

## **NEXUS NORTH AMERICAN INCOME FUND**

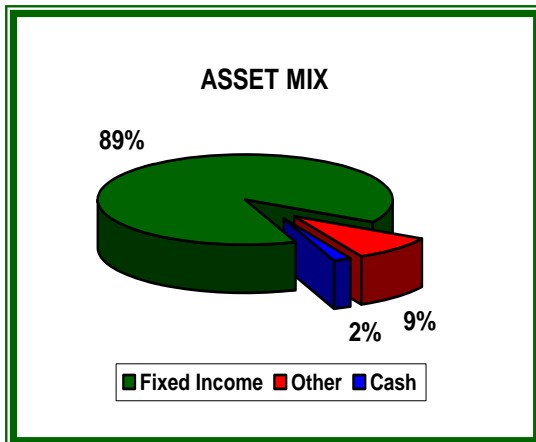
### **QUARTERLY REPORT – March 31, 2009**

The environment for investing remains as complex and unsettled as it has been in the last 75 years. Weary of the challenges of 2007 and 2008, investors may have hoped for easier markets, but certainly 2009 has started in as difficult a fashion as 2008 had ended. Just as notable as any news regarding markets, was the inauguration of Barack Obama in mid-January, along with the installation of new cabinet members and the implementation of new policies to address the U.S. economic crisis. In response to a quarter where every week brought another release of worrying economic or banking news, the Obama administration rolled out a torrent of ambitious new policy responses and spending initiatives. Indeed, it also spent great effort exhorting other countries to do likewise. Globally, the size and speed of government response to the economic crisis is without precedent.

It remains to be seen how successful this “shock and awe” fiscal and monetary policy will be, for it is certainly not without risk. As we assess the likely effects, three issues are worth noting:

- ◆ Firstly, interest rate changes operate with long lags - conventionally it takes 12 months or more for their effects to be felt. The substantial reduction to interest rates that occurred in late 2008 has yet to be fully felt economically.
- ◆ Secondly, it may take well into 2010 for the direct injection of government spending to be fully deployed. Even the most “shovel-ready” projects will take months to be implemented.
- ◆ Finally, while these responses to our economic challenges are meant to offset the economic effects of a retrenchment in the consumer sector, the almost incalculable size and scope is also meant to shore up public confidence that politicians are addressing the challenges in a bold and creative fashion. Unfortunately, the prospect of ultra-low interest rates and massive spending programs introduces the unsettling worry in capital markets of potential future inflation and debasement of the U.S. dollar.

The economic news continues to be weak and the weakness is spread globally. Japan, still the world’s second largest economy, is heavily oriented to the export of machinery and equipment to faster-growing, less-developed economies in the rest of Asia. Two worrying data points released this quarter are worth noting; as of February, export levels are running 35% below the levels of the previous year and, GDP in the 4<sup>th</sup> quarter of 2008 contracted at a 12.1% annualized rate.<sup>1</sup>



In the U.S., many measures reflect an economic contraction, but perhaps none is more important than housing, which continues to be weak. The latest release of the Case-Shiller home price survey shows that across the U.S home prices are declining at an 18% rate and are now almost 30% below their peak in 2006. Currently, almost 13 million homes in the U.S. have mortgages that exceed their market value and this amount will double if home prices decrease a further 15%.<sup>2</sup> The effect of declining home prices remains chilling to consumer spending and asset quality in the banking system.

As for Canada, the notion advanced by others, including the Governor of the Bank of Canada, that somehow we might avoid the worst of the global economic torment now looks misplaced. We have a particularly open economy, directly reliant on demand from the developing world for our energy and raw materials as well as for our manufactured goods in the United States. The weakness in the rest of the world has now come home to roost as evidenced by the effect on Canadian unemployment, which jumped from 6.6% at the end of last year to 7.7% currently. It seems set to climb even further in the months ahead.

<sup>1</sup> Bloomberg.

<sup>2</sup> House Keys, Bank of America Merrill Lynch – February 23<sup>rd</sup>, 2009.

That the global economy is weak is no longer news. In fact, a depiction of doom and gloom has now become almost fashionable. Authors of the most dire forecasts attract significant media attention and, as a consequence, it is hard not to believe that bond and stock markets don't already anticipate a continued barrage of weak economic data in the months ahead. Equity prices declined at a record pace in the first two months of the year before rebounding sharply in March. The cause of the sharp recovery seemed linked to the announcement that the Federal Reserve in the U.S. would embark on a program of quantitative easing – a term used to describe a particularly expansionary monetary policy. However, markets were also relieved when the CEO of Citigroup commented that they had been modestly profitable in the first two months of 2009 and when GE was only downgraded one notch from its longstanding AAA bond-rating status. Interest rates remain low, reflecting an investor preference for absolute safety as well as a reflection of the recent direct bond purchases by global central banks. As we said in our last report, the key to navigating successfully 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 continue to be difficult, but not without opportunity.

The Fund gained 1.4%<sup>3</sup> in the last quarter, and is up 2.3% in the last 12 months. The DEX Universe Bond Index (DUBI) was higher by 1.5% for the quarter and increased 4.9% since last March. Our bond performance continues to be excellent with our holdings continuing to run well ahead of the index. While overall Fund performance was again hampered by the drag of our 'other income-oriented securities', we continue to believe that these securities will value to the Fund in the future.

