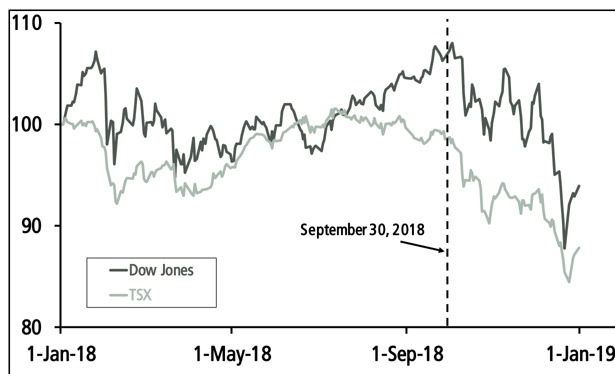
A Tough Year

2018 proved to be a difficult year for investors, mostly as a result of the turmoil in markets during the last three months. For all of 2018, the return on the TSX Composite was a loss of 8.9%. It was slightly positive in the first 9 months of the year and then down 10.1% in the last quarter.[1] The Energy sector led the way lower, falling 18.3% during the year. Financials, the largest sector in the Canadian market, also struggled with a 9.3% decline. Very few sectors of the market did not suffer significantly.

In the U.S., the situation was even more dramatic. The major stock market indexes hit all-time highs between the end of August and beginning of October. Then the wheels came off. When the dust settled, the S&P 500 was down 4.4%[2] for the year, its worst performance since 2008. In the fourth quarter alone, the S&P plunged 13.5%, thanks to the worst December performance since 1931.[3] From its high, the NASDAQ retreated more than 20%, crossing into bear market territory on December 21. The S&P narrowly averted a bear market, falling 19.8% from its September peak.



TSX Composite and Dow Jones Industrial Average in 2018 (Indexed to 100 at December 31, 2017)

Volatility also was remarkable in December. As an example, the Dow Jones Industrial Average had its worst ever Christmas Eve selloff (down 653 points). This was followed, on December 26, by its biggest point gain ever recorded (1,086 points), which was then followed by a wild session on December 27 when there was an 871-point swing from low to high. Undoubtedly, these wild gyrations were exaggerated by poor liquidity in the year's final days. Regardless, it left investors' heads spinning. In contrast to the market moves, not a lot changed in the fundamentals. Aggregate corporate earnings were modestly higher in Canada during 2018, and dramatically higher in the U.S., thanks to tax cuts passed by the U.S. Congress late in 2017. The selloff primarily was the result of a change in investor sentiment that resulted in a sharp decline in valuation multiples. As one commentator put it, in 2018 we had a bull market in earnings and a bear market in valuation.[4]

Is the Glass Half Full or Half Empty?

Early in January, the U.S. Bureau of Labor Statistics released a blockbuster report on job growth in December. In the face of the stock market turmoil described above, U.S. employers added 312,000 new jobs to the economy, and job growth for previous months was revised higher. Not only was this performance significantly better than expected, it marked the 99th consecutive month of job growth in the U.S. economy, by far the longest streak on record. Average hourly earnings rose 3.2% year-over-year, the strongest level in a decade. While the unemployment rate moved higher – from 3.7% to 3.9% – it is still at a remarkably low level. In fact, the higher rate is actually a good sign as it reflects a large influx of people into the workforce, attracted by strong employment prospects. There remain more job openings in the U.S. than there are people looking for work.

The robust employment situation underpins the ongoing strength of the U.S. consumer, the most important driver of U.S. economic growth. Moreover, low energy prices will help keep inflation moderate and could act to prolong the current U.S. expansion. There is good reason to be optimistic.

At the same time that there are positive economic trends, there also are signs of a slowdown. In early January, the Institute of Supply Management survey of businesses around the country reported that its index level dropped to 54.1 in December from 59.3 in November. This sharp decline is the largest since the credit crisis and clearly reflects additional caution in the business community. Having said that, the ISM at 54.1 continues to portend solid economic growth, just not as strong as the U.S. enjoyed in 2018.[5] The economy also won't benefit from the same year-

[1] Returns in this paragraph are total returns in CDN dollars.

[2] Returns in this paragraph are total returns in US dollars.

[3] Raymond James Weekly Market Guide, January 3, 2019.

[4] *Barron's*, December 14, 2018.

