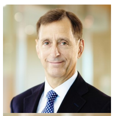
Ninepoint Fixed Income Strategy

August 2020 Commentary

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

Investment Team



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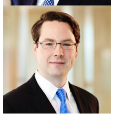

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Macro

The last full month of summer saw a continuation of the relentless rally in equities, pushing both the S&P 500 and Nasdaq to fresh all-time highs. For its part, credit performed well, but not to the same extent as equities. The highlight of the month was the Jackson Hole Symposium, hosted by the Federal Reserve of Kansas City, where central bankers from around the world congregate each year (this time virtually) to discuss monetary policy issues. This year's event was of particular importance because it was widely expected that the Fed's Chair, Jerome Powell, would use his speech to reveal the conclusions of the Fed's review of their monetary policy goals. While the content of the speech was as expected, the shift in policy was very material. For decades, the Fed has been operating under a dual mandate, full employment and stable prices, with no particular emphasis on one or the other. But, in practice, the business cycles would typically evolve in the following way: tight labour markets push up wages, which put upward pressure on prices (the so-called Phillips Curve). The Fed, seeing the signs of a potentially overheating economy (defined as inflation above 2%), pulls the brakes and raises interest rates to slow things down, usually ending the cycle with a recession, during which the Fed then later cuts interest rates and we start all over again.

However, the experience since the Great Financial Crisis of 2008 has had the Fed rethink their ways, for three important reasons. First, there are structural factors in the economy that make the "natural rate" of interest very low. That's the interest rate that neither stimulates nor slows the economy. A very low natural rate of interest means that more often than not, the Fed will be pushing against the zero-lower bound on interest rates when trying to fight a recession.

Second, the 2% inflation target has proved elusive. Even with a very strong economy and labour market, we have failed to see inflation at 2% for any meaningful period of time. This, in turn, puts downward pressure on inflation expectations, which is the key tenet of an inflation targeting framework. Once inflation expectations start slipping, the risk of being stuck in a situation similar to Europe or Japan increases dramatically. That's what the Fed would like to avoid.

Finally, it appears as though the Phillips Curve is "dead". Historically, when the unemployment rate declines below the "natural level" of unemployment, wages would push prices up and inflation would ensue. This past cycle, even with the unemployment rate at 3.5% early in 2020, inflation never really took off. The conclusion from Fed officials is that the Phillips Curve is now very "flat" and therefore looking to the labour market to forecast future inflation behaviour isn't particularly predictive.

Tying it all together, what does this mean for the future of monetary policy in the US? Clearly, the Fed is afraid of becoming stuck at the zero-lower bound like Japan and Europe. To avoid that trap, the new strategy is to stop worrying about too tight a labour market in good times, since the Phillips Curve is flat, and wait for inflation to reach and then surpass 2% for a while before doing anything on the interest rates front (they call it soft inflation averaging). In theory, if inflation never reaches 2%, we could stay at 0% rates forever…

Considering all of this our outlook for longer term interest rates is a direct product of whether or not the Fed's commitment to 2% inflation target is credible. If it is, then the interest rate curve should be upward sloping and steeper, as we price in higher rates in the future. Conversely, under this new framework, if we believe inflation will remain low for a long time due to structural and demographic factors, then the US treasury curve should be very flat, like Europe or Japan.

Given the large amount of slack in the global economy due to the Covid recession, our current predisposition is to assume that inflation will be low for the foreseeable future, keeping short term interest rates very low for a long time (expected long term Fed funds rate will decline), and with the amount of debt governments that has been accumulated over the past few months, it will be impossible for central bankers around the world to raise interest rates in any meaningful way. QE programs will continue to gobble up excess government debt, focusing on longer term purchases to help reduce borrowing costs, further pushing down the yield curve (term premium will remain low).

Under this new Fed framework, a scenario that has failed to attract attention is one where inflation is high, but the labour market is still very far from full employment. In the 1970s, this scenario was called stagflation. What the Fed would do in this situation is unclear, since their review didn't address this question head on. Given the Fed's emphasis on returning the labour market to full employment as soon as possible while being somewhat more dismissive of inflation risks (since they have failed to materialize for 10 years) leads us to believe they would, at least initially, tolerate higher inflation and leave rates at the lower bound. Given this framework could a Fed "behind the curve" on inflation lead to runaway inflation similar to the 70s and 80s? It is entirely possible, and this is clearly a tail risk for the treasury market that few seem willing to contemplate. We do not believe that this is a short-term risk, but we're, keeping a close eye on inflation dynamics just in case

We're currently very focused on the US election coming up in November and the failure of the US government to enact a fourth fiscal package. Solid jobs numbers in August are reducing the impetus for compromise in Washington, and with the election coming up, they will soon run out of time. With most of the earlier benefits having now expired, there is a clear risk that the economic data starts to disappoint this fall. As well, we have both the Bank of Canada and the Federal Reserve meetings coming up in September . It will be interesting to see how they react to the current equity market weakness, which will give us a sense of how far out of the money the Fed put really is. Finally, they could also announce some changes to their respective QE programs. Stay tuned!

