Ninepoint Fixed Income Strategy

March 2022 Commentary

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

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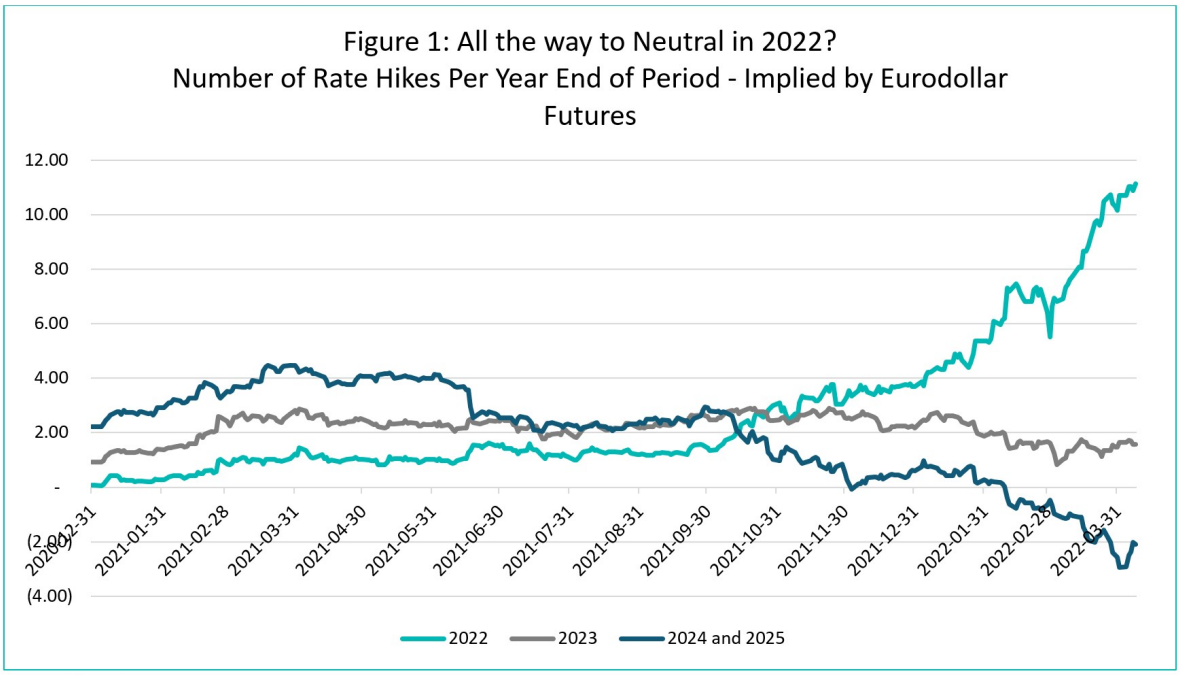
Macro

