

NEXUS NORTH AMERICAN INCOME FUND QUARTERLY REPORT – March 31, 2006

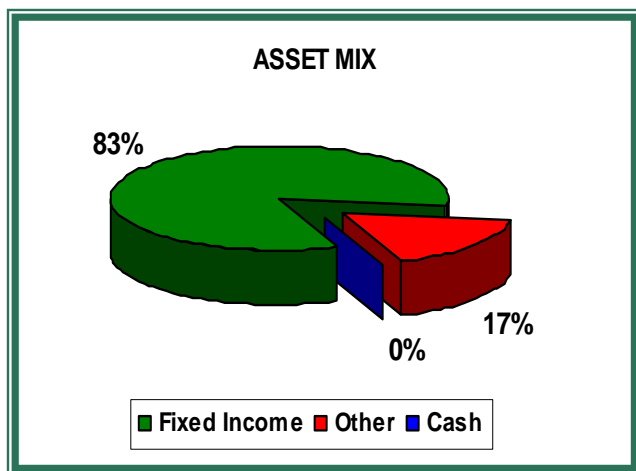
This was a quarter of trading water for the Fund and its unitholders, as distributions and interest income basically cancelled the modest decline in bond prices. There was little volatility as interest rates moved slowly and steadily higher. In short, an uninspiring and unexciting quarterly experience – basically consistent with our own forecast that Canadian interest rates would stay in a fairly narrow range over the course of the year.

Over the course of the quarter, ten year interest rates increased 30 basis points, to 4.26%, but they rose almost 45 basis points in the U.S., taking their ten year rate to 4.85%. Despite a continuation of the trend for firmer commodity prices, this widening interest rate differential between Canadian and U.S. rates continued to put pressure on the Canadian dollar. After beginning the year at US\$ 0.86 it reached a high above US\$ 0.88 in early February and slipped all the way to US\$ 0.85 at quarter end.

Both the Bank of Canada and the U.S. Federal Reserve increased their short-term interest rates twice this past quarter. For the most part, these changes to official interest rates were well anticipated and came as little surprise to the markets. In fact, what captured most of the market's attention was the passing of the reins of power from Alan Greenspan, Chairman of the U.S. Federal Reserve, to his successor Ben Bernanke.

The Chair of “the Fed” is one of the most powerful positions in government and as a result, commentators are transfixed with divining whether there is anything in Mr. Bernanke's history to indicate where his predilections lie. Having previously been a member of the U.S. Federal Reserve, an economics

professor at Princeton and the Chair of the President's Council of Economic Advisers, Mr. Bernanke has a public record that might suggest what policy changes may be expected under his watch. In our opinion, the Fed under Mr. Bernanke will not depart from the successful pattern established under Mr. Greenspan. That is to say, traditional economic indicators of growth and inflation will be closely monitored and any upside pressures on inflation will be met with monetary restraint (higher interest rates). In the coming months, it is highly likely that the cost of overnight borrowing in the United States (the Fed Funds rate) will rise from 4.75% to a peak of no more than 5.25%.



As an observation, where Mr. Bernanke differs from Mr. Greenspan is in his communication style. In his final years, Mr. Greenspan's pronouncements on economic matters took “convoluted” to a higher plane. Mr. Bernanke will certainly speak more clearly and may well commit the Fed to explicit inflation targets, such as we successfully have had in Canada for many years.

On the economic front, it is clear that the U.S. housing market has finally reached a peak and that the buoyant construction, sales and pricing activity of the last many years are behind us. Recall that surging home prices in both Canada and the U.S. have underpinned a very strong consumer sector. Borrowing against the equity in one's home has allowed many homeowners to consume at a rate not justified by either the level or the growth in their income. In the U.S., the most recent data on sales of new homes suggest that sales activity has declined 13% in the past year, and that median house prices have declined 5.5% from the highs of October. More worryingly, inventories of new unsold homes have increased dramatically, suggesting that the weakness in this area is building momentum. As a very general estimate, Merrill Lynch estimates that almost everyone who has purchased a new home since 2004 has not built up any incremental equity. Another survey, by First American Realty, suggests that in the same period, almost 30% of new borrowers have negative equity in their homes.

