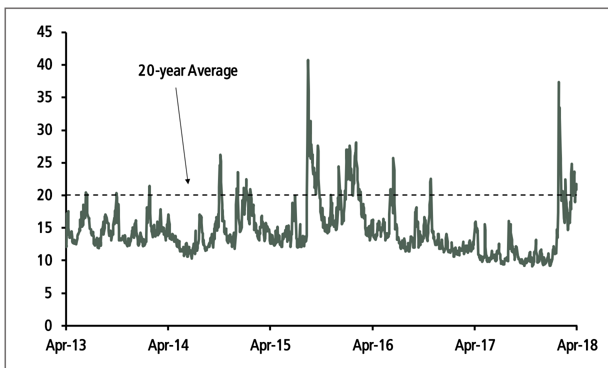
Change is in the Air

Despite an exuberant start to 2018, stock markets grew increasingly uneasy through the first quarter. By quarter-end, Canada's TSX Composite Index posted a total decline of 4.5%. South of the border, the S&P 500 generated a 0.8% loss in U.S. dollars. Thanks to the weakness in the Canadian dollar, this more modest loss in U.S. markets actually turns positive for Canadian investors as the S&P 500 return was 2.0% when expressed in Canadian dollar terms. Nonetheless, over the course of the quarter, the S&P reached "correction" territory as the index fell more than 10% from its January 26 high-water mark.[1]

Not only did the first quarter bring a change in market direction, it also brought a sharp change in the level of volatility. Recall that we noted in the last edition of the *Nexus Report* that the VIX[2] – the standard measure of volatility in U.S. stock markets – had fallen in early 2018 to an all-time low. Investor behavior suggested an unsettling complacency and apparent belief that nothing could go wrong. Since the trough in volatility in January, the quarter had six days during which the S&P moved more than 2% in one direction or the other, compared to zero days in all of 2017. Also of note is that on average the market drops more than 10% once each year and more than 5% five times each year. For the 18 months leading into the first quarter of 2018, the U.S. market had no 5% drop. It ought to have had seven or eight during that period.[3] It's reasonable to expect ongoing volatility in the coming months, just to bring us back to normal.



CBOE S&P 500 Volatility Index (VIX)

[1] The "correction" refers to the U.S. dollar price level of the Index. It was down a bit less if one includes dividends.

[2] VIX is the ticker symbol for the Chicago Board Options Exchange S&P 500 Volatility Index.

[3] JP Morgan, "Guide to the Markets", March 31, 2018.

U.S. Economy Remains Strong

One reason for the heightened stock market volatility is that the media is filled with worrisome stories on a range of crises enveloping the White House. In particular, turnover in the Administration's senior ranks has continued. This past quarter saw the departures of Rex Tillerson, Secretary of State, and H.R. McMaster, National Security Advisor, both of whom were widely respected in the investment community. The Mueller investigation and revelations about Stormy Daniels or Karen McDougal spice up any slow news day. Perhaps most importantly, the drumbeat of trade battles has been unrelenting – first it was unrealistic U.S. demands in the NAFTA renegotiation (which seem to be waning), then it was the imposition of tarrifs on imported steel and aluminum (from which most countries ended up being temporarily exempt), and most recently the escalating trade war-of-words with China. To make matters worse, much of the news the market digests on these important issues comes via Twitter, rather than a more conventional and responsible medium.

Despite the apparent chaos in Washington, the U.S. economy continues to hum. In particular, the U.S. labour market remains a pillar of U.S. economic strength. While the March non-farm payroll report disappointed at 103,000 new jobs created vs. an expectation for 180,000, this follows an incredibly strong February. On average, the U.S. generated 202,000 new jobs per month over the first three months of 2018, nicely higher than the 182,000 average in 2017. The headline unemployment rate remained at 4.1%, the lowest level the U.S. economy has seen since December 2000. And despite virtually full employment, average hourly earnings growth remains under control at a 2.7% year-over-year growth rate. The labour market continues to exhibit the "Goldilocks" characteristic of being strong, but not too hot.

U.S. corporate earnings growth also is expected to be strong in 2018. S&P 500 earnings estimates for full-year 2018 increased significantly in the last three months, such that analysts are now expecting 2018 earnings to be about 25% higher than 2017. Much of this remarkable gain owes to the significant cuts in corporate tax rates implemented late last year, but there also remains strong consumer confidence and business optimism – despite the noise in Washington.

