

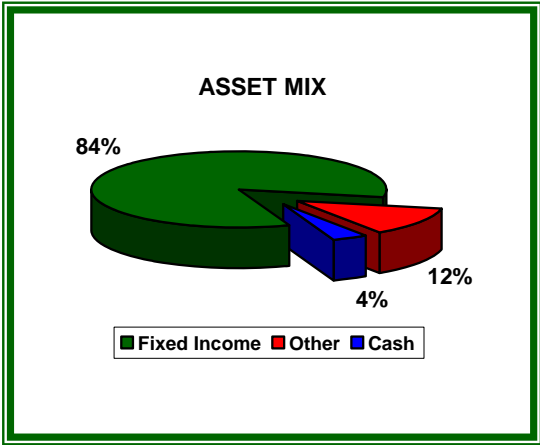
**NEXUS NORTH AMERICAN INCOME FUND**  
**QUARTERLY REPORT – June 30, 2009**

*From the initially careful references to data that suggested a slowing of the rate of decline in global activity, the use of the term “green shoots” has quickly evolved. Some now refer to green shoots as if the global recovery is a forgone conclusion or even as if sustainable growth had already begun.....Just as you don’t count your chickens before they are hatched, we shouldn’t presume that green shoots today guarantee a bumper crop tomorrow<sup>1</sup>.*

*Mark Carney, Governor of the Bank of Canada*

Despite continued deterioration in a wide range of economic fundamentals around the globe, bond and equity markets generated substantial positive returns in the second quarter of the year. Since the end of the first quarter, economic news continues to indicate widespread weakness across a range of economic measures such as employment, factory output, and consumer spending. For those not inclined to track economic statistics, there were bankruptcy filings by such former corporate leaders as GM and Chrysler, as well as General Growth Properties, the second largest mall operator in the United States. Even California, on its own the 8<sup>th</sup> largest economy in the world, seems set to default on its bonds. There is abundant evidence that the economy, especially in the developed world, remains in a deep recession. Yet, it is also evident that the pace of economic contraction has also moderated, holding out hope that a more stable economic period lies ahead. In the face of a litany of dark economic news, and keeping to their well-broadcast public commitments, politicians and central bankers continued to roll-out spending programs, interest rate cuts and other policies to address the widespread economic weakness.

For investors, it remains a period without easy or accurate precedent. For now, our confidence has risen that economies in the developed world will avoid a deep depression and that a profound period of economic weakness will not necessarily be accompanied by a like amount of earnings weakness.



In the Great Depression, the length and depth of economic contraction was much more extreme than our present circumstances, but this recession has been without precedent in the pace with which the economy has shed jobs and industrial activity has declined. It would only be natural that after such a sharp slowdown such as we’ve recently endured, and in the face of unprecedented economic stimulus, some rebound in activity will occur.

We remain concerned with the ongoing weakness in the U.S. housing sector. Despite some signs of moderation in the rate of decline of house prices, as well as an improvement in the sentiment of homebuilders, the housing sector remains very weak. Mortgage delinquencies are rising rapidly, home prices are still falling and, as we said in our last report, the effect of this

continues to reduce consumer spending and asset quality in the banking system. In response to job losses and sliding asset values, consumers have become more cautious. The number of unemployed has risen for 18 consecutive months and over that time, more than 6 million jobs have been lost.

On the bright side, after many years of excessive spending, Americans are now saving again. Over the course of this year the savings rate has risen from nil to 6.9% and may well rise further. Not since 1993 have Americans consumed so little of their disposable income. After years of spending as much as they

<sup>1</sup> Remarks to the Regina & District Chamber of Commerce, June 18, 2009.

could, this new thriftiness is undoubtedly an indication of a greater realism about economic matters on the part of U.S. consumers. Another welcome development arising from the economic turmoil is that, as a result of consumer restraint and a decline in the price of imported energy, the U.S. trade deficit has made a stunning improvement. After many years where the monthly imbalances exceeded \$60 billion, the trade deficit has now been below the \$30 billion level for three months. A correction in the imbalance between consumption in the U.S. and savings in the rest of the world is an early, first step toward better global economic stability.

Unfortunately, although necessary in the long run, a more cautious consumer will act as a drag on economic recovery in the short-run. However, lower personal consumption is more than being made up by government stimulus efforts. Around the globe, governments are spending and borrowing with abandon. The IMF estimates that for its 10 largest members, public debt as a percentage of GDP will rise from 78% in 2007 to 114% by 2014.<sup>2</sup> The future burden of servicing and paying off this debt is a present worry overhanging capital markets.

Here in Canada, despite many structural advantages, our economy remains seriously affected by the global economic slowdown. GDP has now fallen for 9 months in a row and is currently declining at a 3% annual rate. After being as low as 5.8% in January of 2008, unemployment is now 8.4%. It is widely expected to move higher still. A slow recovery in the United States logically means a slow recovery here. However, there is hope that commodity prices have begun to stabilize, reflecting resilient demand in the developing world and a source of potential export growth for Canada.