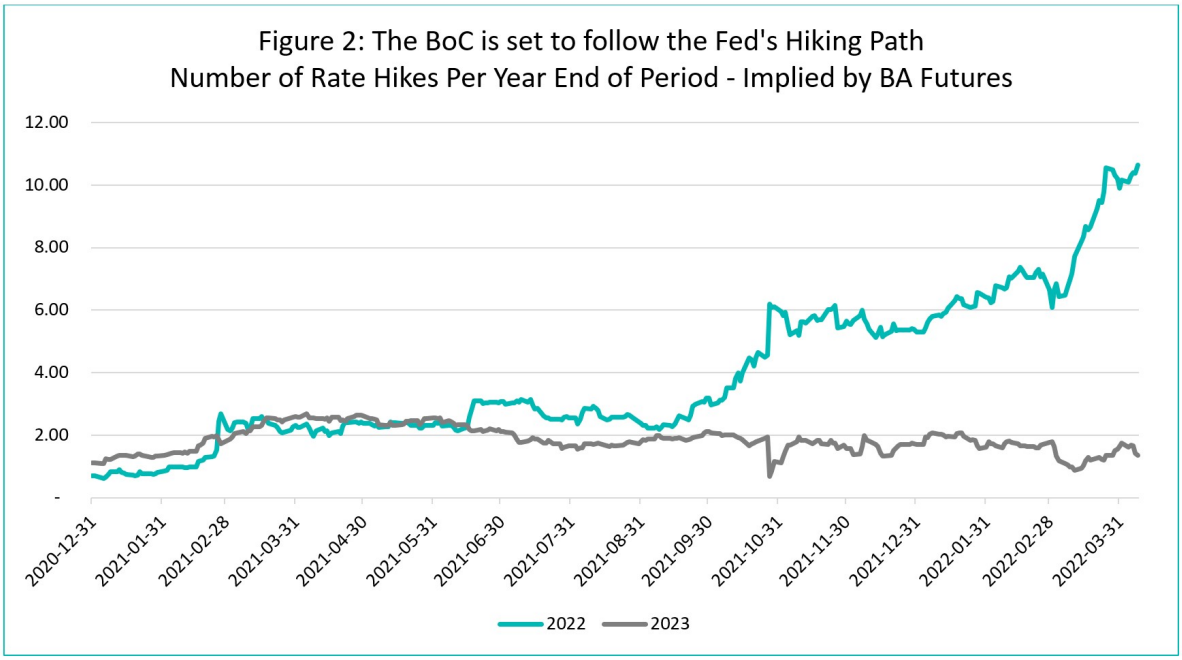
And the hawkish pivot continues; as discussed last month, the war in Ukraine and the associated increase in commodity prices globally is further fanning the flames of inflation, therefore reinforcing the resolve of central banks to get it under control. Listening to various Fed speakers over the last few weeks, there is a distinct feeling that they are now far behind the curve, and they know it. The reaction in the bond market has been immediate; futures are now pricing a full 11 rate hikes this year (Figure 1 below), taking the Fed Funds Rate all the way to 2.75% by year end 2022 (similar story in Canada, Figure 2).



Source: Bloomberg

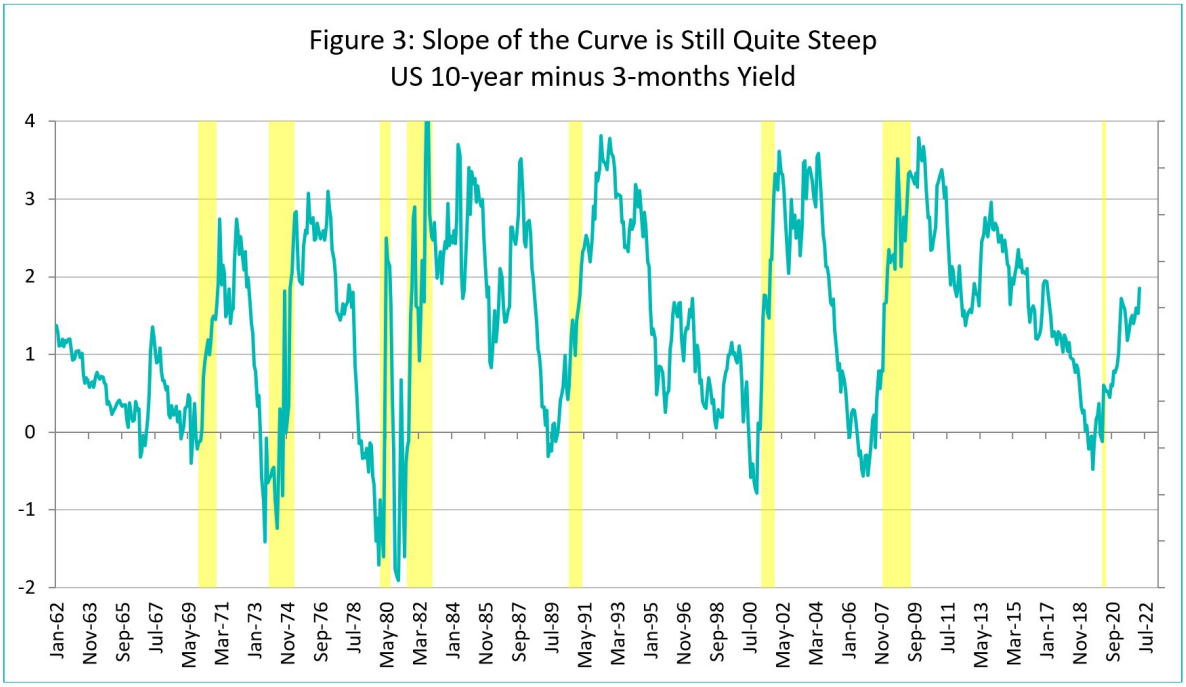
Naturally, the rest of the yield curve has followed. At the time of writing, the curve is essentially flat from 3-years to 30-years. In just one month, the 5-year yield on government bonds has increased by more than 100bps. Just like during the last hiking cycle, the flattening of the yield curve has elicited an animated discussion around the odds of recession. So we are, once again, dusting off our old yield curve recession model/chart that we haven't used since the last yield curve inversion, to assess

