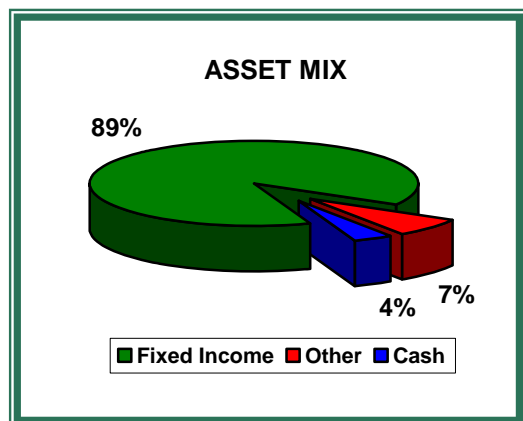


NEXUS NORTH AMERICAN INCOME FUND

QUARTERLY REPORT – December 31, 2008

Thankfully, 2008 is now in the history books. Economic historians describing this period will surely relish the rich trove of problems made manifest in the global economy over the year, as well as the severity of the reactions in the commodity, equity and bond markets. On the other hand, investors, worn down by the many catastrophic developments of the year, are anxious to put the year behind them. Unfortunately for investors, it seems likely that the unsettled markets and difficult conditions which have prevailed in 2008 are unlikely to fade quietly into the background.

On the brighter side, after more than a year of convulsions and disruption, the credit markets may at last be coming to a period of relative stability. Optimism in this sector is premised almost entirely on the worldwide commitment of governments and their agencies to backstop almost any financial institution in distress. The list of actions undertaken is too lengthy to cite comprehensively, but two are worth noting. The first is truly global in nature, and that is the recapitalization of the banking system by governments. For the most part, this has been achieved by the direct investment of taxpayer monies in the institutions themselves, but it has also been enhanced by the relaxation of the applicable rules regarding what regulators require for capital. The second action worth highlighting is the abrupt and steep declines in interest rates orchestrated by central banks around the world. In Canada, the Bank of Canada's target for the overnight lending rate is now 1.5%, half the level it was in June¹. Yet this pales in comparison to the U.S. Federal Reserve which has lowered their policy rate to a level just above 0%.² Like Japan in the early part of this decade, the U.S. has instituted a ZIRP (Zero Interest Rate Policy).



Turning to the economy, in the final quarter of the year, global economic news continued to deteriorate. In Canada, the effect of falling commodity prices and the sagging economic performance of our major trading partners is the primary source of weakness. For now, our economic woes pale as compared to the U.S. In the U.S., there are many sources of weakness: economic reports from the housing and construction sector are unrelentingly bad and measures of consumer and business confidence are at record low levels. Further afield, it is clear that the economic slowdown is truly global. The U.K. and

European economies are also in retrenchment and, increasingly, it is clear that both China and India are growing at much slower rates than what was predicted.

The cure for this malaise is complicated. Whether we get the right policy prescriptions is very much up in the air at this time. After many years of excess spending and borrowing, consumers in the developed world (particularly North America) need to repair their household balance sheets by spending less and saving more. This process is now underway as individuals realize that the idea of building wealth through home ownership is insufficient. This will take time - perhaps years. To replace lost consumer demand, governments will need to spend more. Properly done, there is a large opportunity for governments in Canada and the U.S. to make important investments in renewing and expanding the transportation, technology and education infrastructure in North America, truly enhancing our global competitiveness.

¹ In Q4 '08, the Bank of Canada lowered rates three times, culminating in a 0.75% reduction on Dec. 9th.

² On December 16th, the Federal Reserve Open Market Committee established a target rate for the Federal Funds rate of between 0 and ¼ of a per cent.

Unsurprisingly, the politicians and special interest groups are lined up and ready to go. At the time of writing, the U.S. seems ready to commit to \$1 trillion of stimulus and our own Conservative government is rumoured to be considering deficits of as much as \$30 billion.³ Sadly, we don't have great confidence that our partisan politicians, influenced by the usual vested interests, will allocate such large sums of capital and make investment decisions wisely. If you watched any of the congressional and senate hearings regarding the bailout of the 'big three' automakers, or followed our own recent parliamentary debacle in Canada, even the most optimistic person would worry about the risks that lie ahead.

As we survey the investment landscape for 2009, we expect that the economic news will continue to deteriorate. The early read on holiday sales was soft. While sales levels were better than the direst of forecasts, it was largely due to aggressive price discounting throughout the Christmas season. As well, in both Canada and the U.S. employment continues to deteriorate. The travails of the auto industry and their parts suppliers are indicative of what many industries will be going through. Even with generous bailouts or rescue packages, industry will need to make adjustments to the size of their workforce in order to be competitive. We are prepared for more bad news.

