Ninepoint Fixed Income Strategy

May 2022 Commentary

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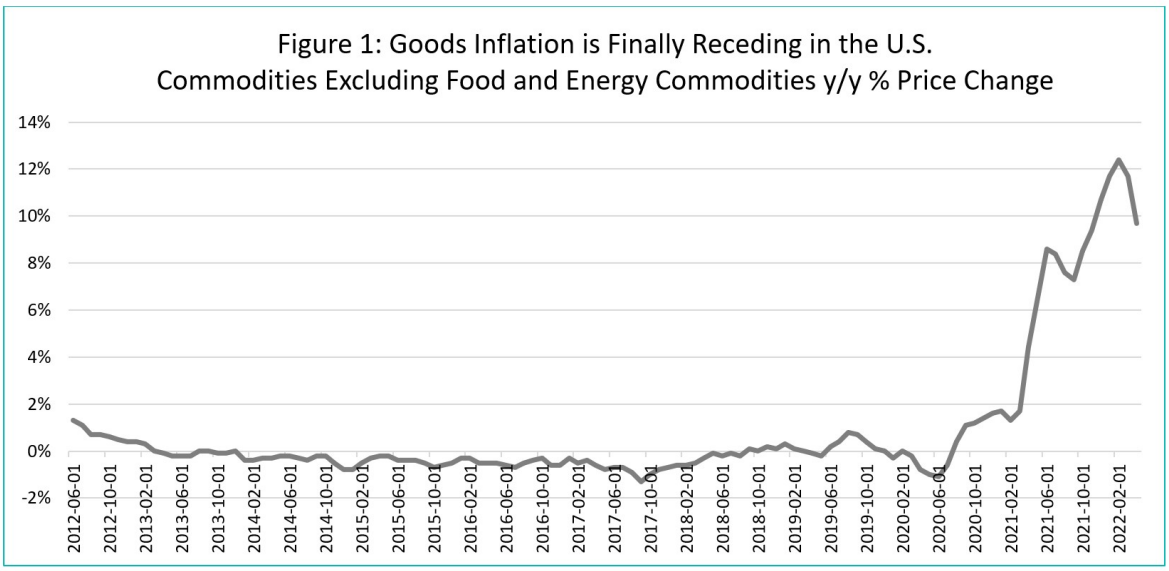
Monthly commentary discusses recent developments across the ***Diversified Bond****,* ***Alternative Credit Opportunities*** *and* ***Credit Income Opportunities Funds****.*

The song remains the same. Inflation is high, central banks are raising rates expeditiously to avoid the risk that higher inflation expectations become entrenched in consumer behavior. Investors are becoming more worried that we are heading for a downturn. How far will rates have to go up for inflation to finally come down, and then how significant will the downturn be, are the questions on everyone's minds.

So far, the most interest rate sensitive sectors of the economy are feeling the pinch, with housing slowing down and overall goods prices (~22% of CPI in the U.S.) finally starting to decelerate (Figure 1).

