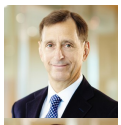
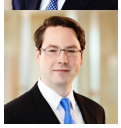
Ninepoint Fixed Income Strategy

April 2022 Commentary

*Monthly commentary discusses recent developments across the **Diversified Bond**, **Alternative Credit Opportunities** and **Credit Income Opportunities Funds**.*



Mark Wisniewski,
Partner, Senior Portfolio Manager



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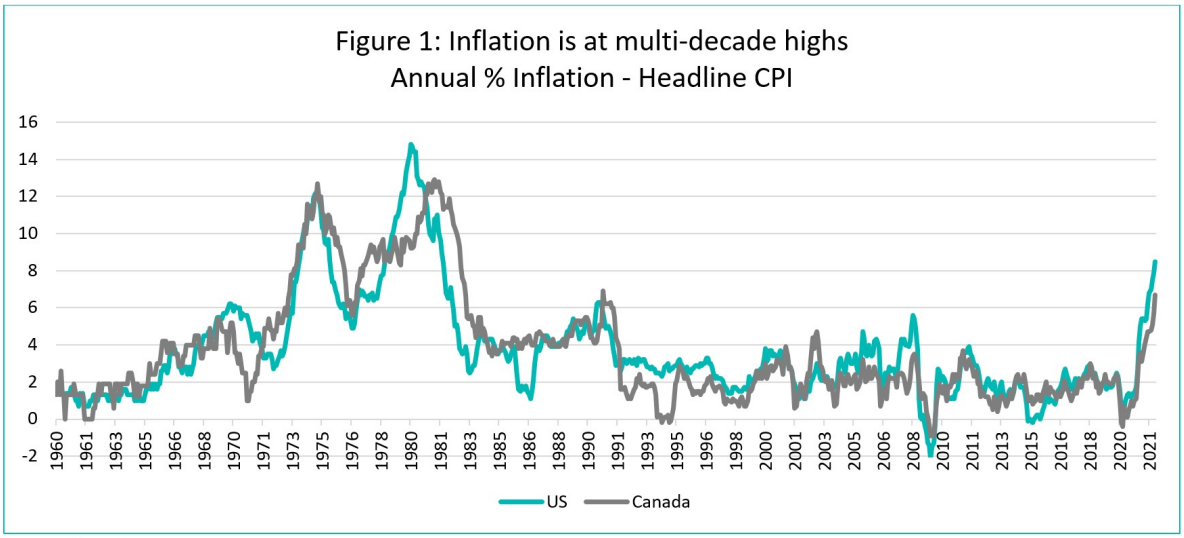
The "Income" is back in Fixed Income

Given how high inflation has gone (Figure 1), the question on every investor's mind is whether Central Banks can bring it back under control, and at what cost to economic growth. Both the BoC and the Fed hiked rates by 25bps in March, followed by a promise to do more in order to bring short term rates closer to neutral expeditiously. The BoC hiked a further 50bps in April, and after much hawkish rhetoric, all eyes were on the Federal Reserve FOMC meeting on May 4th. They did not disappoint, raising rates by 50bps, announcing the beginning of their Quantitative Tightening (QT) program (i.e. winding down their balance sheet) and guiding to "a couple" more 50bps rate hikes in subsequent meetings.