Of course, trees don't grow to the sky and there would be good reason to expect more moderate earnings growth in 2019 and beyond. Moreover, the

corporate tax cuts that are fueling the current growth spurt also raise troubling concerns about U.S. government deficits. Early in April the non-partisan Congressional Budget Office forecast that the U.S. budget deficit would balloon to $1 trillion in 2020, despite assumptions of healthy economic growth.[4] It also forecast that the national debt will soar to $33 trillion by 2028. At $33 trillion, U.S. government debt will approximately equal the size of the economy, a level that economists believe will have serious negative consequences for economic growth. This is a sobering thought at a time when economic conditions are otherwise robust.

Canada Hanging in There

After a surprisingly strong performance in 2017, we expect Canadian economic growth to slow in 2018. While there are certainly some signs of moderation, our economy remains in very decent shape.

The Bank of Canada's quarterly Business Outlook Survey, released in early April, painted a fairly rosy picture of conditions in the first quarter and optimism for the months ahead. The outlook among companies both for sales and for hiring intentions was actually higher than last quarter. Measures of capacity pressures and plans for capital investment are modestly lower than last quarter, but remain at historically strong levels. Overall, the Bank of Canada's commentary was very positive.

In the last *Nexus Report* we highlighted two big concerns for the Canadian economy going forward – NAFTA, and the risk that lower U.S. tax rates would undermine our competitiveness. On the NAFTA front, there is a decidedly more positive spin coming out of the negotiations. The U.S. has dropped several demands that Canada deemed unacceptable, and there seems to be motivation to get an agreement in principle in place within weeks. It's a bit hard to judge why the sudden change in tone from U.S. negotiators has occurred. Perhaps the more recent trade tiff with China has caused the U.S. to conclude it has more pressing trade issues to resolve? In any event, a NAFTA resolution in a form acceptable to Canada will be unambiguously good news for our economic future.

Tax and regulatory issues, however, remain a significant challenge. In recent days, several Canadian bank CEOs have spoken publicly about the loss of competitiveness in Canada. As the U.S. has lowered tax rates and loosened regulation, the appeal of Canada for business investment has diminished significantly. Why would a company invest in the Canadian economy when the tax and regulatory burden is so clearly higher than in the U.S.? And as financial capital migrates south of the border, so, ultimately, will our human capital. So far, governments at both the federal and provincial level seem blind to this potential crisis.

Investment Outlook

After a nine-year bull market, we were reminded in the last quarter that stocks can go down, and that the stock market is supposed to be volatile. The fairy tale investment environment of 2016 and 2017 is behind us. However, that does not mean we are pessimistic. In the U.S., there is a growing tension between the good news and the bad news. On the positive side, the economy is strong and earnings will grow significantly this year. In fact, with the decline in the stock market indexes, and the sharp increase in earnings estimates, the U.S. market has become much more attractively valued. Compared to bond yields, it is very attractively valued.

On the other hand, we have entered the 10th year of a bull market and, as we said earlier, trees don't grow to the sky. We're due for a correction. Perhaps it will be caused by rising interest rates, or maybe a trade war, or maybe a loss of confidence in Facebook or Amazon. Or perhaps there will be a military confrontation between the U.S. and Russia in Syria. Something bad will happen eventually. We just don't know what or when.

Clients are no doubt tired of us saying we can't predict what will happen in the coming months and quarters. It can be fun to try, but since we know we will be wrong, we like to avoid it. However, we are pretty confident about the prosperity of Canada and the U.S. over the long term. Our goal is to be positioned to take advantage of that. By investing in high quality companies we will withstand the inevitable crises ahead and be positioned to benefit when the next bull market arrives. At times like the present, when it is easy to worry about the risks all around, it's important to focus on the long term. As Nexus celebrates its 30th anniversary this summer we are reminded that this approach has proven rewarding through good times and bad.

[4] *The New York Times,* April 10, 2018.

