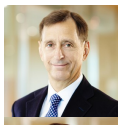
Ninepoint Fixed Income Strategy

March 2020 Commentary

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

Investment Team



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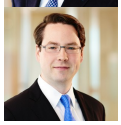

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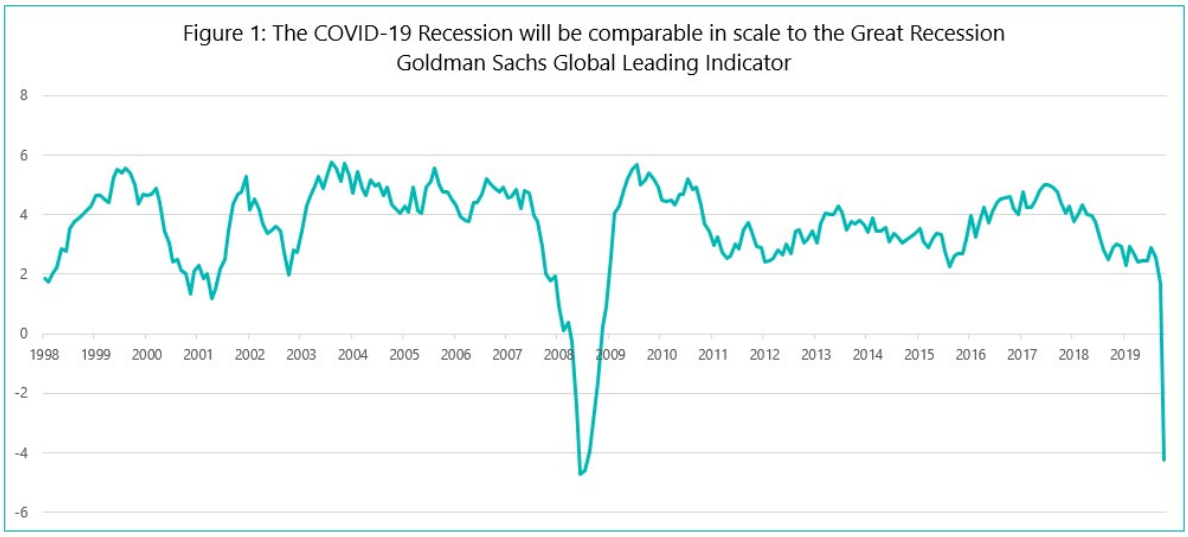
Macro

As we had feared, the coronavirus is now a global pandemic. Europe has been particularly affected, and several Canadian provinces and US states are now in lockdown, maintaining only essential services. Most of us are either working from home or temporarily unemployed. The virus' progression in the United States has now exceeded that of China and Italy, making it the world's new COVID-19 battleground. Unfortunately, the U.S.' response has been slow and uneven, which means that their chances of flattening the curve quickly (i.e. stop the progression) aren't encouraging

With most of the G7 in lockdown, economic activity has come to a sudden stop. As an example, new jobless claims in the U.S. reached 3.3 million in the week ending March 21, with an additional 3.5 million expected for the last week of March. To put these numbers in perspective, the previous worst week for claims was 665 thousand, in March 2009. While it is impossible at this point to accurately measure the extent of the downturn, it is fair to expect that it could be on par with the Global Financial Crisis (Figure 1).



Source: Bloomberg

Thankfully, the fiscal and monetary response around the world has been large and swift. Since this health crisis and ensuing economic shutdown is expected to be temporary, the authorities' goal is

to come up with measures that will help bridge people and businesses through the crisis, hoping to prevent unnecessary bankruptcies. Most fiscal packages so far include a combination of enhanced unemployment benefits, payroll subsidies and lump sum grants. Commercial banks have been asked to defer loan payments, again as a way to help households that have temporarily lost income. In the short term, these measures will provide much needed help, but if this situation persists for several months, they will prove insufficient.

Central banks have also responded in force after several key funding markets had become completely dysfunctional. In Canada and the U.S., interest rates are back to the zero lower bound (0.25%). Several countries have also announced new/additional QE programs and measures to increase key funding markets liquidity (Canada, US, Euro Zone, UK, Australia, New Zealand, etc.). Perhaps the most aggressive of all has been the Federal Reserve. In the span of a few weeks, they reactivated all of their 2008/2009 crisis fighting tools (unlimited QE, commercial paper and money market facilities, repo facilities, FX swap facilities with other central banks), including several other measures aimed at restoring proper functioning to the corporate bond market and even announced a small business lending program. Starting soon, the Fed will be buying investment grade corporate bonds in the primary and secondary markets.