[5] The ISM survey is designed so that an index level above 50 is highly correlated with future economic growth. An index level below 50 is correlated with future economic contraction.

over-year boost to growth that was driven by U.S. tax cuts last year.

Considering the measurable U.S. economic factors, the glass is definitely half full. Continued economic growth and earnings gains seem likely. The glass becomes half empty, however, when one worries about a number of unpredictable factors. The slow dance of U.S.-China trade negotiations could yet end in punitive tariffs that harm all sides. Investors know that the U.S. Federal Reserve must tread carefully in the year ahead as it manages interest rates in a way that controls inflation but does not push a slowing U.S. economy into recession. And the dysfunction in the U.S. political system seems to worsen every day. At the moment, the government is partly closed as the President and Congress fight over a wall. While these are only worries today, there is a risk that one or more of them could undermine the U.S. economic expansion.

Surprisingly Resilient

The big story in Canada in 2018, but particularly in the last three months of the year, was oil. Oil prices slid globally as demand did not keep up with growing supplies. In Canada, the problem was even more acute, largely as the result of a critical shortage of transportation capacity. The delay or cancellation of several pipeline projects means that we have oil to sell and no way to get it all to market. Unsurprisingly, the consequence was a glut in Western Canada and a collapse in the price of our benchmark crude, Western Canadian Select. At its worst, WCS crude traded at a US$50 per barrel discount to the U.S. benchmark crude, and US$13.46 per barrel on an absolute basis. This hit the western provinces hard and presents a significant headwind to overall Canadian economic growth.

Given this challenge, together with the turmoil that surrounded the NAFTA renegotiation and the ongoing U.S. tariffs on our steel and aluminum exports, it is surprising how resilient the Canadian economy remained. The December unemployment rate of 5.6% is the lowest in four decades and has underpinned continued strength in the consumer sector. The Ivey Purchasing Managers survey suggests businesses remain optimistic and points to solid economic growth in 2019. As in the U.S., the unmeasurable worries that surround us could abruptly change these positive trends. But the data give comfort that positive growth may continue.

Investment Outlook

As is so often the case, the future path of financial markets is remarkably uncertain. A year ago there was near giddiness among investors. Today, confidence is fragile. Elevated political uncertainty may be the most vexing issue of the day. In addition to what we describe above, there also remains real risk around a disorderly Brexit, a serious confrontation between Russia and the West, the nuclear aspirations of Iran and North Korea, and even deeper dysfunction in Washington given the divided Congress. As the Bank of Nova Scotia's Derek Holt wrote in the Globe and Mail, "These human-made problems jeopardize great progress made by the world economy."[6]

However, a consequence of these fears and the turmoil of 2018, is that investors find themselves well positioned for 2019. Valuation multiples have dropped considerably such that many indexes, like the S&P 500, are trading at valuation levels below their long-term averages. Moreover, while U.S. equity returns have been wonderful in the last 10 years, they have been well below normal over the last 20.[7] There is reason to be optimistic that investors are in a good place today and that the prospect for strong investment returns over time remains.

Given the roller coaster ride investors endured in 2018, it is understandable that many are cautious about the future. An unavoidable truth in investing is that there is no way to predict when times will be good and when they will be more challenging. However, if one maintains an appropriate asset mix, and a well-diversified portfolio of quality companies, we remain certain that investment success will be achieved.

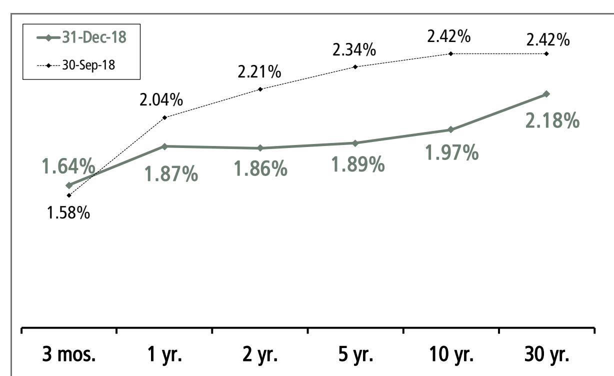
[6] *Globe and Mail*, January 6, 2019.

[7] One analyst calculates that the 20-year period ended December 31, 2018 was the worst 20-year period for the S&P 500 since the Great Depression. *Barron's,* January 5, 2019.