Asset Class Investment Review

Fixed Income

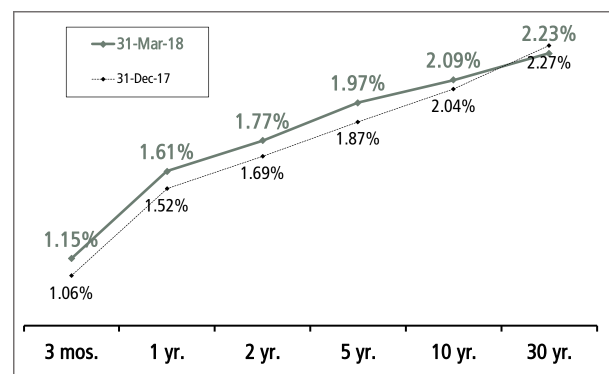
There was little to show in the way of return in the bond market in the first quarter of 2018. Over that period, bond returns in our Income Fund and the FTSE TMX Bond Universe Index both returned 0.1%. Obviously, these are not returns one would expect to retire on. Yet bonds did fulfill their role of providing stability in balanced portfolios during what was a very rocky quarter in the rest of the capital markets.

Because we are invested in a manner that's different from the composition of the Bond Index, it's pure coincidence that our return over this period matched the its return. Of note, we have maintained our short-duration strategy, concentrated in holdings that mature between 2 and 7 years. Specifically, our duration is 4.3 years, which is substantially less than the Index duration of 7.4 years. Last quarter, our holdings suffered a slight decline in price due to rising yields, whereas bonds of longer maturity either held their value or even rose in price as the curve flattened.

However, the credit quality of our holdings also differs notably from the Bond Index, and this was a benefit in the most recent period. Over the course of the quarter, credit spreads widened with lower-rated credits generally widening more than higher-rated ones.[5] Our emphasis on quality meant that we were less exposed to this erosion in value than was the Bond Index.

But we would not want a discussion of the subtleties of curve shape and credit spreads to distract from the central question confronting bond investors and why we have chosen to continue with our high-quality, defensive positioning. At this time, the bond market is caught between two narratives. The first is a story of expanding global economies, tightening labour markets and percolating, but not yet problematic, inflation. In such circumstances, bonds would be expected to rise in yield to provide a return in excess of expected future inflation. In the second story, there is the safe-haven status of the U.S. Treasury market and, by close association, the Canadian bond market. In this version of events, U.S. Treasuries are desired because they provide an attractive alternative for European and Japanese investors, whose national central banks have, through the effect of quantitative easing policies, reduced interest rates to virtually zero.[6] In essence, pricing is being set not by price sensitive long-term investors, but instead by the ECB, which according to estimates, owns more than 90% of the German Bund market[7] and the BOJ, which owns 45% of the Japanese Government Bond market.[8]

Our opinion aligns more with the first version of events. We think that eventually rates will go higher due to an unwinding of quantitative easing policies abroad, rising inflation in North America leading to further Federal Reserve tightening, and importantly, a coming tsunami of new bond issuance driven by deficit spending policies in the U.S. and Canada. On this last point, at a time in North America when economies are operating near or above capacity, it seems recklessly irresponsible that governments are cutting taxes (U.S.), and increasing budget deficits (Canada, Ontario, and the U.S.). Now more than ever, the role of bonds is to safeguard capital and an emphasis on quality and minimizing the risk of capital erosion from higher rates seems most appropriate.



Government of Canada Yield Curve

Equities

The market started well in January, then delivered a 10% correction in February, followed by ongoing volatility for the rest of the quarter. For the full quarter, the Equity Fund's market benchmark lost 1.3%. Relative to this, the Fund itself performed well, gaining 1.0% in the quarter. Over the past

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[5] Province of Ontario 10-year bond yields moved from 0.62% above 10-year Canada yields to 0.73% above, and major bank 5-year deposit notes moved from 0.67% to 0.73% above Canada bonds of a similar maturity.

[6] 10-year German bonds yield 0.50% and Japanese 10-year bonds yield 0.02%!

[7] Grant's Interest Rate Observer, March 23, 2018.

[8] Japan Macro Advisors, March 21, 2018.

twelve months, the Equity Fund returned 8.2% and was well ahead of the benchmark's 5.6% return.[9]

In the quarter, our Canadian equities were down, but our U.S. and international equities all generated positive returns – as described more fully below.[10]

The Canadian dollar weakened in over the same period, such that it slightly increased our U.S. equity returns when measured in Canadian dollars by 2.8 percentage points.

