Ninepoint Fixed Income Strategy

July 2022 Commentary

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

What a difference a month makes! For the past 6 months, the word on everyone's lips was recession. Now, with solid employment numbers for July, good Q2 earnings and a seemingly less hawkish Fed at the July FOMC meeting, the narrative seems to be shifting to a rosier outlook.

Such optimism is misguided, as the fight against inflation is not over.

Despite a slight moderation in US headline inflation in July due to lower gasoline prices, the core figures remain high (5.9%) and will take time to decelerate, primarily due to the shelter component (~32% of CPI), which is still accelerating. Moreover, given the volatile geopolitical environment, it seems premature to call the top in energy and food prices. Russia will likely use all the tools at its disposal to inflict maximum pain on Europeans this winter, which will have repercussions for global commodity markets.

Yes, the economy is clearly slowing down, but not enough to have a meaningful impact on consumer demand. Some of this weakness is simply the impact of elevated inflation (inflation tax) on consumers. The full effects of this rate hike cycle probably won't be felt until later this year or early 2023, as monetary policy acts with a 6-to-12-month lag.

Therefore, it appears to be somewhat presumptuous for the Fed/BoC to be declaring an early victory on their fight against inflation. Over the past few weeks, several Fed officials, some of whom are considered quite dovish, came out in the media to fight back against the idea of a "Fed pivot" at the July FOMC meeting. They are repeating that they are "nowhere near done with inflation". We agree with this assessment, and as such, expect them to keep going with rate hikes until the end of this year. We believe that the terminal rate for this cycle is still above 3% and that three rate cuts next year is optimistic.

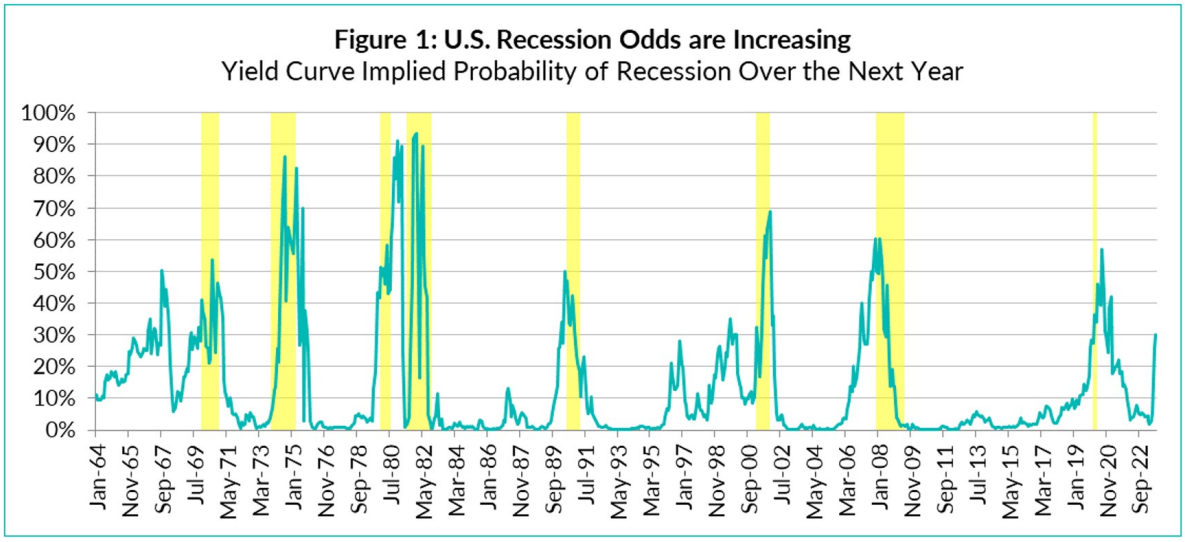
The big question for the Fed (and us) remains: how many rate hikes are required to decelerate growth enough for inflation to be on a sustainable downward path towards their 2% target?