Credit

Spreads were more range bound in August, even as equities made new highs. As expected, given summer, primary issuance was light, but we did see some interesting developments in the Canadian bank space. Royal Bank issued their inaugural Limited Recourse Capital Note (LRCN), which is a Tier 1 instrument very similar to a preferred share, but that pays interest (not dividends) and is issued to institutional investors, thereby providing much greater liquidity and price discovery. This is a very significant development for our market as it will, over time, displace preferred shares (which faced liquidity issues) and create a new sub-asset class in the marketplace. Both National Bank and BMO have announced and issued LRCN notes. We expect all banks to eventually redeem and replace some of their preferred shares with those LRCN notes. Furthermore, it is possible that insurance companies could tap the same structure and replace their preferred shares for this more efficient vehicle. We welcome this development, as it will offer us a better alternative to preferred shares, which have attractive features, but greatly lack liquidity.

Diversified Bond Fund (DBF)

Leading to the Jackson Hole Symposium, longer term interest rates increased slightly impacting our performance. The fund gave back 22bps, primarily due to this move in interest rates which we believe is temporary. Throughout August, we monetized some higher beta credit position, recycled capital into short dated corporate bonds and commercial paper and slightly increased our government bond duration. Additionally, to round up our hedging strategy, we have bought a small S&P 500 options hedge (put spreads) maturing in both October and November. We spent about 7bps of premium and our maximum payout is around 50bps. This coupled with our government bonds, small USD position and HYG short makes up the defensive side of the portfolio. We are well positioned to capitalize on what we expect will be a volatile Autumn; a good diverse set of hedges and sizeable portfolio liquidity (19% of the portfolio matures within a year) should allow us to act from a position of strength.

Diversified Bond Fund 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	August 2020	Outlook
Government Bonds	**100%**	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	**8%**	↔
Investment Grade	**80%**	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	**75%**	↔
High Yield	**40%**	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	**11%**	↓
Emerging Market Governments	**10%**	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	**0%**	↔
Preferred Equities	**10%**	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	**0%**	↔
Common Equities & ETFs	**10%**	0%	0%	0%	1.5%	1.5%	4.3%	2.4%	-1.3%	0%	0%	-6%	**-5%**	↔
Derivatives	**+/- 2.5%**	-0.1%	+0.5%	-0.1%	-0.05%	0.0%	0.0%	-0.2%	0.0%	0.2%	0%	0%	**0%**	**N/A**
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	**10%**	↑
Total		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	**5.6**	↔
Spread Duration		-	-	-	3.4	2.9	3.0	2.3	3.1	3.0	2.2	4.1	**3.7**	↓
Unhedged FX Exposure	**20%**	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	**5%**	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

The fund continues to perform well, returning 2.3% in August, taking our year-to-date return to 8.5%. As discussed last month, we think the move tighter in credit spreads has been a little over done. We've started to de-risk the portfolio; leverage is now 1.33x (from 1.61x) and we have slightly increased the duration of the fund to 4.4 years (from 3.1 years). As with the DBF, we have monetized some high beta credit positions that had done quite well and added new hedges (S&P 500 put options). In the next quarter, coming into election, we will continue to decrease portfolio risk and wait for a more opportune environment to redeploy capital.

Credit Income Opportunities Portfolio Characteristics

	Limits	Oct 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	June 2020	Aug 2020	Outlook
Government Bonds	**100%**	0%	0%	6%	0%	18%	0%	0%	0%	**0%**	↔
Investment Grade	**100%**	58%	55%	58%	53%	68%	64%	72%	65%	**84%**	↑
High Yield	**40%**	29%	24%	19%	16%	10%	6%	22%	28%	**21%**	↔
Private Loans	**10%**	3%	3%	2%	3%	2%	2%	4%	7%	**6%**	↑
Preferred Equities	**10%**	4%	4%	0.5%	0%	0%	0%	0%	0%	**0%**	↔
Common Equities & ETFs	**10%**	0%	0%	0%	0%	-7%	-7%	-10%	-15%	**-14%**	↔
Derivatives	**+/- 2.5%**	0%	0%	0%	-0.4%	0%	0%	0%	1%	**0%**	**N/A**
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	**2%**	↓
Total		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	**4.6**	↔
Leverage	**0-4x**	0.7x	0.7x	1.0x	1.0x	0.77x	1.04x	0.87x	1.67x	**1.33x**	↓
Unhedged FX Exposure	**>25%**	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	**2.7%**	↔

Source: Ninepoint Partners

Conclusion

The Covid-crisis is far from over, we simply had a nice summer lull and a fiscal bonanza that has kept everything going artificially higher. We have started to ready the portfolios for what we think will be the second leg of this crisis. Our objectives remain the same: capital preservation and a smoother ride towards acceptable returns.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1] AS OF AUGUST 31, 2020 (SERIES F NPP221)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-0.22	5.30	2.85	2.95	3.64	3.62	3.79	4.76

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF AUGUST 31, 2020 (SERIES F NPP118)

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-0.22	5.45	2.87	3.07	3.83	3.79	3.93	4.63	4.64

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF AUGUST 31, 2020 (SERIES F NPP507)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	2.30	8.50	10.30	7.44	9.05	5.35	5.37	5.06

[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 August 31, 2020 [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 August 31, 2020.

The Risks associated worth investing in a Fund depend on the securities and assets in which the Funds invests, based upon the Fund's particular objectives. There is no assurance that any Fund will achieve its investment objective, and its net asset value, yield and investment return will fluctuate from time to time with market conditions. There is no guarantee that the full amount of your original investment in a Fund will be returned to you. The Funds are not insured by the Canada Deposit Insurance Corporation or any other government deposit insurer. Please read a Fund's prospectus or offering memorandum before investing.

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