Canadian Equities

Nexus's Canadian stocks were down 3.2% in first the quarter and up 4.8% for the year. This was better than the TSX Composite's loss of 4.5% in the quarter and gain of 1.7% for the twelve months.

For the quarter, only the industrial stocks in our Canadian portfolio had positive returns (up a meagre 1.1%), with CAE performing the best amongst our three holdings. The good industrial sector performance was an extension of 2017, in which our industrial holdings were our #1 Canadian sector, and reflects a recovering global economy. All our domestically-listed industrial holdings benefit directly (CAE and Finning) or indirectly (Toromont) from global growth.

At the end of the quarter, we established a new position in Magna International, one of the world's largest auto parts suppliers. Magna designs and manufactures auto components and assembles complete vehicles, primarily on behalf of the major car companies. It has a total market value of $27 billion and operates more than 300 plants in 28 countries. We were attracted to Magna's high return on equity (20%), conservative balance sheet, and very attractive valuation. It is clearly successful in today's automotive world and we think it will be a survivor as and when the world evolves to a more autonomous, ride-sharing and possibly electric future.

U.S. Equities

Nexus's U.S. equities were up a strong 4.6% in first quarter, and ahead of the S&P 500's 2.0% return. For the twelve months, our U.S. holdings are up 11.0% and slightly ahead of the S&P 500's 10.4% return.

For the quarter, this certainly felt like a good outcome as the S&P 500 declined 0.8% in U.S. dollar terms. Relative to this, the weaker Canadian dollar added 2.8 percentage points of return and our portfolio's outperformance added another 2.6 percentage points to produce the 4.6%.

We benefitted from strong returns from our U.S. technology holdings. These stocks have done particularly well for several years, such that they are now a large weighting in our U.S. portfolio. As such, while we still like their prospects, we trimmed several of our tech holdings in the quarter.

Our largest disappointment in the last 3 months has been GE, which has continued to trade lower. The bad news has dribbled out gradually and an impatient investor may have avoided some of the damage by selling earlier. As a general comment, we take a 3 to 5-year view with our stocks and intend to be patient. On average, this is a beneficial feature of our investment approach, but it doesn't always work. At this point, we think GE is close to or has passed the point of maximum investor pessimism.

Other Equity Investments

We continue to hold two non-North American equity investments within our Balanced and Equity Funds. These are externally-managed pooled funds called EQIT (international developed market equities) and EMEC (emerging market equities).[11]

Both funds had a positive quarter. EMEC returned 4.3% in the quarter and a very strong 22.4% for the twelve months. EQIT returned 1.0% and 14.8%, respectively, for the same periods. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

[9] All the return data in the Equities section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar. For more specific performance, please refer to the Fund reports in this document or your client-specific report.

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

[11] Both funds are managed by teams from JPMorgan Asset Management in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund generated a positive total return of 1.0% in the first quarter. This return compares to the 1.3% decline of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 8.2%, better than the benchmark return of 5.6%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

In Canada, the equity market fell 4.5% in the quarter. Our Canadian holdings were down less, falling 3.2%. The main positive contributor to the Fund's relative performance in the first quarter was our limited exposure to the Energy sector, which declined 9.4%. While we were not immune to the effects of the downturn in Energy, we did manage to sidestep much of the damage that was inflicted in the quarter. In addition, our holdings of CAE Inc. and Toronto Dominion Bank were positive contributors this quarter.

In the U.S., the equity market rose 2.0% in the quarter. Our U.S. holdings outperformed, generating a 4.6% return. The outperformance was driven primarily by our investments in the Information Technology sector, including strong stock price gains from Western Digital and Cisco. There were some offsetting negatives from a few individual stocks (GE and CarMax), but overall our U.S. performance was strong.