All these measures are starting to help markets function more normally. Government bonds, which for a few weeks behaved very erratically, are once again responding as a safe heaven asset. Corporate bond markets are still strained, but things are improving. Recently, a few corporate issuers have tapped the Canadian market, at very wide spreads. These deals were very well subscribed for and allocations cut significantly. Since the Fed announced its corporate bond buying program, conditions in the U.S. market have improved markedly. More on credit below.

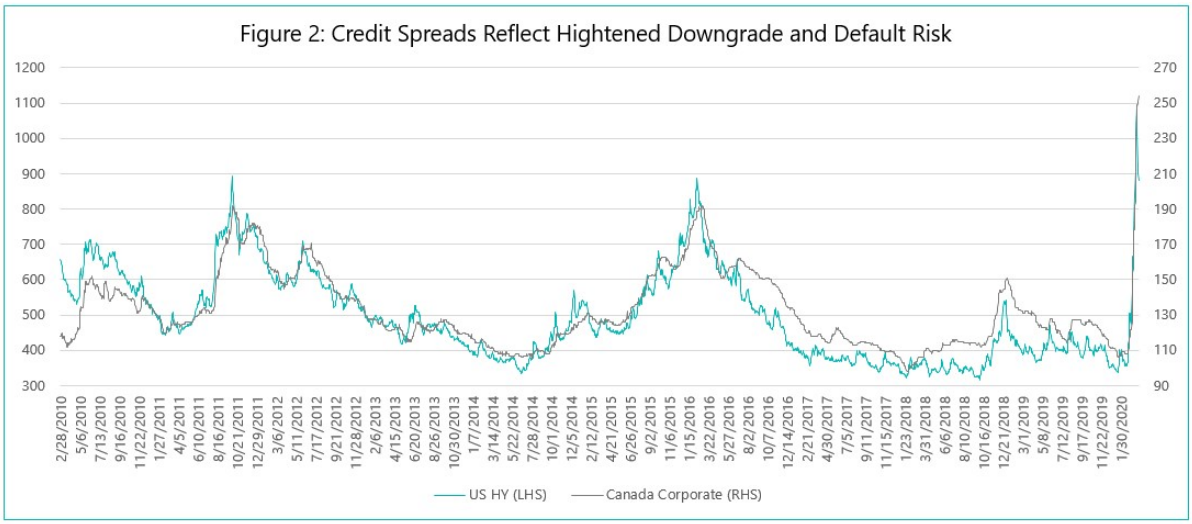
Several market strategists and economists are expecting a V-shaped recovery, hoping that the virus spread slows down with the spring weather and growth accelerates back to trend in the second half of 2020. We still think this is too optimistic and U-shaped is more likely. Some jurisdictions such as Japan and China are taking extreme precautions to avoid a second wave of infections. As of March 28th, China more or less closed its borders as a precautionary measure. At this point, it seems that only once we have a vaccine approved and available to protect the most vulnerable will we be able to return to normal. Several vaccines are currently under development, but so far, the earliest date being discussed for widespread availability is early 2021. Clearly, we are not out of the woods yet.

Credit

After a slow start, the correction in credit has picked up steam. Market liquidity has been worse than December 2018; many bonds could not find a bid, even typically “safe” assets such as short-term bank deposit notes. Thankfully, the Fed came to the market’s rescue by announcing their corporate bond buying program, and since then conditions in the US have improved. At home here, the Bank of Canada is buying government bonds, CMB bonds, mortgages, short term investment grade commercial paper and provincial treasury bills, but not corporate securities. Although liquidity here is showing signs of improvement, the secondary market is still functioning below average.

Nonetheless, credit spreads remain quite elevated (Figure 2), reflecting the uncertainty vis-à-vis the economic outlook and lingering liquidity issues. Estimates by Goldman Sachs suggest that the U.S. IG market could see as many as $555bn fallen angels (investment grade companies that get downgraded to high yield). To put this number in perspective, the current USD HY market is about $1.2tn, so this volume of fallen angels would add more than 40% to the HY market. Already,

companies such as Ford, Kraft Heinz and Occidental Petroleum have been downgraded to HY, and have become amongst the largest HY issuers. With oil prices around $20 and the economy in lock down, we expect the level of defaults in the HY universe to rise substantially in the coming months. We therefore think that HY remains, for now, too vulnerable and consequently not a priority for us, yet.