the probability of recession starting 12 months from now. Our model is based on the 10-year to 3-month yield spread, following the work done at the NY Fed (amongst others) that has proven to be a more reliable predictor of recession (less false signals).



Source: Bloomberg

In Figure 3 below, we show the long-term chart of that 10y/3m spread along with actual US recessions (yellow shading). Inversions of this spread (negative readings) do precede all recessions since the 1960s. even the most recent, pandemic induced recession.

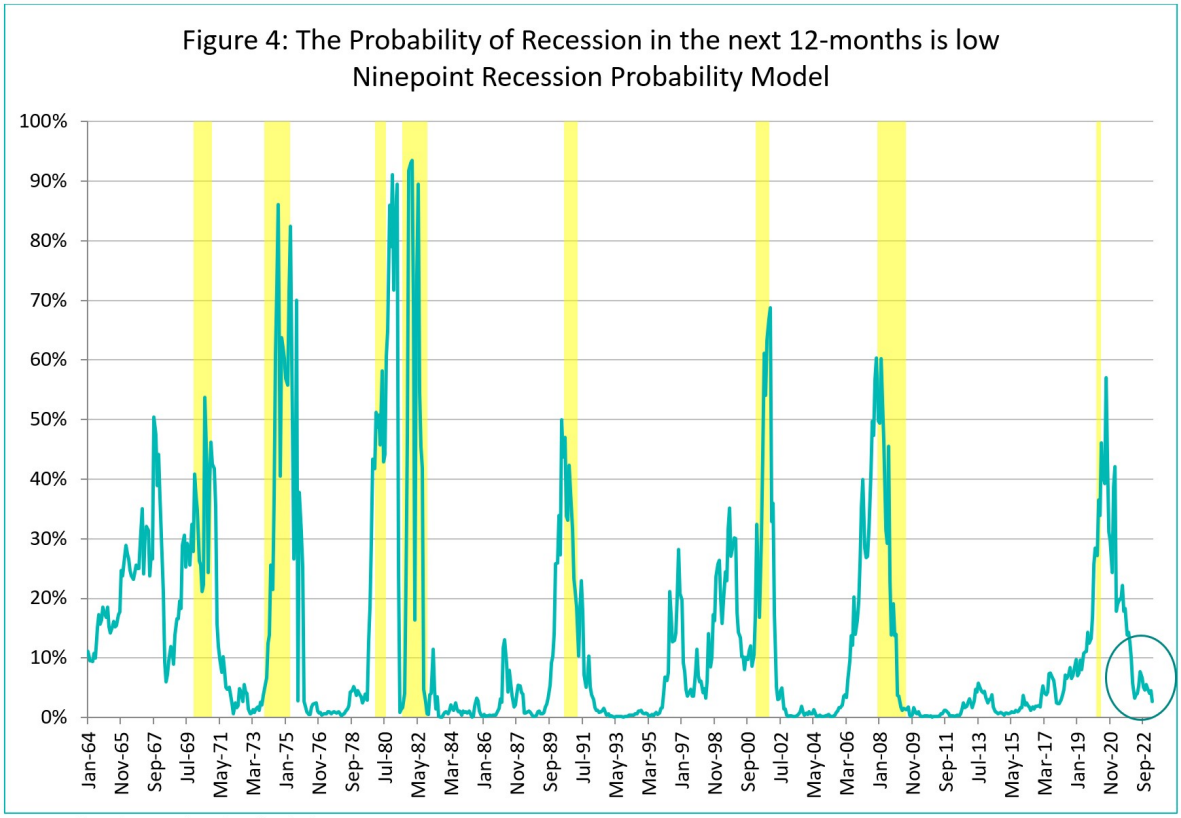


Source: Bloomberg and Authors' Calculation

However, unlike the 2s/10s, 5s/30s or other measures of the slope of the yield curve which are all currently flat or inverted, the 3m/10s is still very steep. Why? Simply because so far, the Fed/BoC

have only hiked interest rates once. All other models tend to be a forecast/projection that the actual market is making. The 3-month yield incorporates actions that have been taken, not expectations about future actions/rate increases. It is most useful in forecasting recessions, because when the 3m10s actually does invert, the bond market is essentially saying: "you've hiked too far, we now expect rate cuts in the future". A useful rule of thumb used in central banking circles is that a rate hike takes anywhere between 6 to 18 months to be fully reflected in the economy. Therefore, actual hikes matter a lot more than expected rate hikes for the real economy.