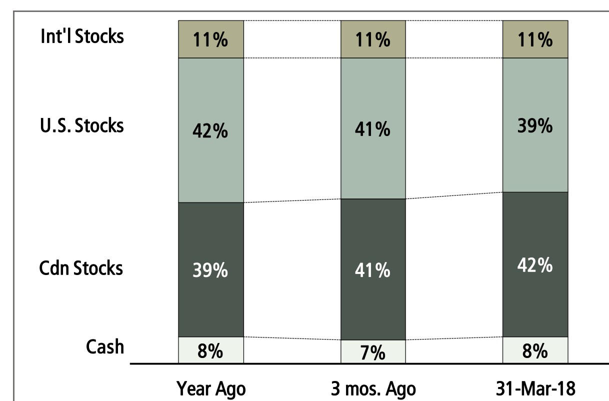
Our international holdings continued to perform well. The developed markets fund, EQIT, was up 1.0% this quarter and the emerging markets fund, EMEC, rose 4.3%.

At the end of the first quarter, the Fund's cash position was 8%. Our allocation to Canadian stocks was 42%, while U.S. stocks represented 39% of the mix. We have maintained an allocation of 11% 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	1.0%	-3.2%	4.6%	2.4%
Benchmark	*-1.3%*	*-4.5%*	*2.0%*	
One Year				
Fund	8.2%	4.8%	11.0%	17.9%
Benchmark	*5.6%*	*1.7%*	*10.4%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 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 March 31, 2018



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a positive total return of 0.6% in the first quarter. This return compares to the 1.3% decline of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 5.3%, surpassing the benchmark return of 3.8%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

Our bond holdings produced a modest gain of 0.1% in the quarter, equal to the return of the bond benchmark. While our performance was in-line with the benchmark, our composition continues to differ. The maturity of our bond portfolio remains shorter than the FTSE TMX Universe Bond Index, which was a mild negative this quarter. However, this was offset by our higher quality holdings which outperformed lower quality in the quarter as spreads generally moved wider.

In equities, we saw declines in both our Canadian stocks (-3.7%) and the benchmark (-4.5%) in the quarter. The weakness in Canada was broad-based across industries, but our positioning helped us avoid some of the worst performance in the Energy sector. Our U.S. stocks delivered a very satisfactory quarter (4.0%) which surpassed the U.S. benchmark (2.0%) due to positive contributions from our Information Technology holdings, particularly Western Digital and Cisco, as well as foreign exchange tailwinds.

Our international holdings continued to perform well. The developed markets fund, EQIT, was up 1.0% this quarter and the emerging markets fund, EMEC, rose 4.3%.

At the end of the quarter, cash represented 7% of the Fund's asset mix, bonds were 28% and stocks accounted for the remaining 65%. These asset allocations continue to remain close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	0.6%	0.1%	-3.7%	4.0%	2.3%
Benchmark	*-1.3%*	*0.1%*	*-4.5%*	*2.0%*	
One Year					
Fund	5.3%	-0.2%	3.7%	11.4%	17.9%
Benchmark	*3.8%*	*1.4%*	*1.7%*	*10.4%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day TBill, 30% FTSE TMX Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: FTSE TMX Universe Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at March 31, 2018

	Year Ago	3 mos. Ago	31-Mar-18
Int'l Stocks	7%	8%	8%
U.S. Stocks	33%	31%	30%
Cdn Stocks	26%	27%	27%
Bonds	27%	28%	28%
Cash	7%	6%	7%

Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a loss of 0.5% in the first quarter, compared to a modest gain of 0.1% for the Fund's benchmark. In the last 12 months, the Fund has been flat, lagging the benchmark return of 1.4%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain above the benchmark and are very attractive on an outright basis.

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

Our bond holdings gained a modest of 0.1% in the quarter, which matched the performance of the underlying benchmark. While our performance was in-line with the benchmark, our composition continues to differ. The maturity of our bond portfolio remains shorter than the FTSE TMX Universe Bond Index, which was a mild negative this quarter. However, this was offset by our higher quality holdings, which outperformed lower quality in the quarter as spreads generally moved wider.