Asset Class Investment Review

Fixed Income

While equity markets captured great attention for the degree of volatility they exhibited to close the year, the fixed income markets exhibited a tumultuous performance as well. As the fourth quarter began, rates continued to rise, the result of positive economic data and conviction that central banks were intent on withdrawing financial stimulus and returning interest rates back to more normal levels. At their peak on October 5th, 10-year Canada bonds traded at 2.60%, up 0.17% from their third quarter close. But the same talk that rattled equity markets – trade frictions, election uncertainty, policy dysfunction in Washington, and weakening economic results abroad (particularly China) – conspired to undermine confidence that the Bank of Canada and the Fed could continue to raise rates without creating risks to the economic expansion.



Government of Canada Yield Curve

As described in the first section of this report, the prospect of a slowdown was exaggerated in Canada as the global price for oil collapsed and the price of Canadian oil (Western Canadian Select) fell even further. After averaging US$41.50 during the third quarter, WCS fell to as low as US$13.46 in mid-November. This is a "Made in Canada" problem caused by a lack of transportation capacity to U.S. and international markets. And while prices have recently rebounded, weakened confidence in the viability of the energy sector in Alberta and Saskatchewan means that new investment in further oil sands development is likely to be less than anticipated. This may contribute to weaker economic conditions in the period ahead than would normally be expected.

Over the quarter, 2-year yields fell 0.35% (from 2.21% to 1.86%) and 10-year yields fell 0.45% (from 2.42% to 1.97%). For 2018 overall, a year when the bank rate rose 0.75%, 10-year Government of Canada Bonds finished almost precisely where they started, declining just 0.08% over the course of the year. As rates fell in the last quarter, bond returns were positive – a small, but desirable, offset to the negative returns in the equity markets. The bond return in our Income Fund was 1.6% in the last 3 months, and 1.7% for the year. These results slightly trailed the return on the FTSE TMX Canada Universe Bond Index this quarter (up 1.8%), but slightly beat its 1.4% return for the year.

While rates fell (and prices rose) on the soft economic data and the multitude of geopolitical worries, the difference in yields between which provincial and corporate bonds trade versus Canada bonds widened noticeably. These bouts of spread widening occur naturally during periods of investor anxiety, when investors demand greater return from lending to less creditworthy borrowers and prefer the absolute safety and liquidity of Canada bonds. Despite carrying a guarantee from the Federal government, spreads on Canada Housing Trust bonds, which are our largest exposure, widened about 0.15%. Province of Ontario bond spreads, where we have no exposure, widened 0.20% and corporate bond spreads for issuers such as Bell Canada or the major Canadian banks widened between 0.30% and 0.50%. Our positioning, which has emphasized higher credit quality, insulated us from some of the effects of this spread widening, and our concentration in 3-year to 8-year bonds meant we benefitted from some capital appreciation as rates fell.

Conventional economic considerations make interpreting the present environment challenging. However, at the present time, political uncertainty (a divided congress), trade negotiations (China), the partial U.S. government shutdown (wall or no wall), and even the veiled threat of President Trump asking for Fed Chairman Powell's resignation, all amplify the risks. It is a time that calls for managing the downside risk in the bond portfolio and acknowledging that the primary role for bonds is to provide safety. That means we'll continue with our current strategy of emphasizing high-quality credits and bonds with shorter maturities. High-quality gives the portfolio superior liquidity, which may prove useful in the event of a sudden shift in risk sentiment, and the shorter-maturity profile will moderate capital volatility as interest rates fluctuate.

Equities

The fourth quarter was marked by the return of volatility and a sharp sell-off in equity markets. The Equity Fund declined 8.0% in the quarter, compared to the larger 9.0% decline of the market benchmark. For the full year, the downturn was less pronounced, with the Equity Fund down 2.0% as compared to its benchmark, which fell 2.7%.[8]

The fourth quarter decline occurred in both Canada (the TSX Composite fell 10.1%) and the U.S. (the S&P 500 fell 11.2%).[9] By most measures, economic conditions and corporate fundamentals held up well during the quarter. However, market sentiment deteriorated quickly on concerns about global trade, tightening monetary policy, and slowing global growth. These concerns manifested in the rapid decline of the price-to-forward-earnings multiple (P/E) which, for the S&P 500, fell from slightly more than 18x at the start of 2018 to only 14.4x at the end of the year.