So, if the Fed/BoC do hike a total of 10-11 times this year and take the overnight rate all the way to 2.75% by the end of the year, only then would the 3m/10s curve likely invert. Based on our model, the curve needs to be about -20bps inverted (so 3-month yields 20bps higher than 10-year yields) to forecast a 50% chance of recession 12-months in the future. Only then would the "clock start" to forecast the start of a recession. When clients ask us if we're worried about recession in 2022, the answer is no (Figure 4 below).



Source: Bloomberg and Authors' Calculation

So, that is the current playbook assuming that consensus plays out with regards to rate hikes. And that is a lot of rate hikes in quite a short period of time. Both the US and Canada have clearly messaged that a 50bps hike for their next meeting (May and April, respectively) is the base case. At this juncture, it is fair to assume that they could do the same at the following meeting (June). But, once 100-125bps of rate hikes are done by the end of June, we believe that the FED and BoC will slow the cadence and become more "data dependent", particularly with regards to inflation.

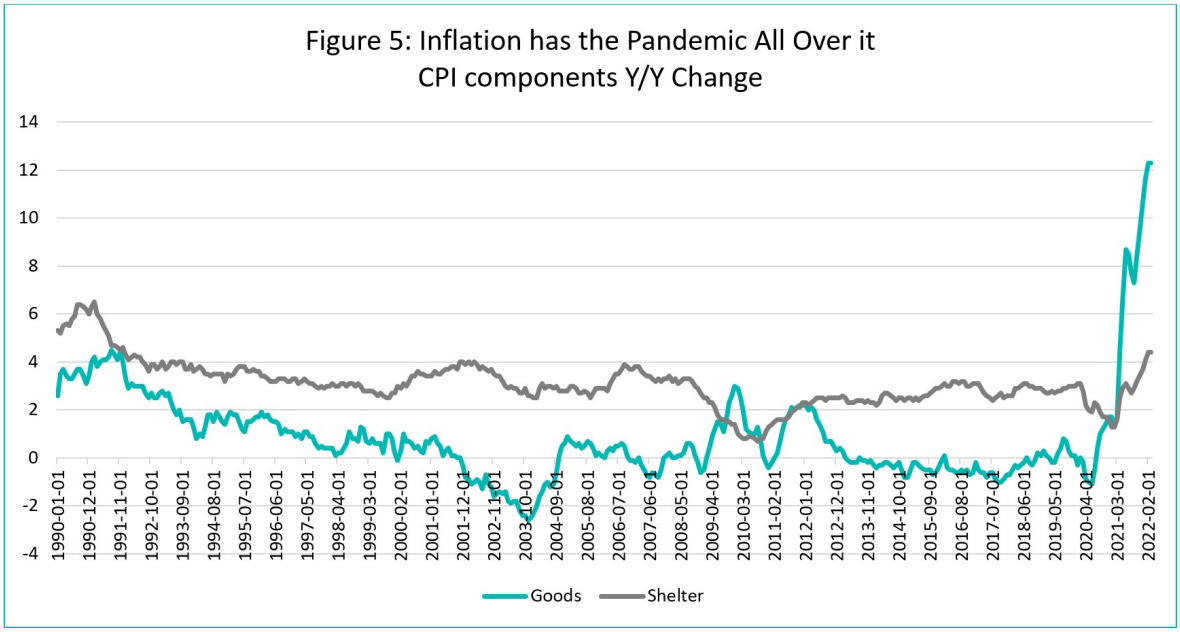
There have been three important drivers of inflation over the past year:

1. Shelter (i.e. housing costs), which represents about 30% of the CPI basket (~40% of the Core CPI basket)

2. Goods prices, which represent 22% of the CPI basket (~30% of the Core CPI basket)

3. Food and Energy, which represent another 20% of the CPI basket (excluded from the Core CPI basket)

Since the Fed and other central banks typically ignore the effects of food and energy (and would have this time around if inflation wasn't already this high), we will focus on those "Core" components. Figure 5 below shows the annual change in those two very important CPI sub-components (alone, they represent 65% of the Core CPI basket). Because of the large increase in home prices following the pandemic, shelter is about 1% higher than the last 30-years trend. With the rapid increase in mortgage rates, housing activity is already starting to slow down (i.e. monetary policy is already having an impact). On the goods front, the increase over the past year or so has been nothing short of shocking, more than 12%. That category alone is contributing 3 percentage points to overall inflation in February (out of 7.9% headline inflation and 6.4% Core).



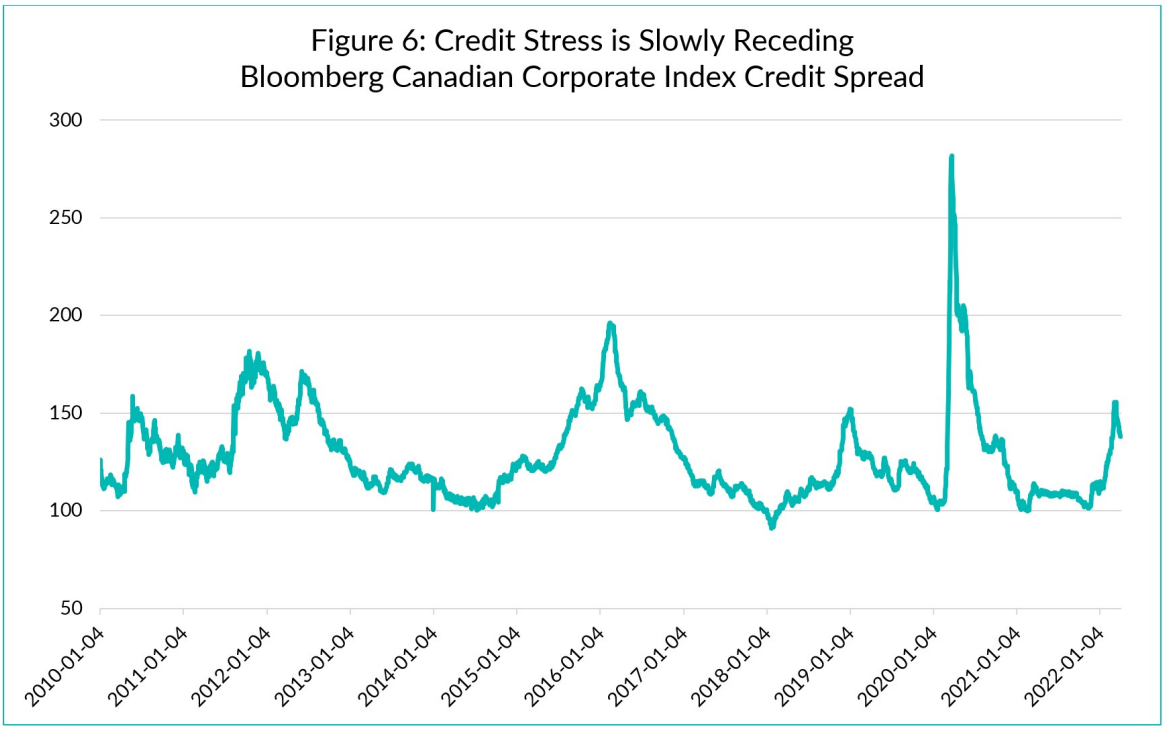
Source: Bloomberg

Yes, for what seems like a long time now, we have been told that this is due to temporary factors such as supply chain issues and chip shortages in cars. However, we are starting to see some signs that this might reverse. Inventories are starting to build up as companies have double or triple ordered when faced with shortages, and more importantly, demand is waning. Between the front loading of purchases during the pandemic, higher financing rates, inflation acting as a tax on spending and lower government transfers, consumer demand for goods is normalizing. Lower demand coupled with higher inventories, should lead to a stabilization (or decline) in good prices.

All this to say: with 10 or 11 rate hikes priced-in for this year, we believe that the market (and central bankers) are at "peak level of hawkishness" and we would not be surprised if over the next few months, inflation no longer surprises to the upside, coming back down a little, as goods deflation replaces goods inflation. Therefore, we believe the market is becoming too aggressive on rate increases. As far as the economy is concerned, we are constructive on the growth outlook in North America, consequently we believe it is too early to be talking about a 2022 recession.

Credit