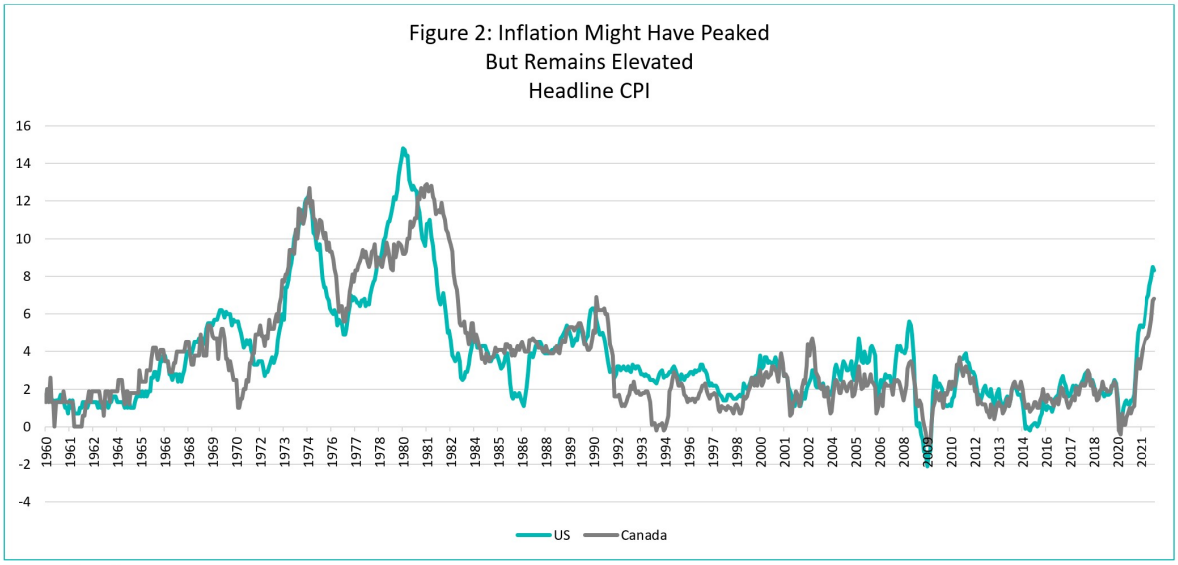


Source: Bloomberg

Unfortunately, the war in Ukraine is making an already tight energy market even tighter, pushing up oil and gas prices. Ukraine is also the breadbasket for a large part of Europe and the Middle East, leading to rising food prices across the globe. Usually, central banks look through these temporary commodity price increases because they are global in nature, and thus unlikely to be affected by monetary policy, which affects domestic demand.

But, in the current context, with inflation at decade highs (Figure 2), the longer it stays elevated, the

more likely it is that households and firms' inflation expectations risk becoming anchored at these lofty levels. Once that happens, workers ask for higher wages, companies increase prices, and the wage-price spiral begins. So, even though monetary policy has no real way to impact gasoline or wheat prices, to maintain their credibility as inflation fighters, central banks will need to keep hiking interest rates.



Source: Bloomberg

And that's exactly what is happening. The BoC raised rates by another 50bps on June 1st, taking the overnight rate to 1.5%. In the US, the Fed raised rates by 50bps in May and is expected to do the same again in June. Both central banks have guided to another 50bps hike in July. At this point, a 2% Overnight/Fed Funds Rate by July is pretty much baked in.

What happens next is a little murkier. Monetary policy works with a lag of between 6 to 18 months, so the actions that were taken this spring will start showing up in economic data this fall. If growth slows down and inflation decelerates due to lower goods and housing costs, accompanied by more slack in the labour market and less upward pressure on wages, this might be enough for Messrs. Powell and Macklem to slow the cadence of rate hikes (back to a more usual 25bps per meeting) or even pause to assess the damage. This is the much-desired soft-landing scenario.

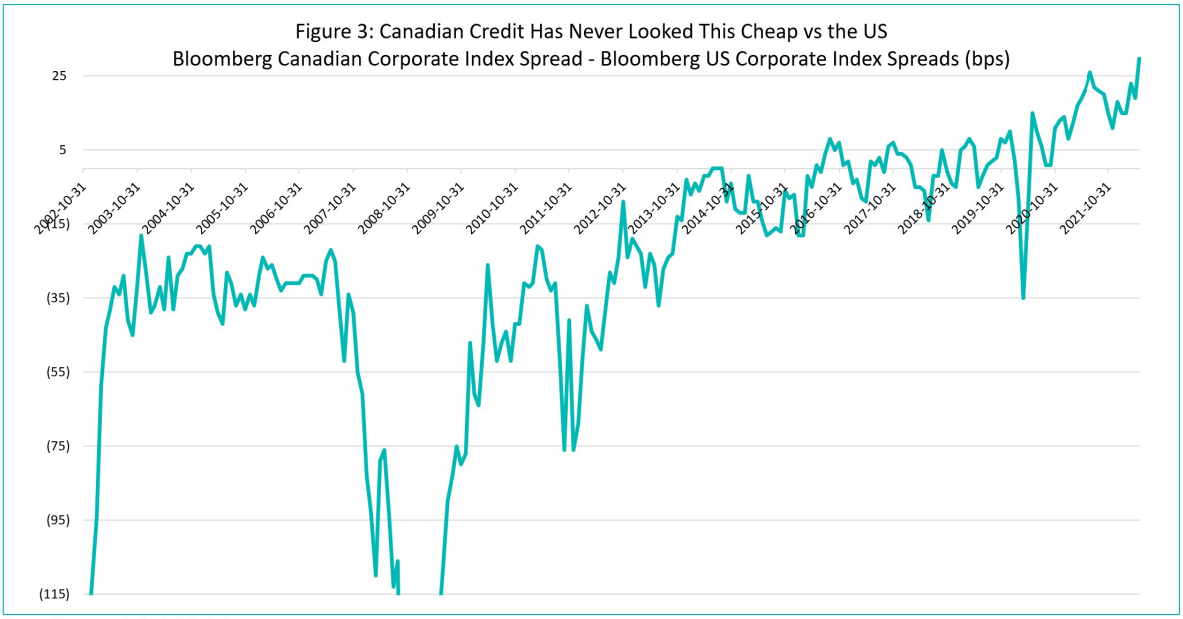
However, if demand doesn't abate, and energy and food prices continue to rise because of the situation in Ukraine they might, reluctantly, have to keep hiking rates past neutral (estimated to be around 2 to 3%) to further soften demand. This would likely lead to a recession sometime in 2023. According to the futures markets, this scenario is currently the most likely. The market sees a series of aggressive rate hikes taking us to just above 3% by year end, followed by a pause and then rate cuts later in 2023/24.

