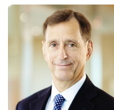
H1 2022 Fixed Income Market Review and Outlook

July 25, 2022

Investment Team



Mark Wisniewski,
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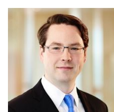

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Transcript

Mark Wisniewski: Good morning, my name is Mark Wisniewski. I manage the fixed income funds here at Ninepoint, the Diversified Bond Fund, the Credit Income Opportunities, and our new liquid alternative. I thought it would be a really good time to basically give a second-half view and how things have gone for the year so far. It's probably, fair to say as most of you know, it's been pretty challenging environment for just about any type of asset this year.

Obviously, inflation being a lot higher than what was expected or significantly higher than what's expected has really changed the dynamics of investing. I'll just walk you through a little bit of what's going on from a central bank perspective, and what that means for obviously, the economy growth and what that means for how we're positioning the funds.

As I said, central banks are raising rates a lot more aggressively to basically fight inflation that's a lot higher than you ever expected and if you go back to last year, the consensus was that inflation would be a little bit higher this year, but not anywhere near 9% in the US, or 8%, in Canada. Inflation, obviously, it's become a really, really big problem.

The other side of it, though, that is a little bit different in this cycle is that growth has actually been quite good. It's certainly been lower than what it was expected but it certainly hasn't been as poorly as what was anticipated. In addition to that, we have record low unemployment, and corporate earnings actually have been given the environment have probably been a little bit better than expected.

Things in the economy really aren't that bad. As they said, the real problem is inflation, and basically what central banks do and how far they go. Getting back to last year, most economists didn't think inflation was going to be as high as it is. With that, their expectations for raising rates were pretty marginal. At that time, the expectation was that the terminal rate, the level that they would get interest rates, that would be maybe 2%.

Well, now, the expectation on the terminal rate is greater than 3% and there's also the expectation by some economists and strategists out there that it probably, should be closer to 4%. Which means in Canada right now, we're basically at 2½%, US we're at 1½, right now. They're probably going to raise rates, another 75 basis points to get themselves to two and a quarter.

We still have a few more rate increases to get ourselves up to that three-point or 3% level, and a lot more to get us up to that 4% level if that's in fact, needed. The issue here is how far we're going to have to go in and when inflation actually starts to subside. That's the real question for the market right now and what we've seen, obviously, is that the yield curve has started to invert.

Longer-dated yields are a lot lower than people would have expected. We got up to almost three-and-a-half in 10 years, and we're back below 3% again. The market is starting to anticipate a pretty significant risk of recession, which seems to be the case. Most economists think that that's going to happen somewhere, the first-half of next year, or maybe a little bit after that, but the consensus is now that we're going to go into recession next year, although it'll be fairly mild.

The other thing that's going to be interesting is that rate cuts are already been priced into next year, 50 to 75 basis points. This is the big challenge in the marketplace right now is, will inflation actually go down? If it doesn't go down, how far will central banks have to raise rates? With that, will this be a soft landing recession or will this be a significant recession, basically, inflicted by central banks to lower inflation?

The way we see it, and the way we're thinking about is that we've already seen the impact of interest rates. Higher interest rates have already started to cool the housing market. We're also seeing a lot of reports from companies coming out, that demand is starting to wane a little bit. Consumers are spending less money. I mean, I think part of that is that a lot of the money that they were given through the pandemic is gone. Consumers are spending less.

Housing seems to be slowing. The good news is energy seems to be declining a little bit. As interest rates go up and again, the question is, how far they go up between now and the end of the year? Our expectation is that the terminal rate gets to somewhere in the mid-threes. With that, as I said, our expectation would be a mild recession. We also think that inflation probably declines a little bit this year.

We weren't surprised that we really didn't see peak inflation in the first-half of this year. We thought a lot of what was happening in inflation was fairly sticky. Our expectation is that you'll start to see inflation decline a little bit at the end of the year. There's no way it's going to go back to the Bank of Canada Central or the Federal Reserve's expectation that it could be 2%.