As volatility returned in the quarter, there proved to be few places to hide with most sectors declining, some quite substantially. However, we are reminded that volatility is a normal characteristic of equity investing, and the last few years of relative calm was more the exception than the rule. Despite the sell-off, we retain a positive outlook given that forward-looking economic indicators do not suggest a recession on the horizon, inflation remains subdued and corporate earnings growth looks set to continue in 2019, albeit at a more modest pace.

Canadian Equities

Nexus's Canadian stocks were down 8.6% in the quarter, somewhat better than the 10.1% decline of the TSX Composite. For the full year, our Canadian stocks declined 6.1% outperforming the TSX, which was down 8.9%.

The Canadian market did not offer many opportunities to take shelter from the storm, with 8 of 11 sectors declining in the quarter. Canada's Healthcare sector was hardest hit (down 35.3%), but so too were some of the larger sectors of the market including Energy (down 17.3%) and Financials (down 11.3%). We benefitted on a relative basis from our positions in three defensive sectors, including Real Estate (Allied Properties and H&R REIT), Consumer Staples (Metro and Alimentation Couche-Tard), and Utilities.

U.S. Equities

In the U.S., the S&P 500 declined 8.9% in the fourth quarter. Other than Utilities and Real Estate, every sector was down, highlighting the breadth of the negative sentiment.

In this environment, the Canadian dollar weakened, which *improved* the U.S. returns when measured in Canadian dollars. In U.S. dollars, the S&P returns were noticeably worse (down 13.5%) in the period.

Overall, our U.S. stocks lagged the benchmark, declining 11.2% in the quarter. We endured sizable declines in Western Digital, Apple and Citigroup, all of which were materially affected by the downdrafts in the Information Technology and Financial sectors. Longer term, we remain optimistic about the prospects for each of these businesses. In the quarter, we sold our Walmart holding, which was a successful investment that we held for many years. In mid-2018, Walmart announced the acquisition of Flipkart, an e-commerce company in India. The acquisition will require substantial investment and will reduce earnings for at least several years. We felt Walmart was fully valued, given its higher risk profile following the acquisition, so we decided to sell.

Other Equity Investments

We are invested in two non-North American equity holdings within our Balanced and Equity Funds. These are externally-managed pooled funds called EQIT (international developed market equities) and EMEC (emerging market equities).[10]

EQIT was buffeted by the same winds that affected markets in North America, principally trade frictions and slowing global growth. In addition, Europe faced a series of local political challenges, such as Brexit uncertainty, Italian budget issues, and riots in France. EQIT fell 7.7% in the quarter and has declined 10.9% over the last twelve months. By contrast, EMEC demonstrated resilience in the face of global headwinds and managed to eke out a modest 0.3% gain this quarter. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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[8] 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.

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

[10] 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 declined 8.0% in the fourth quarter. While this was a difficult period for the Fund, it was not as poor as the 9.0% decline of the Fund's benchmark over the same period. In the last 12 months, the Fund declined 2.0%, falling less than benchmark which fell 2.7%. From a longer-term perspective, our returns for the 2, 5 and 10-year periods remain above the benchmark and are attractive on an outright basis.

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

In Canada, the equity market fell 10.1% in the quarter. Our Canadian holdings fared better due to our positions in defensive sectors such as Real Estate, Consumer Staples and Utilities, but still declined 8.6%.

In the U.S., our holdings declined 11.2%, which was more than the benchmark which lost 8.9%. Almost every sector in the U.S. market declined in the quarter, with particular weakness in Energy (down 19.7%), Information Technology (down 12.9%) and Industrials (down 12.8%). Our holdings of Apple, Western Digital and Citigroup were significant detractors in the quarter, and this was only partly offset by the relative resilience of Dollar General, General Motors and Pfizer.