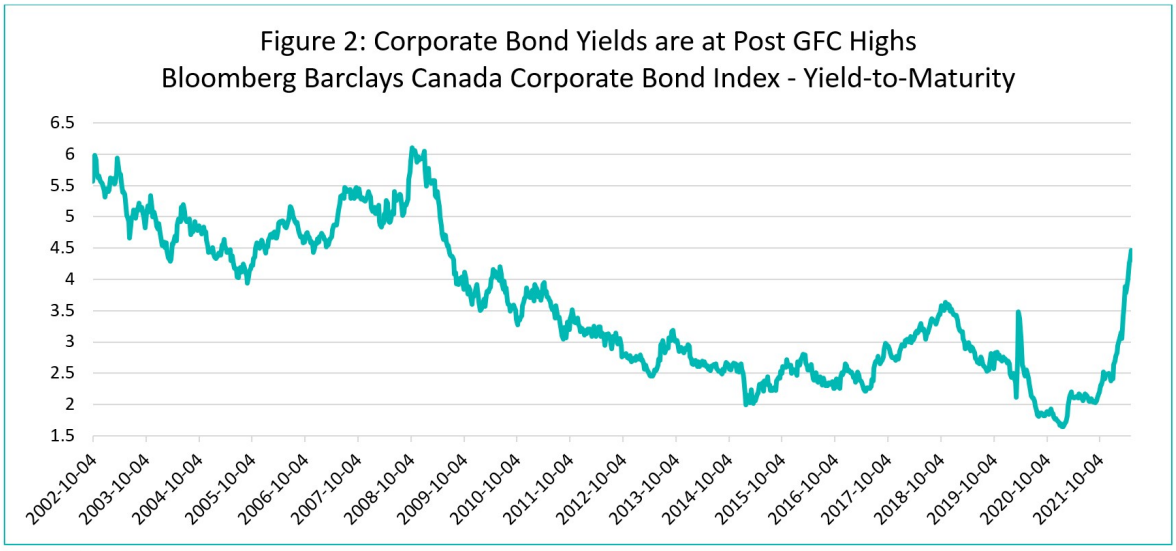
Source: Bloomberg

While the message coming out of the Fed was unquestionably hawkish, it stopped short of vindicating market expectations for ever increasing hawkishness (and a 3% Fed Funds Rate by year end 2022). Instead, Powell dismissed the idea of even higher hikes (i.e., 75bps in a single meeting), and offered a more balanced view of the outlook. Yes, inflation is high, but it is also expected to slow down materially later this year (see last month's commentary for a longer discussion on what will drive inflation lower). The outlook is highly uncertain due to the war in Ukraine and the lockdowns in China, but the US economy is on a solid footing, and they are hopeful that they can engineer a soft landing.

Powell clearly laid out their strategy: if things pan out the way they expect, they will raise rates to the lower end of neutral (~2%) over the next few meetings (June and July), then take a pause and observe what happens with inflation and the overall economy. They know well that higher interest rates take time to feed through the real economy, so overdoing it now would increase downside economic risks unnecessarily.

This message from the Fed (the BoC has a very similar stance right now) was in line with our expectations, and we think that unless inflation and inflation expectations increase further from here, we have probably reached "peak hawkishness" from policy makers. As such, with the bond market pricing a Fed Funds Rate (and overnight rate in Canada) of around 3% by year end, at this juncture we believe that the bond market doesn't have much more room to sell-off. To be clear, we aren't out of the woods yet, we still need to see a sustained decline in inflation and a moderation in the labour market before the prospects of a successful "soft landing" by the Fed/BoC gets internalized by markets. The next few months will be decisive.

Notwithstanding how painful the last 6 months have been for fixed income investors, the current setup presents a generational investment opportunity. Given the large selloff in both rates and credit so far this year, we are now seeing **Corporate Bond Yields at their highest level since the Great Financial Crisis** (Figure 2).



Source: Bloomberg

For fixed income investors, the income generated in a bond portfolio is also the first line of defense against losses. The higher the income, the bigger the cushion. For example, in the table below, we show the yield-to-maturity of our three funds, along with their "breakeven" with regards to the two main sources of risk in our portfolios: interest rates and credit spreads. In other words, how much would interest rates (or credit spreads) need to increase over the next 12 months before the portfolio's negative mark-to-market losses offsets the income earned over those 12 months. In the case of the Diversified Bond Fund, given its 5.6% yield and 3.3 years of duration, the answer is 1.7% (5.6% ÷ 3.3).