Those are the two scenarios we and other market participants have been wrestling with all year. It is still too early to tell which way it will go. This is why markets have been so volatile; every new piece of data shifts the odds of these scenarios and has large implications for asset prices. For now, we are leaning towards the soft-landing scenario, chiefly because Canada is rich in natural resources and should, on net, benefit from the current environment. But unlike firms, households are more vulnerable to rising interest rates and elevated inflation. Past excesses in the housing market are currently in the process of reversing themselves. This is healthy, but also where the bigger risk lies for the Canadian economy.

This is a very tricky environment, with many moving parts. Over the next few months, geopolitical developments in Europe, energy prices and economic data releases will be of particular importance to determine which scenario we are heading towards.

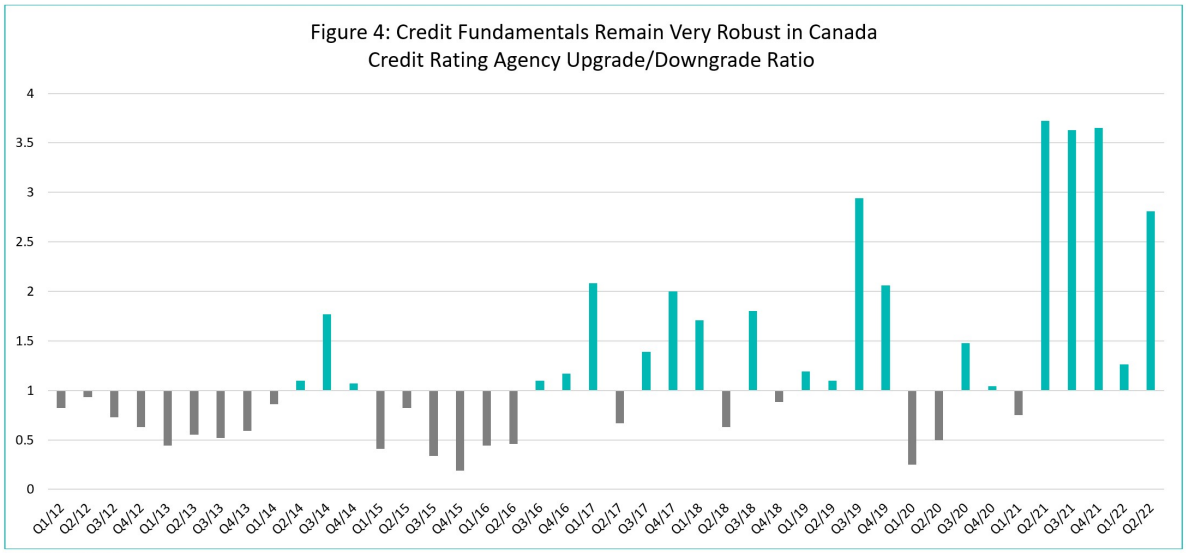
Credit

While the first three weeks of May were challenging for credit, the tone completely reversed later in May as risk assets stabilized and subsequently rallied into month-end. The strength in Canadian credit has continued into June thus far as market participants are beginning to realize the compelling valuations presented by the domestic marketplace. In our March commentary, we discussed how Canadian credit spreads were cheap when compared to past risk-off environments. In our April commentary, we discussed how elevated the all-in yields were on Canadian corporate credit. This month, we include two charts that further showcase the attractiveness of Canadian credit. Figure 3 shows the Canadian vs US corporate spreads. Canada has not been cheaper, relative to the US, since the dataset was created (2002).