We stop well short of becoming too alarmed at the weakness in this sector just yet. Thankfully, employment in both Canada and the U.S. remains at very high levels, and employment income is the single most important determinant of housing affordability. Given the strong employment situation, the increase in posted mortgage rates in Canada, from 5.25% in the summer of 2005 to more than 6.5% currently,¹ looks manageable. However, we know that interest rate increases operate with a lagged effect on the economy, and what seems apparent is that a long awaited slowdown in consumer spending is upon us. In our opinion, interest rate increases put in effect by both central banks will "bite" a little deeper than many expect, and consumer discretionary spending will be "pinched" in the months ahead.

Over the quarter, the Fund returned -0.1%². This was better than the small negative return of -0.4% from the Scotia Capital Bond Universe Index (SCBU) in the same period. The Fund is up 5.6% in the last year, comfortably ahead of the SCBU's return of 4.9%.

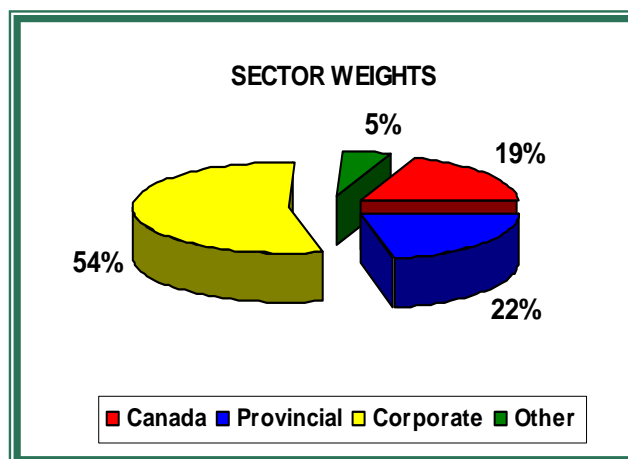
Asset Mix

The allocation between bonds and other income producing securities remains at about the level it was at year-end. We continue to run with a very small cash position. As a practical matter, we are fairly close to our guideline limit of 20% invested in income producing equity and income trust securities.

Fixed Income Summary (83% of Assets)

As mentioned above, it has been a reasonably uneventful quarter in fixed income markets. However, an unexciting interest rate environment is actually good for bringing new issues to the marketplace. It gives the issuer the time to tell its story without the distractions of market volatility, and it affords investors such as Nexus the time to properly evaluate the credit characteristics of each particular issuer.

This past quarter, we have been able to add to our list of holdings with a number of different issues. For the most part, the new issuance has broken down into two broad categories. Firstly, financial services companies who have well established credit profiles and very regular borrowing requirements, and secondly, foreign companies and governments of high credit quality issuing debt securities in our market. This latter group has come to be known as "Maple bonds". In the past quarter, we have improved the diversification and the credit quality of our portfolio holdings. This strategy



¹ Bank of Canada.

² Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

of emphasizing quality will be rewarding should economic activity moderate more than general expectations.

In international markets, upward pressure on interest rates is becoming apparent. In Japan, where macro-economic policy changes at a glacial pace, it is clear that the Bank of Japan is preparing the country for a shifting away from the “zero-interest rate” regime that has been policy for many years. Likewise in Europe, after many years of slow growth and competitive adjustment, there is a measurable pick-up in economic activity. This will almost assuredly be accompanied by modest interest rate increases. Given the enormous trade and budget deficits in the United States, we expect that as other central banks around the globe embark on their own tightening programs the effect will be to pressure interest rates higher in the United States. Undoubtedly, this will affect Canadian rates as well. We are positioned to take advantage of a gentle rise in interest rates – particularly longer dated maturities. We are maintaining an emphasis on maturities of less than ten years and are running a duration of 5.6 years, almost a full year shorter than the SCBU.

Income Trusts and Equities (17% of Assets)

Continued positive returns from our equity and income trust holdings abetted the Fund's out-performance this quarter. In late 2005 our positions benefited from the change of policy announced by then Finance Minister Goodale. Currently, the balance of opinion favours that the new Conservative government will enact changes in their upcoming budget that are at least the equivalent of what had previously been proposed. Our holdings remain heavily concentrated in banks and utilities. Our holding of Income Trusts, diversified in a broad array of industries, totals 5.9% of our total exposure at this time.

