S&P 500 was up 0.6% in U.S. dollars, but up 3.4% in Canadian due to the weaker Loonie.

The Equity Fund slightly lagged the blended benchmark in the quarter and comfortably outperformed over the 12 months (the Fund's blended benchmark was up 1.6%, and 24.9%, respectively).

Canadian Equities

Nexus's Canadian stocks declined 0.4% in the quarter, but still had a very strong return of 39.1% for the 12 months.

A key macro event in the third quarter was the increase in energy prices, which benefitted our oil and gas holdings. Indeed, our strongest individual stock was ARC Resources, which we added to the portfolio in July. ARC is a Canadian energy company with a focus on natural gas and natural gas liquids. We believe that there is a favourable supply-demand set-up in oil and gas. The economy is recovering post-COVID, so demand for fuel is increasing. However, oil and gas producers around the world have severely cut back on capital expenditure, constraining supply, and these circumstances may continue for some time as producers remain disciplined and focussed on positive cash flow. One stock-specific contributor was George Weston which gained 16% in the quarter as its plans for a corporate reorganization progress. We also benefitted from *not* holding Canadian materials or cannabis stocks, which sank in the quarter.

The main detractor from returns in the third quarter was Magna, which fell on expectations of a more extended period of constrained auto production due to the semiconductor shortage and on the announcement of a pricey acquisition (since withdrawn).

U.S. Equities

Our U.S. equity portfolio increased 1.9% in the third quarter and 32.1% for the 12 months.[8] As noted, the Canadian dollar weakened in over that period, which boosted the S&P 500 return by 2.8 percentage points from what it would have been with an unchanged dollar. However, even with the third quarter's weakness, for the 12 months the Canadian dollar is noticeably stronger, which reduced U.S equity returns: the S&P 500's 12-month return was 30.0% in US dollars, but only 24.2% in Canadian.

As occurred in Canada, the latest quarter was mixed in the U.S. We had three sectors that did well and three that fell. Financials, Healthcare and Communication Services (Alphabet) did well. Our banks (JP Morgan and Citigroup) perked up, as the prospect of higher interest rates is beneficial for their future net interest margins and a stronger economy should improve demand for loans. All our Health Care stocks were respectable, but Pfizer did particularly well on expectations for a longer period of demand for their COVID vaccine. Our three declining sectors in the quarter were Industrials, Information Technology and Consumer Discretionary. Notably, Western Digital (computer memory chips and data storage disks) declined, as did GM and UPS. GM is also struggling with semiconductor shortages curtailing production, and UPS was down on fears of labour shortages and possible wage inflation, issues which we think will pass.

Stock markets have had a strong run, not only in the COVID recovery, but also over the past 12 years since the global financial crisis. At this point, U.S. equity market valuations are elevated on an absolute basis (although they are reasonable in comparison to bond valuations). We continue to feel comfortable, as our equity portfolio has a lower valuation multiple than the market, and this is especially so when compared to the currently in-favour growth stocks.

Other Equity Investments

We remain invested in two externally-managed pooled funds, which add international exposure and diversification to our Funds.[9] After a strong period, third quarter returns from international were slightly negative, as the delta variant and events in China (such as Evergrande) caused wobbles in emerging markets. In the quarter and for the 12 months, EQIT (international developed market equities) returned 1.3% and 17.4%, while EMEC (emerging market equities) fell 4.3% and gained 15.0%. These holdings remain 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.

[7] 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.

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

[9] 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 generated a total return of 0.3% in the third quarter. This return marks a moderation from the large gains achieved in the first half of the year, when the market recovery from COVID was in full force. Market sentiment shifted in the quarter, from a narrow focus on COVID to a broader set of considerations including inflation, potential Federal Reserve actions, the leveraged Chinese property market and the proposed U.S. infrastructure bill.

In the last 12 months, the Fund has returned a remarkable 29.3% reflecting both the market recovery from the depths of the COVID crisis as well as the improving fundamentals of the companies that we own in the Fund. We are pleased with the resiliency of our holdings and are optimistic that profit growth will continue as the world returns to a more normal state.

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

The Canadian market produced only a modest gain of 0.2% in the quarter. The Energy sector gained during the period, particularly in September. Our new holding in energy company ARC Resources gained 23% in the quarter and our existing holding Cenovus also rose 8%. Another highlight was George Weston, which rose 16%. On the other end of the spectrum, Magna declined 16% as its business was affected by automotive supply chain disruption. Allied Properties also fell as the Delta variant has delayed many return-to-office plans.