Just as we are prepared for more bad news, so too in many respects is the market. Interest rates on government bonds are low, reflecting an investor preference for absolute safety as well as a period ahead of subdued inflation or even the risk of deflation. Likewise, share prices reflect valuations that in many instances incorporate an almost never-ending run of bad economic and corporate news. If we take for granted that the economic news in 2009 will be weak, then the key to navigating through this period will be to position portfolios to take advantage of sectors and companies where more bad news is anticipated than what unfolds, and to avoid sectors of the capital markets that may yet feel the brunt of the coming recession. 2009 will undoubtedly be a difficult year, but not without opportunity.

The Fund gained 1.8%⁴ in the last quarter, and was up 2.6% for the year. The DEX Universe Bond Index (DUBI) was higher by 4.5% for the quarter and increased 6.4% for this year. While our bond results (+7.2%) outpaced the return of the DUBI this year, the Fund's total return suffered from a decline in the value of our holdings of 'other income-producing securities'. The Fund continues to maintain its out-performance relative to the DUBI over longer time periods.

Asset Mix

We increased our allocation to fixed income this quarter primarily by reducing the allocation of 'other income-producing securities'. Our allocation to traditional fixed income is 89%, our holdings of cash equivalents is now 4% and the balance of 'other income-producing' securities rests at 7%.

Fixed Income Summary (89% of Assets)

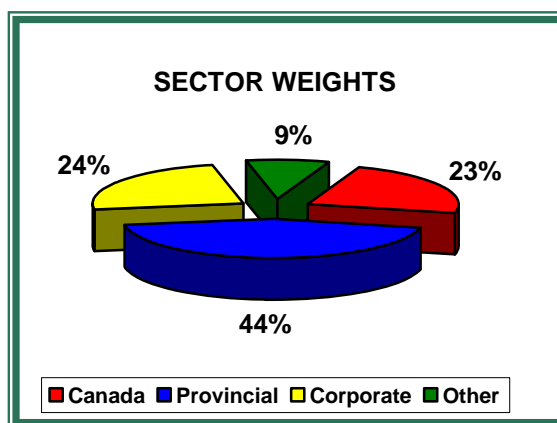
Government interest rates plunged this quarter, led lower by aggressive and concerted central bank easing. This was a world-wide phenomenon, effected in co-ordination with other national stimulus and rescue packages. After many years of central banks leading campaigns to fight inflation and to convince investors, consumers, and businesses alike that it would stay low, central banks now seem pre-occupied with the worry that this period of economic adjustment might cause deflation. As the Japanese discovered while they endured a prolonged period of economic recession, deflation - the experience of falling prices - encourages spenders to postpone purchases which exaggerates an economic recession.

³ National Post, December 23, 2008.

⁴ Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

As investors have rushed to safety around the globe, the spread between corporate bonds and government bonds has increased to record levels. Accurate historical data on this market is scarce but, in the U.S., spreads have moved to levels last seen in the depths of the Depression. Interestingly, returns to investors who held bonds from that point forward proved to be excellent.⁵ In Canada, corporate bond spreads have also moved dramatically wider. Five year government securities in Canada yield about 1.7%, a massive decline of 1.5% since the end of the 3rd quarter. Unfortunately, the rates for other issuers declined much less. The spread over five year Canada bonds at which Province of Ontario bonds of similar maturity trade widened by 0.35% and now yield 1.20% more than Canada bonds. In the corporate sector, the spread widening has been extreme - particularly for the financial companies that dominate the Canadian bond market. The spread between Canada bonds and subordinated bank debt (a common form of bank borrowing) actually widened 1.75% in the last quarter alone. As such, for most banks, the price of borrowing money actually increased in the last quarter, despite the record decline in government interest rates.

The focus of central banks moving forward will be to encourage properly functioning credit markets, as confidence has been damaged by the credit losses emanating from the mortgage crisis and even the most worthy non-government borrowers are having trouble accessing markets. With an emphasis on quality, we expect that our holding of provincial and corporate securities will benefit from a reduction in the spread over Canada bonds. Between five and ten years in maturity, there are a number of solid credits that yield between 6% and 8%, which should prove attractive – especially if inflation remains under control as we expect.



Other Income-Oriented Securities (7% of Assets)

The steep decline in equity prices this past quarter affected the value of our holdings in this area, detracting from performance in the Fund and reducing the relative weighting of this portion of the Fund. This has been especially true of bank shares but has even affected our two pipeline companies, Enbridge and TransCanada as well. We view their businesses as stable, their dividends as safe and think they look more attractive than ever at these levels.

As we discussed in our previous report, Teranet Income Fund was the subject of a takeover which has now been completed. Despite the unsettled times and even though the offer price was at a premium to where it was trading in the market, we had hoped that other shareholders like us would have been reluctant to sell at the offer price of \$10.25 and that the buyer would have been forced to pay more. Unfortunately, this did not occur.

While our allocation to 'other income-oriented' securities has had a negative impact on the Fund in the last year, we continue to believe that an allocation to these securities will enhance long-term returns to unit holders.

⁵ Barclays Capital, as reported in the Financial Times January 6th, 2009.