While January and February were challenging months for credit, March finally saw the tone turn less negative and eventually outright positive. While we shared our view in last month's commentary that credit spreads tend to mean revert, we can see the improvement now taking hold (Figure 6 below). While predicting the exact date of when credit spreads actually improve is a mugs game, we have ensured that our portfolios were positioned appropriately to benefit from the eventual improvement in credit spreads.



Source: Bloomberg

While credit recovered during most of March, there were interesting divergences between sectors. In Canada, telecommunication and pipelines were the best performers, whereas the worst performing sectors tended to be lower-beta financials. Last month, we mentioned we were eyeing some opportunities within REITs, which we were able to execute this month. We took advantage of strong performance within the industrial and retail-backed REITs complex to trim our positions in Granite REIT and CT REIT. We continue to view the sector as broadly attractive, so we recycled those proceeds into SmartCentres REIT (which we already own and like) and into Primaris REIT (new issuer).

Turning to the Canadian new issue market, $28.5bn was raised by corporate borrowers this month, which translated into one of the busiest months on record. Regardless of the market environment, corporate borrowers still must find ways to access capital, and in the current backdrop, they often have to "pay up" in the corporate bond market by means of New Issue Concessions ("NICs"). Think of NICs as the price an issuer needs to pay to get a new issue across the finish line. NICs are something we track closely as they are a good barometer of the tone in corporate credit. For much of March, NICs were very wide, but progressively narrowed, strengthening our conviction that things were finally turning around.

Here are some recent examples of new issues we participated in:

Rogers Communications: To fund the C$26bln Shaw acquisition, Rogers tapped both the US and Canadian bond markets in early March to lock-in acquisition funding. This was a well anticipated deal, and we had been waiting for this to re-enter the name. For context, the 30-year Rogers tranche which came at a ~25bps NIC, is something we rarely see. At the time of writing, this 30-year bond is one of the best performing Canadian new issues YTD.

Keyera: We also participated in the Keyera new issue whereby the company issued a $400mm 10-year bond. While we currently own Keyera hybrids across all three portfolios, we took advantage of the healthy NIC of ~15bps to add to a credit we already like. Its integrated pipeline system, steady cash flows and deep commitment to the balance sheet are just some of the characteristics we like in Keyera. Additionally, the yield on the new issue was north of 5% which we viewed as an attractive level to add yield to the portfolio.