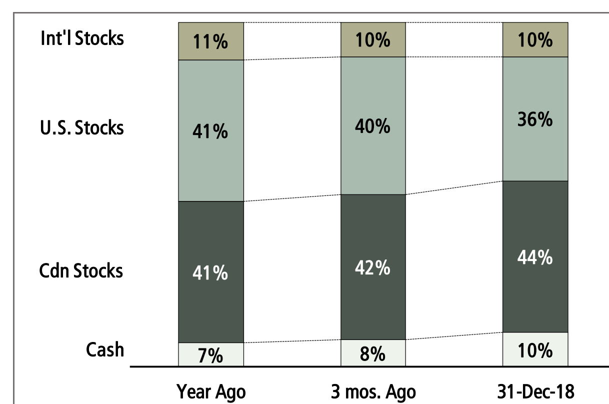
Our international holdings produced mixed results in the fourth quarter. The developed markets fund, EQIT, declined 7.7%, largely mirroring the declines in Canada and the U.S. In contrast, the emerging markets fund, EMEC, helped considerably by delivering a small positive return of 0.3%.

At the end of the fourth quarter, the Fund's cash position was 10%. Our allocation to Canadian stocks was 44%, while U.S. stocks represented 36% of the mix. We have maintained an allocation of 10% to markets outside North America and remain confident that this will provide important diversification to our North American investments, as well as good long-term returns.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	-8.0%	-8.6%	-11.2%	-4.4%
Benchmark	*-9.0%*	*-10.1%*	*-8.9%*	
One Year				
Fund	-2.0%	-6.1%	1.4%	-7.6%
Benchmark	*-2.7%*	*-8.9%*	*4.0%*	

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 December 31, 2018



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund declined 5.1% in the fourth quarter. Although this was a tough quarter for the Fund, it was slightly better than the 5.8% decline in the Fund's benchmark over the same period. In the last 12 months, the Fund declined 0.4%, falling less than the benchmark, which declined 2.1%. From a longer-term perspective, our returns for the 2, 5 and 10-year periods remain above the benchmark and are attractive on an outright basis.

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

Our bond holdings generated a positive return of 1.6% in the quarter, but modestly lagged the bond benchmark's return of 1.8%. The underperformance was due to our shorter duration positioning, as it limited our participation in the December rally in government bonds. However, our high-quality fixed income holdings sheltered us from some of the negative impact of wider corporate spreads (spreads widen as the perception of risk increases, causing bond prices to fall).

In equities, our U.S. stocks declined 10.5% and our Canadian stocks fell 7.7%, reflecting the market sell-off that characterized the fourth quarter. The weakness in the U.S. was broad-based, with almost every sector in the U.S. market declining during the period, particularly in December. The declines were steep, with notable weakness in Energy (down 19.7%), Information Technology (down 12.9%) and Industrials (down 12.8%). Our holdings of Apple, Western Digital and Citigroup were significant detractors in the quarter, and this was only partly offset by the relatively good resilience of Dollar General, General Motors and Pfizer. The weakness was similarly broad-based in Canada, although we fared somewhat better than the benchmark due to our positions in defensive sectors such as Real Estate, Consumer Staples and Utilities.

At the end of the quarter, cash represented 8% of the Fund's asset mix, bonds were 29% and stocks accounted for the remaining 63%. 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	-5.1%	1.6%	-7.7%	-10.5%	-4.4%
Benchmark	*-5.8%*	*1.8%*	*-10.1%*	*-8.9%*	
One Year					
Fund	-0.4%	1.8%	-5.9%	2.8%	-7.6%
Benchmark	*-2.1%*	*1.4%*	*-8.9%*	*4.0%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day T Bill, 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 December 31, 2018

	Year Ago	3 mos. Ago	31-Dec-18
Int'l Stocks	8%	7%	8%
U.S. Stocks	31%	31%	27%
Cdn Stocks	27%	28%	28%
Bonds	28%	27%	29%
Cash	6%	7%	8%

Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a total return of 0.6% in the fourth quarter. This return compares to the 1.8% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 1.5%, modestly surpassing the benchmark return of 1.4%. From a longer-term perspective, our returns for the 2, 5 and 10-year periods remain in-line or above the benchmark and are attractive on an outright basis.

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

Our bond holdings generated a positive return of 1.6% in the quarter, but modestly lagged the return of the bond benchmark of 1.8%. The underperformance was due to our shorter duration positioning, as it limited our participation in the December rally in government bonds. However, our high-quality fixed income holdings sheltered us from some of the negative impact of wider corporate spreads (spreads widen as the perception of risk increases, causing bond prices to fall).