U.S. market gains were similarly muted, rising 0.6% in the quarter.[10] Our healthcare holding, Pfizer, gained 11%, helped by vaccine sales and solid traction in other parts of its business, such as its oncology drug portfolio. Several of our financial holdings also performed well as rising rates and normalizing economic conditions helped their businesses. While the 12-month gains in the U.S. have been remarkable, we remain cautiously optimistic that investors can continue to earn reasonable returns as the economic recovery progresses.

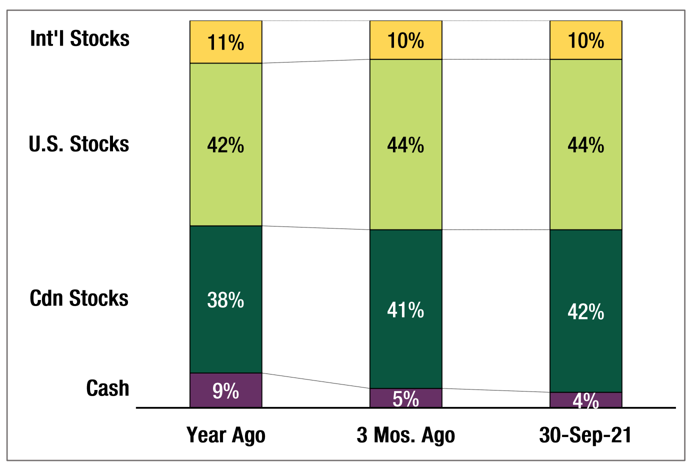
Outside of North America, our international holdings delivered mixed results. The developed markets fund, EQIT, gained 1.3% while the emerging markets fund, EMEC, declined 4.3%.

At the end of the third quarter, the Fund's cash position was 4%. Our allocation to Canadian stocks was 42%, while U.S. stocks represented 44% of the mix. We have maintained an allocation of 10% to markets outside North America and remain confident that this will provide important diversification to our North American investments.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	0.3%	-0.4%	1.9%	-1.2%
Benchmark	*1.6%*	*0.2%*	*3.4%*	
One Year				
Fund	29.3%	39.1%	32.1%	16.3%
Benchmark	*24.9%*	*28.0%*	*24.2%*	

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, 2021



Equity Fund Asset Mix

10 All return figures in this paragraph are total returns expressed in US$ terms.

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 0.9% in the third quarter. Our bonds performed well, gaining 0.5% as compared to the bond index which declined 0.5%. Our Canadian stocks were mostly unchanged, while our U.S. stocks gained 3.1% in Canadian dollar terms, helped by the weakening of the Loonie over the quarter.

In the last 12 months, the Fund has returned 19.4% due to the large recovery in our Canadian, U.S. and International stocks.

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

Our bond holdings navigated a volatile quarter, with Government of Canada bonds rallying in July before selling off significantly in September. Nexus's bond performance was protected by our concentration in shorter-dated maturities, as it was longer-dated bonds that were hurt the most by the move in rates.

For our equity holdings, the quarter brought a mix of positive and negative performance. In Canada, two of our energy holdings, ARC Resources and Cenovus, posted strong gains as energy prices rose. However, this was offset by declines in Magna (impacted by auto supply chain disruptions) and Allied Properties (delays in return-to-office plans). In the U.S., Pfizer gained 11%, helped by vaccine sales and solid traction in other parts of its business, while GM and Western Digital declined as challenges in the global semiconductor supply chain persisted.

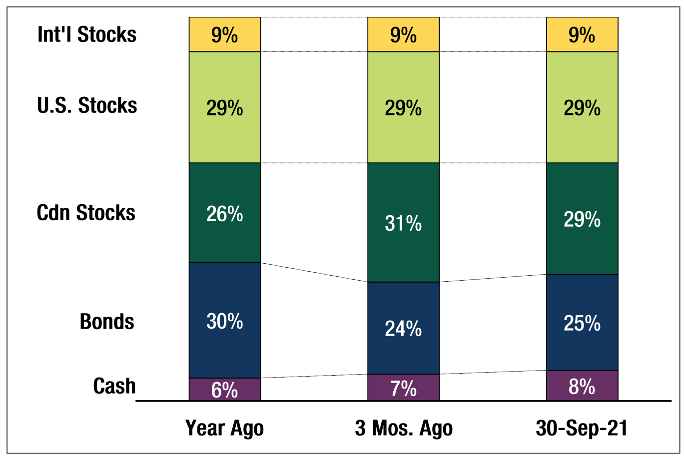
Outside of North America, our international holdings delivered mixed results. The developed markets fund, EQIT, gained 1.3% while the emerging markets fund, EMEC, declined 4.3%.