Primaris REIT: We were able to do plenty of homework on Primaris REIT ahead of their inaugural new issue. After reviewing their documents, presentations and sitting down with the management team, we gained comfort in their corporate strategy, sector leading balance sheet and conservative capital allocation philosophy. We viewed this new issue as an attractive opportunity to initiate a position in the name in addition to slightly increasing our REIT weight (a sector we have been increasingly interested in of late). In the end, Primaris issued $200mm 3-year bonds and $150mm 5-year bonds and we participated in both tranches across the portfolios. The favourable all-in yield, eventual upward credit rating trajectory and the compelling valuation versus lower rated REIT peers were just some of the reasons we participated in this new issue.

As an active manager in a credit-focused strategy the new issue market is important. It allows us to re-initiate names we have owned in the past (e.g. Rogers), add to names we already own (e.g. Keyera) or buy positions in new names (e.g. Primaris REIT). 2022 has been a challenging time for fixed income, but it's providing some very attractive opportunities to purchase great companies "on sale" and add much more income to the portfolios.

Diversified Bond Fund (DBF)

While we were able to take advantage of opportunities within credit (discussed above), the dramatic move higher in government bond yields managed to detract from overall performance. Our duration still remains very low at 2.2 years, which should prove beneficial as the Bank of Canada continues with its tightening cycle. As a reminder, about 40% of our portfolio's exposure is to floating rates, which should prove beneficial as rate hikes continue to occur. The elevated yields on government bonds and central bank rate hikes have now pushed the yield-to-maturity to a very attractive 4.7% (90bps higher than February month-end) with an average credit rating of BBB.

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	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	-7.0%	1%	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	73%	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	23%	↓
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	0%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	5%	3%	1%	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%	↔
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%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	14%	0%	↔
Total		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	↔
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	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	0%	↔

Source: Ninepoint Partners

Alternative Credit Opportunities Fund (NACO)

While we were able to take advantage of opportunities within credit (discussed above), the dramatic move higher in government bond yields detracted slightly from performance. Our duration remains very low at 2.1 which should prove beneficial as the Bank of Canada continues with its tightening cycle. The portfolio's yield-to-maturity is now a very attractive 6.1 with an average credit rating of BBB. As a reminder, earlier this year we layered in some additional interest rate hedging, converting fixed rate bonds to floating, in anticipation of higher yields.

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	Outlook
Government Bonds	100%	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%	↑
High Yield	40%	36%	32%	29%	24%	22%	28%	29%	29%	33%	29%	27%	↓
ABS	20%	0%	4%	1%	8%	6%	7%	7%	7%	9%	10%	11%	↔
Loans	10%	0%	0%	0%	3%	3%	3%	6%	5%	5%	5%	5%	↔
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	2%	2%	2%	2%	1%	↔
Common Equities & ETFs	10%	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%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	6%	13%	7%	8%	5%	↔
Total		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	↔
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	↔
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Ops)

While the move higher in government bond yields detracted slightly from performance, the portfolio's extremely low duration of 1.6 allowed the fund to post its first positive return month of

the year. As the Credit Ops is a highly focused credit strategy, our positioning heading into an improving credit market served us well. The fund's yield-to-maturity is now 7.4%, reflecting an attractive entry point.

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

Source: Ninepoint Partners

Conclusion

After selling off aggressively for the past 3 months, credit spreads have finally stabilized and have started to tighten, reflecting the still solid macroeconomic backdrop, particularly in Canada. The dramatic move up in government bond yields is significantly enhancing the overall yield of debt securities. It's been a long time since we've been able to buy intermediate investment grade credit in the range of 4% to 5%. Our three credit focused strategies have portfolio yields we haven't seen in years. With yields this high we believe fixed income looks increasingly more attractive and a good time for clients to consider adding or increasing their allocation to bonds.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

[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 March 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 March 31, 2022.

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