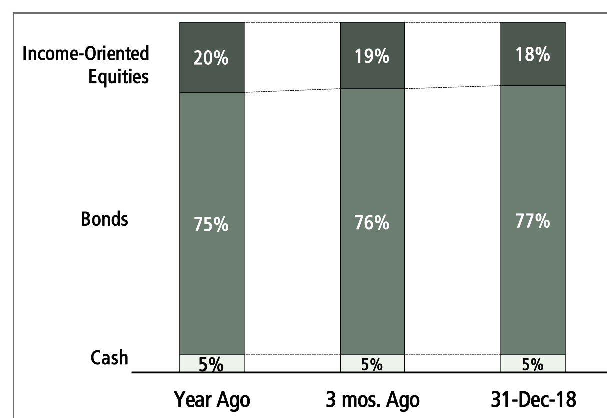
Our holdings of Canadian and U.S. Income-Oriented Equities provided a performance headwind in the fourth quarter as even these lower-volatility names declined along with the rest of the stock market. Specifically, our Canadian stocks were down 2.4% and our U.S. stocks declined 4.8%.

At the end of the fourth quarter, the Fund's cash position was 5%, Income-Oriented Equities accounted for 18% and the balance, 77%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	0.6%	1.6%	-2.4%	-4.8%
Benchmark	*1.8%*	*1.8%*		
One Year				
Fund	1.5%	1.7%	-2.7%	10.8%
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 December 31, 2018



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund holds two underlying funds managed by JPMorgan Asset Management: EQIT (invested in international developed market equities) and EMEC (invested in emerging market equities).[11]

The Nexus International Equity Fund declined 4.5% in the fourth quarter. While this was a difficult quarter for the Fund, it compares favourably to the 6.5% decline in the Fund's blended benchmark during the same period. Over the past year, the Fund declined 7.6%, underperforming the benchmark, which fell 6.4%.

Longer-term returns for both EQIT and EMEC have been mixed, with EQIT up a modest 2.6% per year and EMEC up a strong 12.1% per year on average over the past three years.

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

For EQIT, the fourth quarter decline of 7.7% can be attributed in large part to the seemingly endless political uncertainty facing the EU. In the UK, Brexit negotiations continue to be source of consternation for equity investors, not to mention the citizens of Britain, who face a range of outcomes including a Brexit deal, no deal, or even a second referendum. In Italy, the government's 2019 budget proposal was rejected by the European Commission in an unprecedented move that rattled markets. In France, the gilets jaunes ("yellow vests") protests threaten to upset the reform agenda of President Macron. While political in nature, each of these events has potential economic repercussions and, collectively, served to heighten the mood of caution in the region's equity markets.

For EMEC, events in emerging markets were much more subdued compared to the previous quarter. These conditions were reflected in the performance of EMEC which generated a small 0.3% return. The threat of a global trade war remains a front-and-center concern for emerging markets in general, and China in particular, however equities seem to have already priced in much of the potential risk.

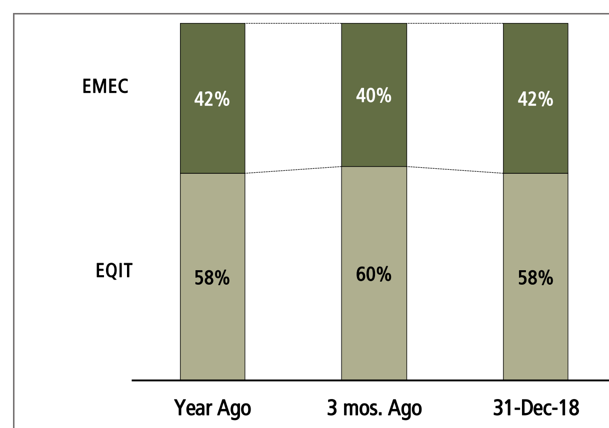
While the year has been marked by many near-term concerns – most of which were political in nature – we continue to view the long-term outlook for both EQIT and EMEC as compelling. Both funds follow a disciplined investment approach that emphasizes quality holdings that should withstand the turmoil. We continue to believe that over time, these international holdings will deliver valuable diversification and growth benefits that add to what is available in Canadian and U.S. markets.

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

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	-4.5%	-7.7%	0.3%
Benchmark	*-6.5%*	*-7.8%*	*-2.5%*
One Year			
Fund	-7.6%	-10.9%	-3.4%
Benchmark	*-6.4%*	*-6.3%*	*-7.1%*

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 December 31, 2018



International Equity Fund Asset Mix

[11] 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.