		Interest Rate Sensitivity		Credit Sensitivity	
	Yield	Duration	Breakeven	Credit Duration	Breakeven
Diversified Bond Fund	5.6%	3.3	1.7%	4.6	1.2%
Alternative Credit Opportunities Fund	8.0%	2.2	3.6%	9.6	0.8%
Credit Income Opportunities	9.4%	1.6	5.9%	11.0	0.9%
Bloomberg Barclays Canada Corporate Index	4.3%	5.7	0.8%	5.8	0.7%

Source: Bloomberg

So, as of today, with an investment horizon of 1 year, we would need to expect interest rates to go up by a further 1.7%, on top of what's already priced in (~3%), to have a negative expected total return. That would be the equivalent of intermediate rates getting to 4.7% which would be not only extraordinary but unlikely. Similarly, in the far-right columns, we show the credit breakeven, which is 1.2% for the Diversified Bond Fund. Credit spreads are currently about 155bps at the index level, so a further 1.2% selloff would take them to 275bps, a level not even seen during the worse of the COVID selloff in March 2020 (peaked at 250bps) and a move that would define a significant recession. The analysis for the Alternative and Credit Income Opportunities Funds displays similar results and is included in the above chart.

There was a good reason fixed income historically generated stable returns, it had high enough income to offset the price volatility of the bonds. Over the past few years, given the rock bottom levels in interest rates, that hasn't been the case. The income generated was so low it was extremely difficult to make a total return in fixed income without interest rates moving persistently lower.

Now that the market has brought back the "Income" into Fixed Income, our funds not only have the highest yields ever, but they also have a significant margin of safety.

Diversified Bond Fund (DBF)

Wider credit spreads and higher government bond yields detracted from overall performance in April, although the portfolio's 40% floating rate exposure helped mitigate some of the adverse effects. Even with a strong Q1 earnings season, credit spreads widened in the month in sympathy with other risk assets. While the new issue market was extremely quiet last month, we were able to take advantage of some opportunities in the LRCN space. Recall, Limited Recourse Capital Notes, "LRCN" are a relatively new debt instrument in Canada that has become popular issuance vehicle among many financial institutions. Since all LRCN issues have unique features, they trade differently in secondary markets and as such we were able to trim some higher priced LRCNs and recycle that capital into lower priced LRCN, while picking up some yield. On a portfolio basis, as of month-end the Yield-to-Maturity was 5.6%, up 90bps vs March, which to us presents a very attractive level to increase or initiate exposure to the fund.

Diversified Bond Portfolio Characteristics

	Limits	Dec 2017	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	Jun 2019	Sept 2019	Dec 2019	Mar 2020	June 2020	Sept 2020	Dec 2020	Mar 2021	June 2021	Sept 2021	Dec 2021	March 2022	April 2022	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	-7.0%	1%	2%	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	73%	68%	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	23%	26%	↓
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	0%	0%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	5%	3%	1%	2%	2%	↓
Common Equities & ETFs	10%	0%	0%	0%	1.5%	1.5%	4.3%	2.4%	-1.3%	0%	0%	-6%	-5%	-2%	0%	0%	2%	0%	0%	0%	↔
Derivatives	+/- 2.5%	-0.1%	+0.5%	-0.1%	-0.05%	0.0%	0.0%	-0.2%	0.0%	0.2%	0%	0%	0.1%	0%	0%	0%	0%	0%	1%	2%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	14%	0%	0%	↔
Total		100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	
Duration	1 to 8 years	2.4	2.1	2.3	1.0	2.4	3.4	5.4	6.5	4.3	3.8	5.9	6.2	5.3	3.6	4.5	4.2	2.9	2.2	3.3	↔
Spread Duration		-	-	-	3.4	2.9	3.0	2.3	3.1	3.0	2.2	4.1	3.8	3.9	4.5	5.4	5.1	5.1	4.6	4.6	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Alternative Credit Opportunities Fund (NACO)

Wider credit spreads and higher government bond yields detracted from overall performance in April, although the portfolio's 20% floating rate exposure helped mitigate some of the adverse effects. While the new issue market was extremely quiet this month, we did participate in two new issues that fit nicely into the portfolio. We bought a 3-year Artis REIT new issue (rated BBBL by DBRS), which came with a very attractive 5.6% coupon. Lastly, we participated in the Fortified Trust new issue which was an interesting opportunity to increase the quality of the portfolio while still being compensated in terms of credit spread. Fortified Trust-Class C (an AH-rated residential mortgage-backed security made up of Bank of Montreal HELOCs) printed a ~3-year bond with a 4.46% coupon. These two new issues are good examples of adding yield (in the case of Artis REIT) and quality (in the case of Fortified Trust) to the overall portfolio even when faced with a challenging market backdrop. On a portfolio basis, as of month-end the Yield-to-Maturity was 8%, up 190bps vs March, which to us presents a very alluring level to increase or initiate exposure in the fund.