## Asset Mix

We increased our allocation to 'other income-oriented securities' slightly this quarter primarily by reducing the allocation of cash. Our allocation to bonds is 89%, our holdings of cash equivalents is now 2% and the balance of 'other income-producing' securities rests at 9%.

## Fixed Income Summary (89% of Assets)

In early March, the Bank of Canada continued to try and lead market interest rates lower with a 0.50% reduction in the target overnight borrowing rate to 0.50%. While interest rates less than one year did decline, rates for maturities longer than two years actually rose slightly this quarter.

For many years, interest rate policy has been the primary policy instrument utilized by central banks. But increasingly, they are intervening in markets and implementing policy by expanding their balance sheets through the direct purchases of assets from a strained banking system or the creation of money with quantitative easing. In Canada, estimates of the amount of fiscal stimulus that the government has planned for the next two years are about 2% of GDP. Financing our deficits is no worry for the markets. On the other hand it's estimated that the new administration in Washington could spend as much as 12% of GDP in the coming year, and only slightly less in the following two years.<sup>4</sup> As a result, there is a growing worry that the coming supply of U.S. Treasury bonds will exhaust investor appetite and that rates will either need to go higher to attract capital or that the amount of quantitative easing will debase the value of the currency. In such circumstances, a sharp acceleration in the rate of inflation could provide a very unsettling surprise for bond investors.

While Canada might compare favourably to the U.S. if such a situation arises, it would most assuredly also force interest rates higher here as well. In light of the concern we harbour about the extent of spending and borrowing that looms ahead, we have continued to shorten the average maturity of our portfolios. The prices of longer-maturity bonds fluctuate more than do the prices of shorter-term bonds. By reducing our holdings of longer-dated maturities, we reduce our exposure to the chance of capital loss should interest rates increase in the future. This is a pre-emptive move in that we are highly confident that given the extent of economic weakness currently, inflationary pressures are well controlled at this time.

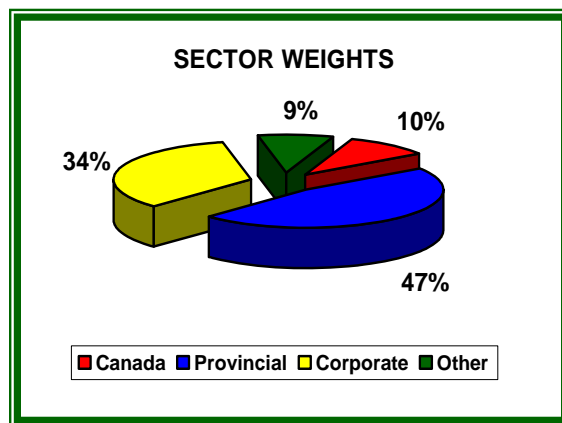
<sup>3</sup> Fund returns are shown before the deduction of management fees but after the deduction of direct expenses.

<sup>4</sup> RBC Investment Strategy Weekly - April 1<sup>st</sup>, 2009.

Our portfolio is now substantially shorter than the DEX Universe Bond Index (DUBI) that we are measured against.

In early 2008 we reduced our allocation to corporate bonds, particularly those issued by subsidiaries of U.S. financial companies. Over the course of 2008, the spread between corporate bonds and Canada bonds widened substantially. In February, we began to rotate back into the corporate bond market, switching out of both Canada bonds and Provincial bonds. In many instances, we are increasing the yield by 5% or more for the assumption of some credit risk, but in every instance these bonds carry a credit rating of at least single A or better. In the coming months, we expect spreads between corporates and governments to contract and that returns in the corporate bond market will exceed the returns in either the Provincial or Canada markets.

A consequence of the current challenges of the banking system is a reduction of liquidity in the bond market. While liquidity for Canada bonds is fine, the same is not true in the corporate market where the spread between bid and offer has rarely been wider and more erratic. As a result, the 'friction costs' of managing the portfolio have increased. As tempting as it is to add to corporate holdings at wide spreads, a manager must be wary that this introduces a level of transaction risk that was not present historically. In the past we have had as much as 60% of our bond allocation in the corporate sector. In the future, it is unlikely that we will carry as large an allocation until liquidity conditions in the market improve.



## Other Income-Oriented Securities (9% of Assets)

We remain well below our limit of a 20% allocation to this sector, but we did increase our allocation by 2% over the course of the quarter. Specifically, we have added three new holdings. In the financial sector, we have initiated a small position in Manulife Financial which, after a sell-off, now carries an attractive dividend yield. We also added a small position in Pfizer, the world's largest pharmaceutical company. Pfizer has perhaps the strongest balance sheet of any large company in the U.S., but has found it challenging to develop new drugs. Without the opportunity to re-invest their profits in their business, they had been paying out a generous dividend. In January, they announced that they were intending to acquire Wyeth, a rival drug maker, best known for its branded products such as Advil or Centrum vitamins. While this deal may make considerable financial sense, it has caused Pfizer to reduce their dividend. Accordingly, we may pursue other income-generating opportunities once this deal closes. Lastly, we have purchased a full position in BFI Canada Ltd., one of North America's largest full-service waste management companies. It provides waste collection and disposal services in five Canadian provinces and ten states in the U.S. It had previously operated as an income trust but has recently reverted to a corporation. It is a steady business, with low cyclicalty that should be able to sustain a generous distribution of its profits in the future.

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.