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	0.9%	0.5%	0.1%	3.1%	-1.2%
Benchmark	*0.8%*	*-0.5%*	*0.2%*	*3.4%*	
One Year					
Fund	19.4%	0.0%	37.9%	30.8%	16.4%
Benchmark	*15.6%*	*-3.3%*	*28.0%*	*24.2%*	

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 September 30, 2021



Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 0.4% in the third quarter. Our bond holdings gained 0.5% and our income-oriented stocks also contributed to the positive returns. Over the past 12 months, the Fund rose 5.6%, outpacing the benchmark which fell 3.3%.

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

Our bond holdings navigated a volatile quarter, with Government of Canada bonds rallying in July before selling off significantly in September. Nexus's bond performance was protected by our concentration in shorter-dated maturities, as it was longer-dated bonds that were hurt the most by the move in rates.

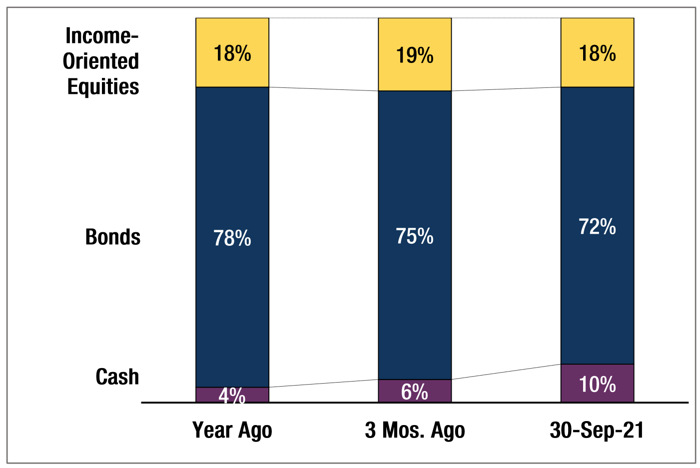
The income-oriented equities we hold in the Fund performed well in the quarter, with both our Canadian and U.S. stocks gaining ground. Over the last 12 months, the income-oriented stocks have performed remarkably well, with the Canadian holdings up 31.5% and the US holdings up 30.9%. These gains reflect both the market recovery from the depths of the COVID crisis as well as the improving fundamentals of the companies that we own in the Fund.

At the end of the third quarter, the Fund's cash position was 10%, Income-Oriented Equities accounted for 18% and the balance, 72%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	0.4%	0.5%	0.5%	4.6%
Benchmark	*-0.5%*	*-0.5%*		
One Year				
Fund	5.6%	0.1%	31.5%	30.9%
Benchmark	*-3.3%*	*-3.3%*		

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, 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).[11]

NIEF declined 1.1% in the third quarter. EQIT performed well, gaining 1.3% in the period, but EMEC fell 4.3%.

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

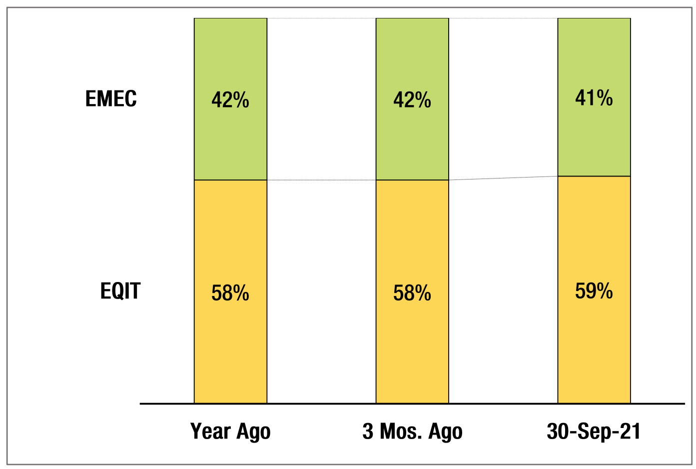
Many emerging markets continue to struggle with COVID and, in particular, the Delta variant. The other factor that worried markets this quarter was China's highly leveraged property market, which came to the fore with headlines around the Chinese real estate developer Evergrande. While neither of these challenges will be resolved immediately, we expect that most emerging market economies will regain their footing over time as vaccine distribution gains breadth, COVID recedes and global growth reaccelerates.

At the close of the third quarter, the International Equity Fund's investment in EQIT accounted for 59%, while EMEC accounted for 41%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-1.1%	1.3%	-4.3%
Benchmark	*0.4%*	*2.3%*	*-5.5%*
One Year			
Fund	16.5%	17.4%	15.0%
Benchmark	*18.4%*	*20.1%*	*12.9%*

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 September 30, 2021



International Equity Fund Asset Mix

[11] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 26 developing countries. EQIT and EMEC are managed by JPMorgan Asset Management in the U.K. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.