Alternative Credit Opportunities Portfolio Characteristics

	Limits	May 2021	June 2021	July 2021	August 2021	September 2021	October 2021	November 2021	December 2021	January 2022	February 2022	March 2022	April 2022	Outlook
Government Bonds	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	66%	53%	49%	44%	48%	52%	44%	46%	48%	51%	50%	↑
High Yield	40%	36%	32%	29%	24%	22%	28%	29%	29%	33%	29%	27%	29%	↓
ABS	20%	0%	4%	1%	8%	6%	7%	7%	7%	9%	10%	11%	13%	↔
Loans	10%	0%	0%	0%	3%	3%	3%	6%	5%	5%	5%	5%	4%	↔
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	2%	2%	2%	2%	1%	1%	↔
Common Equities & ETFs	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	6%	13%	7%	8%	5%	0%	↔
Total		100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	
Duration	0 to 5 years	3.0	2.7	3.1	3.0	2.9	3.2	3.0	2.7	1.7	1.9	2.1	2.2	↔
Leverage	0-3x	1.4x	1.37x	1.13x	1.06x	1.09x	1.10x	1.10x	1.00x	1.20x	1.20x	1.10x	1.18x	↔
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Ops)

Wider credit spreads and higher government bond yields detracted from overall performance in April, although the portfolio's 30% floating rate exposure helped mitigate some of the adverse effects. While the new issue market was extremely quiet this month, we did take advantage of a rare opportunity that fit nicely into the portfolio. We participated in the Artis REIT new issue which had a ~3-year maturity and a very attractive 5.6% coupon. On a portfolio basis, as of month-end the YTM was 9.4%, up 200bps vs March month-end, which to us presents a very appealing level to increase or initiate exposure.

Credit Income Opportunities Portfolio Characteristics

	Limits	Oct 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020	Sept 2020	Dec 2020	Mar 2021	June 2021	Sept 2021	Dec 2021	March 2022	April 2022	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	55%	52%	54%	48%	63%	59%	67%	57%	68%	49%	42%	34%	29%	31%	31%	29%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	34%	37%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	11%	11%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	9%	7%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	3%	3%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	1%	1%	1%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	1%	2%	3%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	5%	2%	2%	↑
Total		100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	
Duration	0 to 5 years	2.5	2.1	2.9	2.2	2.9	1.7	2.6	3.3	5.1	3.8	2.6	2.5	3.4	2.5	1.6	1.6	↔
Leverage	0-4x	0.7x	0.7x	1.0x	1.0x	0.77x	1.04x	0.87x	1.67x	1.15x	1.04x	1.26x	1.36x	1.43x	1.30x	1.30x	1.46x	↓
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	1%	0%	0%	0.5%	0.2%	-0.2%	↔

Source: Ninepoint Partners

Conclusion

High quality corporate bonds haven't had this much yield in over 10 years. Yes, the outlook is uncertain given the crosscurrents of interest rates, domestic inflation, commodity prices, wars and COVID lockdowns. But a lot of bad news has already been priced-in, and with all-in-yields where they are, we would need a lot more bad news before we breach breakeven levels in our funds. Therefore, we believe that investors would be well served by increasing their allocation to fixed income, particularly Corporate Credit.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF APRIL 30, 2022 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-2.2%	-6.7%	-5.2%	-5.8%	-5.5%	0.5%	1.2%	3.2%	3.5%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF APRIL 30, 2022 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	-1.6%	-4.6%	-3.1%	-4.2%	-1.1%	5.9%	4.6%	-	-	4.8%

[1] All Ninepoint Diversified Bond Fund/Class returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at April 30, 2022 [1] All Ninepoint Credit Income Opportunities Fund returns and fund details are a) based on Class F units (closed to subscriptions); b) net of fees; c) annualized if period is greater than one year; d) as at April 30, 2022.

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