The Fund gained 3.6%<sup>3</sup> in the last quarter, and is up 7.0% in the last 12 months. The DEX Universe Bond Index gained 1.3% over the quarter and increased 7.0% since last June. Our bond performance continues to be excellent with our holdings continuing to run well ahead of the index. In this quarter, Fund performance was enhanced by the rebound in the value of our 'other income-oriented securities', we continue to believe that these securities will add value to the Fund.

## Asset Mix

We continued to increase our allocation to 'other income-oriented securities' this quarter and also added slightly to our cash position. Our allocation to bonds is 84%, our holdings of cash equivalents is now 4% and the balance of 'other income-producing' securities rests at 12%.

## Fixed Income Summary (84% of Assets)

In mid-April, the Bank of Canada continued to try and lead market interest rates lower with a 0.25% reduction in the target overnight borrowing rate to 0.25%. As a practical matter, there remains no more room to provide interest rate stimulus. As nothing more can be done in terms of lowering rates, the Bank compensated by emphasizing in the press release that accompanied their decision that they intended to keep the Bank Rate at this level until at least the second quarter of 2010.

Yet, despite the clarity of the message that current economic conditions warranted low rates, in fact interest rates for longer maturity government bonds actually rose this quarter. Just as equity prices may be anticipating an eventual recovery and a more hospitable earnings outlook, so too are bond prices forecasting a concern over the size of the deficits and financial commitments made by governments to forestall economic calamity. This problem is most acute in the U.S., but developments there are forcing rates higher in our market as well.

A combination of excess economic capacity, downward wage pressure and falling asset prices means an imminent bout of inflation is unlikely. However, lingering in the minds of bond investors is the worry that a

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<sup>2</sup> Debt: The biggest bill in history - The Economist, June 13<sup>th</sup> 2009.

<sup>3</sup> Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

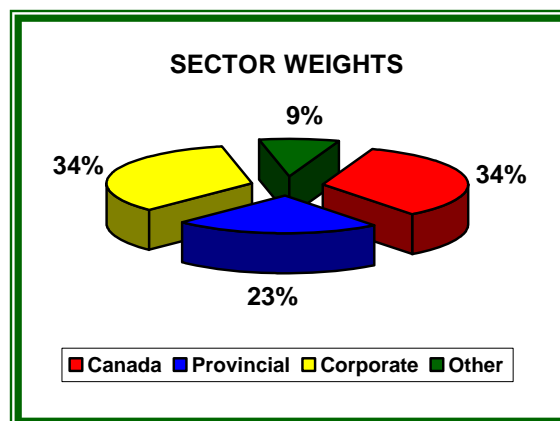
rapid increase in deficits, such as is now occurring, often presages a period of inflation. History has shown that the burden of paying interest and repaying debts often results in policy makers choosing to tolerate an increase in inflation in order that they can more easily service and repay their obligations with devalued currency. As the national debt of the U.S. grows to be larger than its economy, a legitimate worry arises that the interest burden of the debt will be higher than the nominal growth rate of the economy. Such a situation is called a debt-trap and the consequences for bond-holders and citizens alike are very serious.

There is one other issue related to the present economic situation that makes these dire worries more relevant and that is the increasing attention being paid to the underfunded U.S. social security and healthcare systems. To his credit, President Obama has begun to press for attention to these issues, but the sheer scale of the problem certainly contributes to a growing lack of confidence in the integrity of the U.S. economy and the U.S. dollar's status as the global reserve currency.

Aware that inflation is not a problem in the short run, but mindful that the massive deficits being created today eventually may create significant inflation risks, we are operating with a slightly defensive position in the bond portfolios. We hold fewer corporate bonds and more Canada bonds than last quarter and we have a maturity profile that is shorter than our benchmark.

Liquidity, the ability to buy and sell without changing prices, has improved from last quarter but remains challenging. Trading corporate bonds remains particularly problematic. In an ultra-low interest rate environment, it is tempting to reach for extra yield through a larger allocation to corporate bonds, but we remain wary of the risk of this illiquidity that should we

want to alter the structure of our holdings in the future, it will introduce much higher trading costs than has been the norm historically. As we expressed last quarter, it is likely that we will carry a lower allocation to corporate bonds until liquidity conditions in the market improve.



## Other Income-Oriented Securities (12% of Assets)

We remain below our limit of a 20% allocation to this sector, although we did increase our allocation by 3% over the course of the quarter. Specifically, we have added three new holdings in the telecommunication services sector. This is an area of the market we think has attractive defensive characteristics and pays a generous distribution to shareholders. Two of the new positions were Telus, the western based wireline and wireless services provider, and Rogers Communications, predominantly a wireless telephone and cable systems operation. Both are likely familiar to unit holders. Our largest addition was a purchase of Bell Aliant Regional Communications Income Fund. Bell Aliant provides wireline telephone service throughout most of eastern Canada other than the heavily populated Windsor – Quebec City corridor. It pays a generous distribution supported by a stable business that faces no competition in many of its markets. Growth in value-added services such as high-speed internet access should more than offset the slow decline in its traditional landline telephone business.

This quarter, our allocation to 'other income-oriented' securities has had a very positive impact on the Fund, rising 24.1%. We now own 14 different securities spread across 6 different industrial sectors and we continue to believe that an allocation to these securities will enhance long-term returns to unit holders.