We think, could inflation still be 6% in Canada or in the US would be by the end of this year? Probably. Could it be 4% early next year? It could be. The good news is that inflation is starting to go down. With that, it will basically, hopefully, mean that central banks won't have to raise rates beyond that 3½% level. What are we doing from a portfolio perspective? For sure, now we're starting to get in the things that we look at, we're starting to get signals that indicate recession, the yield curve looks almost certain to invert at some point this year, and also things like PMIs, et cetera are starting to decelerate.

We think for us, it's time to start looking to get more defensive in our posture in our portfolio. First of all, we're starting to slowly add duration to our mandates. The way we're going to do that is by adding governments at some point and also using options to give ourselves exposure to governments. Our expectation is that just the addition of governments and few tweaks of the portfolio will probably be closer to, I would say five years of duration, up from about three years of duration at some point this year.

The other thing that will basically impact that is the part of our portfolio was floating. We wanted to have floating rate exposure in the portfolio to give us the benefit of getting paid more as central banks raised interest rates and that floating lending rate increased. We'll be basically converting some of the floating rate percentage of the portfolio to fixed. Then from a credit perspective, first thing that we're going to start to do is lower the duration of our credit.

The reason that we're doing that is that we're getting paid a lot more because short rates have come up so much. We can sell 10-year credit, move down to two-year credit, three-year credit, and give up very, very little yield because as I said, the curves inverted and credit spreads are still fairly generous in the short end. We're shortening the duration of our credit. We're also starting to high-grade the portfolio.

We've looked at the sectors. Two sectors that we think are going to be a little bit vulnerable obviously, will be housing. We want less exposure to REITs. We still like energy but we also think that when you get into a recession there's going to be less demand for energy. We're starting to decrease our exposure to energy.

The last thing is that we're probably going to start adding credit hedges to the portfolio to give ourselves some protection against volatility in the portfolio. As we move into recession, people build more risk of default and with that credit spreads tend to move out a little bit. You get a little bit more volatility in things like equity markets. The other thing that we don't own a lot of and we think it needs a little bit of consideration is high yield. We really haven't owned that much high yield.

At some point, it's a sector that we're going to start looking at but we both avoided high yield. There's not going to be a lot of need for us to reduce that. The last thing I just want to talk about is credit spreads and risk reward. If we're actually going into a recession and it's a mild recession, credit spreads, the difference that you get paid between a corporate bond and a government bond, the additional interest rate you get paid are really, really, really, very generous right now.

When we look at that risk premium right now, we think that you're actually getting paid for recession risk, could credit spreads move a little bit wider? For sure, they could. We don't really think they could move much more than maybe 20 basis points, maybe 30 basis points. The bad news in credit is already priced in. The bad news is for interest rates are up. The bad news is credit spreads are a lot wider. The good news is that all our portfolios are yielding considerably more than they did a while ago.

If you think about diversified bond fund, if it was about a year ago, we would have-- Our expectation and what we were telling clients is that we would've be happy to get 3½%. Now that fund yields closer to 6½% . Our alternative is closer to 9% and our own OM strategy is 10½%. You're getting paid a lot more now to buy fixed income, primarily, because this move in credit spreads. Although I'm not saying the worst is over, a lot is priced in.

I think it's probably a really opportune time to start looking at more of fixed income. As I said, the yields of the income that you can get out of them are quite attractive. I think it's going to be a good place to be for the next two years. We're pretty optimistic. Thank you.

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

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-1.6%	-9.0%	-4.6%	-9.0%	-8.5%	-0.7%	0.7%	2.9%	3.2%

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

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-1.3%	-7.3%	-4.3%	-7.3%	-5.2%	4.5%	4.0%	4.3%

NINEPOINT ALTERNATIVE CREDIT OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JUNE 30, 2022 (SERIES F NPP931) | INCEPTION DATE: APRIL 30, 2021

	1M	YTD	3M	6M	1YR	INCEPTION
Fund	-1.0%	-8.1%	-3.7%	-8.1%	-7.8%	-6.2%

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

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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