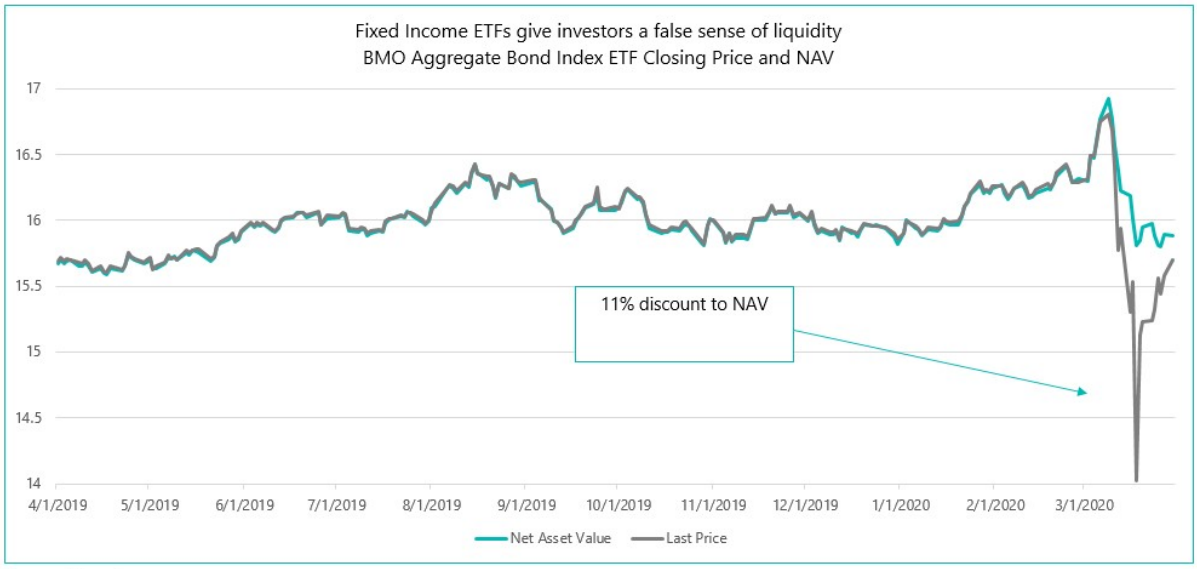


Source: Bloomberg

With the recent pull back in credit spreads and the new FED backstop for Investment grade issuers, we are starting to see some good risk-reward amongst the most highly rated companies. For example, we have participated in a few new issues involving companies such as BCE, Rogers, Enbridge and TransCanada (now called TC Energy). New issue concessions are appealing (10-25bps) and spreads reasonably wide (290bps to 325bps) enticing us to start adding selective positions.

Case Study: Fixed Income ETFs

To give readers a sense of the dislocation in fixed income markets over the past month, we thought it would be instructive to look at the behaviour of a popular ETF. The Chart below shows the closing price and net asset value of Canada's largest fixed income ETF, BMO's Aggregate Bond Index ETF. In normal times, the two track each other quite closely, usually trading at a premium to NAV of about 7bps. However, in times where redemptions are significant, things can get quite ugly. An investor trying to monetize their ETF investment in the past few weeks would have sold their position at as much as 11% lower than the net asset value of the units. This questions the effectiveness of less liquid assets like bonds being packaged and sold in liquid vehicles like ETFs. In times of market dislocation, it is almost impossible for ETF market makers to sell the whole basket of bonds that is representative of the index they track. By contrast, an active mutual fund manager has several levers to pull when facing redemptions, and investors requiring their funds do so at NAV, not at an 11% discount.



Source: Bloomberg

As discussed earlier, we are by no means in the V-shaped recovery camp, which means we expect continued volatility in the coming weeks. In past recessions equity markets corrected by 40% to 50%, high yield spreads topped 20% and investment grade credit spreads were almost twice as wide. Although strong central bank liquidity support and the huge stimulus packages should help mitigate a ferocious move wider in spreads, we expect more credit downgrades and high yield defaults that will pressure spreads wider in many sectors.