If the front-loaded rate increase strategy works, then they can probably pause the rate hike cycle, increasing the odds of a soft landing. If not, then they will keep hiking, increasing the odds of a recession.

We will not know the answer to this until we get closer to year-end or even 2023. The Fed doesn't know this either, and cannot declare a victory now, with core inflation still more than double their target. That would be counterproductive.

Either way, over the next several months, the yield curve (10-year minus 3-month) should continue to flatten and eventually fully invert. Figure 1 below shows our U.S. Recession Probability Model, based on the U.S. yield curve. The shaded areas represent actual recessions. At the time of writing, our model

shows a 30% chance of recession in the U.S. in 12 months. Assuming that the Fed follows through with a 50 or 75bps rate hike in September, our model will be flashing red then (i.e. odds above 50%).



Source: Bloomberg, Authors Calculations. As of August 9th, 2022.

According to our portfolio positioning playbook, in this decelerating economic environment, we will be increasing portfolio duration, reducing credit risk and adding government bond exposure. Given how attractive the all-in yields are on the corporate bonds we own, for now, we have decided to increase our government bond allocation (and duration) by layering in call options in TLT across all three portfolios. This allows us to dip our toes in the water, adding optional duration to the portfolios without altering overall yield.

So far, we have spent about 15-20bps of premium to buy TLT calls to December 2022, increasing the funds' duration today by about 0.5 years (exponentially more if government bond prices keep going up). More duration in the long end (10 and 30 years) will act as ballast as the odds of recession increase.

Credit

Almost all risk assets had strong performance last month. In July, the S&P 500 was up 8% while the US corporate bond index was tighter by 18 bps. The notable laggard in this broad-based rally was the Canadian cash corporate bond market which saw spreads only move 3 bps tighter. Canada tends to lag the US when spreads tighten, so we are not overly surprised by this underperformance. July had an immaterial amount of non-financial bond supply, as the month was dominated by bank issuance. Lack of corporate bond issuance coupled with a solid Q2/2022 earnings season (from a credit perspective) generally serve as tailwinds for Canadian credit spreads from both a technical and fundamental perspective. The macroeconomic environment remains highly uncertain, and we continue to capitalize on valuation dislocations across sectors to high-grade the portfolios, improving both credit ratings and liquidity.

Ninepoint Diversified Bond Fund (DBF)

In July, we continued to trim lower-rated investment-grade credits in real estate and consumer focused sectors to move into higher-rated credits at near flat yields. We also participated in a National Bank new issue which carried a ~5.5% coupon for a bond callable in five years with an average credit rating of BBB. We also executed a Ford Motor retraction whereby we sold US$ bonds maturing in 2027 to buy C$ bonds maturing in 2024 while only giving up minimal yield (8bps for 3 years). As mentioned before, the US corporate bond market rallied in July while Canada corporate bonds lagged this move, so we decided to

take advantage of this cross-border discrepancy to defensively tweak our exposure to a credit we like. As of month-end, the fund's yield-to-maturity was 6.5%, and we moved our duration up to 3.7 years (4.1 years after accounting for the impact of the TLT options position).

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	June 2022	July 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%	2%	↑
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	73%	65%	65%	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	23%	29%	29%	↓
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	0%	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%	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%	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%	3%	1%	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%	1%	↔
Total		100%	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	2.4	4.1*	↑
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	4.3	4.3	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners | *Includes duration from options exposure

Ninepoint Alternative Credit Opportunities Fund (NACO)

Like DBF, we continue to look for attractive switches, in addition to participating in a few new issues. One switch trade worth highlighting was moving into Goldman Sachs from Canadian Natural Resources. We liked this switch for numerous reasons including: retracting one year, picking up two credit rating notches, picking up material liquidity, and picking up 42 bps in spread. We continue to see very attractive switches like these due to unique market dislocations and will continue to capitalize on them.