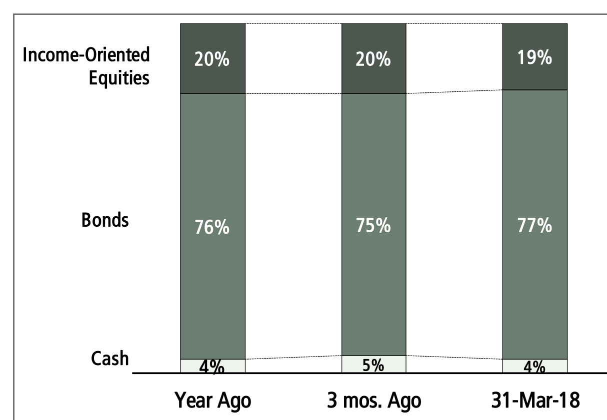
Our holdings of Income-Oriented Equities in Canada were the main detriment to performance in the quarter, producing a loss of 4.3%. Our U.S. equities provided a positive offset, producing a 2.5% gain, helped by foreign exchange tailwinds.

At the end of the first quarter, the Fund's cash position was 4%, Income-Oriented Equities accounted for 19% and the balance, 77%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-0.5%	0.1%	-4.3%	2.5%
Benchmark	*0.1%*	*0.1%*		
One Year				
Fund	0.0%	-0.3%	1.7%	1.4%
Benchmark	*1.4%*	*1.4%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE TMX Universe Bond; (b) for Bonds: FTSE TMX Universe Bond. In addition to bonds, up to 20% of the Fund's portfolio may be invested in equities.

Investment Returns – As at March 31, 2018



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).[12]

In the first quarter NIEF delivered a total return of 2.3%. This return compares to the 1.8% total return of the Fund's blended benchmark during the same period. Over the past year, the Fund has returned a remarkable 17.9%, far surpassing the benchmark return of 13.4%.

Longer-term returns for both EQIT and EMEC remain solid, with EQIT up 7.6% per year and EMEC up 11.7% per year over the past three years.

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

The central issue of the first quarter for the international markets was the looming prospect of a significant trade dispute between the U.S. and China. Although the conflict is ostensibly between those two nations, the knock-on effects of a trade war would be widespread. Many nations rely on the free flow of goods to support their growth and a trade dispute runs the risk of introducing friction into the global trade system. However, visibility is limited today; will it be an extended trade war, or just a temporary tiff? It seems that the opening positions in this negotiation have been staked out, but uncertainty may reign for quite a while before a resolution is found.

In Europe, there was no shortage of attention-grabbing headlines: the poisoning of a former Russian spy in the U.K., rail strikes in France, divisive elections in Italy and the detention of Catalonia's secessionist leader. Nevertheless, business and consumer confidence in Europe are at 18-year highs, suggesting confidence in the outlook, despite the headlines. Last year's surprising recovery in European economic growth may well continue, despite the ongoing concerns about Brexit negotiations which have quieted down of late.

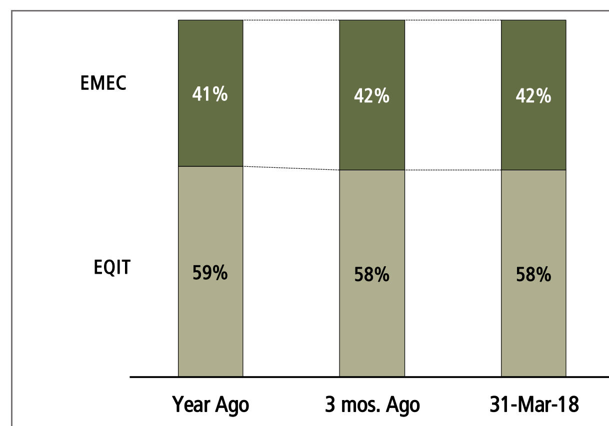
Our longer-term outlook for both EQIT and EMEC remains positive as we believe both offer attractive valuations and unique exposure to well-managed companies with solid growth prospects.

At the close of the first quarter, the International Equity Fund's investment in EQIT accounted for 58%, while EMEC accounted for 42%.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	2.3%	1.0%	4.3%
Benchmark	*1.8%*	*1.0%*	*4.1%*
One Year			
Fund	17.9%	14.8%	22.4%
Benchmark	*13.4%*	*11.0%*	*20.9%*

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 March 31, 2018



International Equity Fund Asset Mix

[12] International developed markets or "EAFE" includes Europe, Australasia and the Far East. Emerging markets include 23 developing countries. EQIT and EMEC are managed by JPMorgan Asset Management in the UK. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.