Diversified Bond Fund

All things considered, the DBF performed very well through this sell off. While our investment grade bonds suffered like everything else, their short duration, coupled with a 9% weight in US and Canadian government bonds (as high as 30% at certain points in the month), provided the necessary ballast to protect our client's capital. As of March month-end, the fund is still up 33bps for the year.
As discussed in the earlier sections, we have lots of liquidity and will be looking to selectively add to IG positions, or at the very least recycle maturities into higher yielding IG bonds. Government bonds have remained a source of stability in the portfolio, but given their low yield we expect to reduce that position in the coming months, depending on the pace of improvement in the global economy. As for high yield, the increase in portfolio weight reflects the migration from investment grade to high yield of Ford (mostly 1-2 year bonds), along with a new position in a July 2020 Kraft-Heinz bond (another fallen angel). In high yield, we expect things to get worse before they get better, and as such will remain very selective for now. At some point retail, airlines, automotive and leisure will be obvious candidates for the portfolio.

Over the past few months, we have been patient and defensively positioned, waiting for better value in a market that made little sense to us. We are now acting from a position of strength:

- The DBF has a 3.5% yield to maturity
- 30% of the fund matures within the next 12 months, offering plenty of dry powder to reinvest at higher yields
- When the time is right, government bonds will be recycled in higher yielding opportunities
- The corporate class is open, offering clients a tax-efficient vehicle to invest in

Looking forward, we believe that we are extremely well positioned to deliver strong risk adjusted returns.

Diversified Bond Fund Portfolio Characteristics

	Limits	Dec 2017	Mar 2018	Jun 2018	Sept 2018	Dec 2018	Mar 2019	June 2019	Sept 2019	Dec 2019	Mar 2020	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	↓
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	↑
Emerging Market Governments	10%	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%	↔
Common Equities & ETFs	10%	0%	0%	0%	1.5%	1.5%	4.3%	2.4%	-1.3%	0%	0%	↔
Derivatives	+/- 2.5%	-0.1%	+0.5%	-0.1%	-0.05%	0.0%	0.0%	-0.2%	0.0%	0.2%	0%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	↑
Total		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	↓
Geographic (% North America)	>75%	89%	90%	89%	93%	91%	87%	85%	86%	85%	92%	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	↓

Source: Ninepoint Partners

Credit Income Opportunities Fund

In light of the rapid sell-off in credit, the Credit Opps performed better than expectations. Going into the Covid crisis, leverage was very low and spread duration was about 5 years, meaning that for every 100bps widening in credit spreads, the fund would be expected to lose 5%. As shown in Figure 2, Canadian IG spreads widened about 150bps. So, all else equal, one would have expected to see the fund decline by at least 150bps x 5 years = 7.5%. - as of month-end, the fund was down approximately 6.75%.

To provide some portfolio ballast in the Credit Opps, we have maintained a short position in the US High Yield ETF HYG, which contributed about 75bps to performance in March. As discussed in the credit section above, we do not believe that HY is out of trouble yet, so we have elected to increase the short position in HYG from 7% to 10%. To mitigate the risk/reward of this hedge, we took advantage of high implied volatility in the ETF to collar the position at no cost, just in case HY rallies more from here.

Over the coming months the Credit Income Opportunities fund will start to slowly add more IG credit and leverage to the portfolio, it is exceptionally well positioned to capitalize on the current situation and generate strong returns.

- The current yield to maturity of the portfolio is 7%
- At 0.87x, leverage is low, affording us the possibility to take risk (when IG spreads are 200bps-300bps, every additional turn of leverage adds 2-3% to portfolio yield).
- 50% of the core portfolio matures within the next 12 months, offering plenty of dry powder to reinvest at higher yields

The last time credit was this attractive an opportunity was the period from 2008 to 2009.

Credit Income Opportunities Portfolio Characteristics

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

Source: Ninepoint Partners

Conclusion

The whole team is healthy and working very efficiently from home. We are 100% operational and continue to manage your investments in our funds at the best of our capacity. We wish our clients and their families good health and the best of luck navigating these challenging conditions.

Until next month,
The Bond Team: Mark, Etienne and Chris

Ninepoint Partners

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

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-2.0%	0.2%	0.2%	-0.6%	2.3%	2.6%	2.9%	4.4%

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

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-1.9%	0.3%	0.3%	-0.5%	2.5%	2.8%	3.0%	4.3%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1]
AS OF MARCH 31, 2020 (SERIES A NPP506)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-6.8%	-5.9%	-5.9%	-5.4%	-3.2%	0.5%	2.2%	3.7%

[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 March 31, 2020 [1] All Ninepoint Credit Income Opportunities Fund returns and fund details are a) based on Class A units (closed to subscriptions); b) net of fees; c) annualized if period is greater than one year; d) as at March 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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