Source: Bloomberg, Author's Calculations

Furthermore, Figure 4 below shows the credit rating agency upgrade/downgrade ratio in Canada over the past decade. Upgrades have far outpaced downgrades for 5 consecutive quarters, reflecting a strengthening of corporate balance sheets. Clearly, the domestic corporate credit market is already pricing in a lot of bad news, it is: cheap vs history, cheap on an all-in-yield basis, cheap vs the US and with improving fundamentals. The change in tone, in late May shouldn't come as a surprise and our portfolios are positioned accordingly.



Source: Bloomberg

As we have said this is a tricky macroeconomic environment, but periods of market uncertainty can create opportunities. So far this month, we have been able to take advantage of numerous switch trades across the portfolios whereby we moved from BBB-low rated corporate bonds into A-rated bank bonds at very similar yields matching terms. If the market offers you a chance to move up in credit quality and in liquidity without sacrificing much yield, we take it. For those curious readers, NVCC (non-viability contingent capital) bank bonds have been amongst the worst performing sector YTD, mostly due to concerns about the volume of bank bond issuance. We have owned very little NVCC , but have recently increased exposure due to this market dynamic.

Diversified Bond Fund (DBF)

Throughout the month we have proactively trimmed our exposure to some REIT/housing/consumer names to move into higher-rated banks at near flat yields. While we are still leaning towards the soft-landing economic scenario (discussed above), we are still many months from knowing with certainty which way it will go. Doing some switch trades felt prudent to us (improve credit quality, improve liquidity, reduce exposure to most vulnerable sectors of the economy). The fund's duration remains low at 2.7 years (vs 3.3 as of April month-end) while the yield-to-maturity is now 6%, offering a high level of income to investors.

Ninepoint Diversified Bond Fund
Changes to Portfolio

	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	May 2022	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	-7.0%	1%	**1%**	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	73%	**67%**	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	23%	**28%**	↓
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	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%**	↓
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%**	↔
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%	**2%**	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%**	↔
Total		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	**2.7**	↔
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	**4.5**	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	0%	**0%**	↔

Source: Ninepoint Partners

Alternative Credit Opportunities Fund (NACO)

We were able to participate in a handful of new issues that allowed us to marginally tweak the quality, term and duration of the portfolio. Fortis, a high-quality regulated utility, helped re-open the Canadian corporate new issue market in mid-May by issuing a 7-yr bond with the highest new issue concession in months. Additionally, Laurentian Bank, issued a 3-year bond with a coupon of 4.6% which to us seemed to be very attractive pricing, notwithstanding the low duration. From a portfolio perspective, duration remains very low at 2 years (2.2 years as of April month-end) while the yield-to-maturity is a very compelling 8.3%.

Ninepoint Alternative Credit Opportunities Fund
Changes to Portfolio

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

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Ops)

We participated in the Fortis 7-year new issue for the same reasons outlined in the NACO section above. A ~20bps new issue concession for a highly rated Canadian utility does not happen every day. On a portfolio basis, the yield-to-maturity topped 10% for the first time, up 60 bps vs April month-end and duration remained essentially unchanged at 1.5 years month-over-month. These two portfolio characteristics, in addition to the strong fundamentals exhibited by the credits we own, present a very compelling opportunity to increase exposure in the fund.

Ninepoint Credit Income Opportunities Fund
Changes to Portfolio

	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	May 2022	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	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%	30%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	34%	37%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	11%	12%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	9%	7%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	3%	3%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	1%	1%	1%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	1%	2%	3%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	5%	2%	0%	↑
Total		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	1.5	↔
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	1.51x	↓
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

Conclusion

Yes, the macroeconomic environment is challenging; inflation is elevated, supply chains are still gummed up and global energy markets are especially tight. But, given the repricing that has taken place over the past 6 months, we believe that the current set up for Canadian credit investors is especially compelling. Canadian credit is cheap vs history, cheap on an all-in-yield basis, cheap vs the US and shows improving fundamentals. It is very rare to see valuations this attractive from so many lenses. We haven't seen risk/reward characteristics this compelling in a long time.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

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

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-0.9%	-7.5%	-4.8%	-6.7%	-6.7%	0.0%	0.9%	3.1%	3.4%

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

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-1.5%	-6.1%	-2.8%	-5.7%	-3.6%	5.0%	4.2%	4.5%

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

	1M	YTD	3M	6M	1YR	INCEPTION
Fund	-1.1%	-7.2%	-3.7%	-6.8%	-6.4%	-5.7%

[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 May 31, 2022 [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 May 31, 2022. [1] All Ninepoint Alternative Credit 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 May 31, 2022.

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