On the new issue front, we participated in a National bank new issue for the same reasons outlined in the DBF section, but also participated in the inaugural Obsidian Energy new issue. While we have been gradually trimming Oil & Gas producer exposure this year (due to very rich valuations, like the CNQ example above), the valuation on this new issue was very attractive (12.5% yield), especially since the bond contains a rare free cash flow sweep (which ensures rapid de-leveraging). As of month-end, the fund's yield-to-maturity was 9.6% and duration moved up 0.5 years to 2.5 years, entirely due to the new TLT call position.

Alternative Credit Opportunities Portfolio Characteristics

	Limits	May 2021	June 2021	July 2021	Aug. 2021	Sept. 2021	Oct. 2021	Nov. 2021	Dec. 2021	Jan. 2022	Feb. 2022	March 2022	April 2022	May 2022	June 2022	July 2022	Outlook
Government Bonds	100%	0%	0%	0%	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%	51%	51%	49%	↑
High Yield	40%	36%	32%	29%	24%	22%	28%	29%	29%	33%	29%	27%	29%	28%	28%	29%	↓
ABS	20%	0%	4%	1%	8%	6%	7%	7%	7%	9%	10%	11%	13%	13%	15%	16%	↔
Loans	10%	0%	0%	0%	3%	3%	3%	6%	5%	5%	5%	5%	4%	4%	4%	4%	↔
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	2%	2%	2%	2%	1%	1%	1%	1%	1%	↔
Common Equities & ETFs	10%	0%	0%	0%	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%	1%	1%	1%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	6%	13%	7%	8%	5%	0%	2%	0%	0%	↔
Total		100%	100%	100%	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	2.0	2.0	2.6*	↑
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	1.17x	1.10x	1.20x	↔
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners | *Includes duration from options exposure

Ninepoint Credit Income Opportunities Fund (Credit Ops)

We participated in the National bank new issue for the same reasons outlined above while the fund had room to increase exposure to the credit. We also participated in the inaugural Obsidian Energy new issue even though we have been gradually trimming Oil & Gas producer exposure this year (due to very rich valuations) across all three funds. The valuation on this new issue was extremely attractive, especially since the bond contains a rare free cash flow sweep (which ensures rapid de-leveraging). To ensure our HY positioning remained prudent, we sold a Russel Metals HY bond against the new issue. As of month-end, the fund's yield-to-maturity was 11.2% while we moved duration up 0.5 years to 1.9 years, entirely due to the new TLT call position.

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	June 2022	July 2022	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	0%	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%	32%	30%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	34%	38%	38%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	11%	8%	8%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	9%	7%	7%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	3%	3%	3%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	1%	1%	2%	2%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	1%	2%	3%	3%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	5%	2%	1%	1%	↑
Total		100%	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	1.4	2.0*	↑
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	1.40x	1.40x	↓
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 | *Includes duration from options exposure

Conclusion

An economic slowdown and potential recession are not necessarily a bad thing for fixed income investors. Duration generally performs well during risk off environments (hence our addition of duration), and the level of yield generated by our funds at this juncture is historically very high, providing a meaningful buffer against any further widening in credit spreads. This might sound premature, but we are quite constructive on our funds' outlook over the next 12-18 months. Investors could be well served by considering this an attractive entry point.

Please reach out to discuss further.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF JULY 31, 2022 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	1.4%	-7.7%	-1.1%	-6.2%	-7.9%	-0.3%	1.0%	3.0%	3.3%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JULY 31, 2022 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.5%	-6.9%	-2.3%	-5.4%	-5.1%	4.5%	4.0%	4.3%

NINEPOINT ALTERNATIVE CREDIT OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JULY 31, 2022 (SERIES F NPP931) | INCEPTION DATE: APRIL 30, 2021

	1M	YTD	3M	6M	1YR	INCEPTION
Fund	0.8%	-7.4%	-1.3%	-5.8%	-7.5%	-5.1%

[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 July 31, 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 July 31, 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 July 31, 2022.

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