Ninepoint Fixed Income Strategy

October 2021 Commentary

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

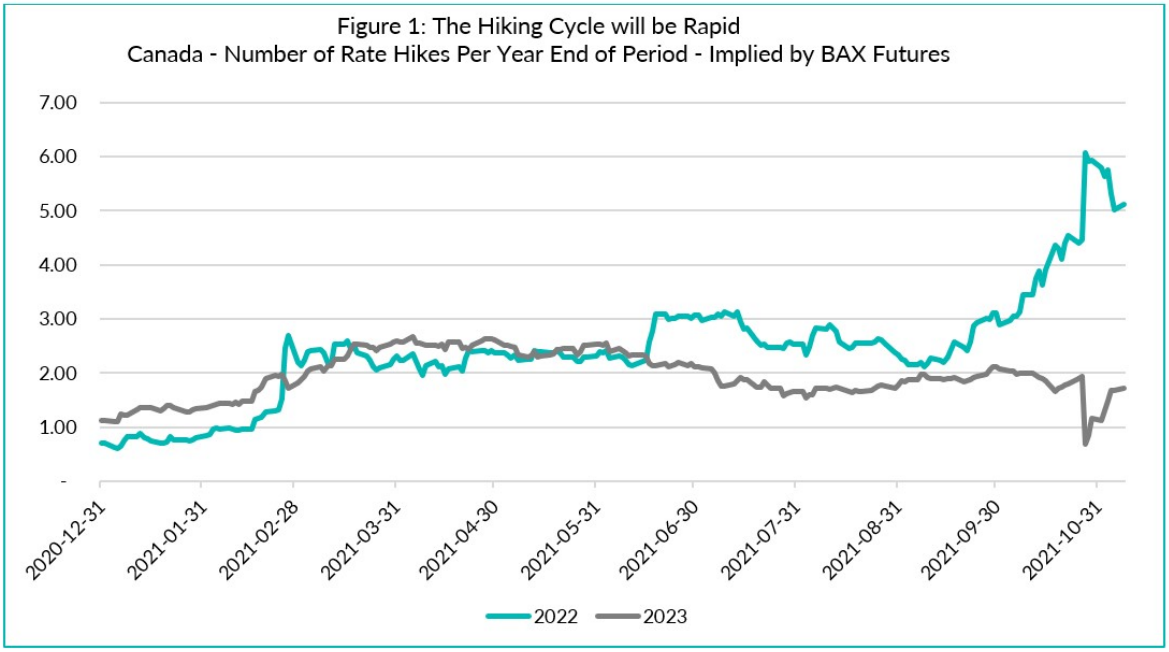
Ninepoint Partners,

Macro

In the global interest rate market, October was a wild month; for central bankers, inflation is quickly becoming the number one concern. Across the world, several top monetary officials (UK, New Zealand, Australia, Canada) have signaled their willingness to raise interest rates in the near future to combat inflation. This shift has taken markets by surprise, resulting in very volatile movements in interest rates, particularly in the short end (2 to 5 years), which is way more susceptible to changes in policy.

In a way, these central bankers are simply catching up to what has already been underway in some smaller economies and emerging markets. For instance, Brazil, Chile, Mexico, Poland the Czech Republic, Norway and South Korea have already started to increase interest rates this year. In some cases, the increases have been drastic; in Brazil for example, rates have been increased from 2% in March 2021, to 7.75% at the end of October. Obviously, there are idiosyncratic and institutional factors in each of those economies that might be behind the magnitude of the monetary policy actions (e.g. Brazil's inflation is 10%), but the trend is clear: inflation is becoming more pervasive everywhere, and central bankers know the cure: higher rates.

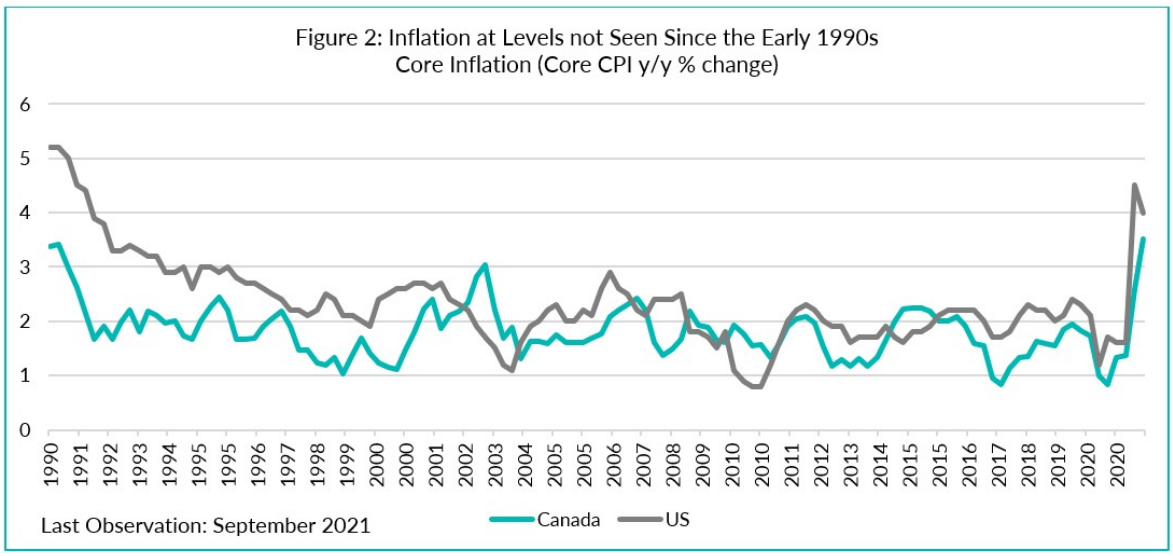
Closer to home, the BoC October meeting was pivotal. While Governor MacKlem stopped short of increasing the overnight rate, he effectively put an end to the BoC's first ever quantitative easing (QE) program and signaled that the Bank might raise rates as early as April 2022 (as opposed to previous forward guidance for 2022H2). The commentary around inflation was also much more cautious, with the Governor stating that "we can and we will keep prices under control".



Source: Bloomberg

Following the meeting, the Canadian yield curve flattened rapidly as more rate hikes got priced-in for 2022 (Figure 1 above). After overshooting all the way up to 6 hikes, the market has retraced somewhat and now prices 5 hikes for next year. Several market participants got caught wrong footed and their position unwind exacerbated some of the moves. Looking back at the 2017/2018 hike cycle as a template, the BoC stopped hiking at only 1.75% before having to pause (6 hikes from where we stand). So 4 or 5 rate hikes in 2022, and perhaps a further 2 hikes in 2023 would represent a very steep and quite short monetary cycle, particularly considering the amount of household and government debt that has been accumulated in the last few years, which makes every rate hike more impactful.

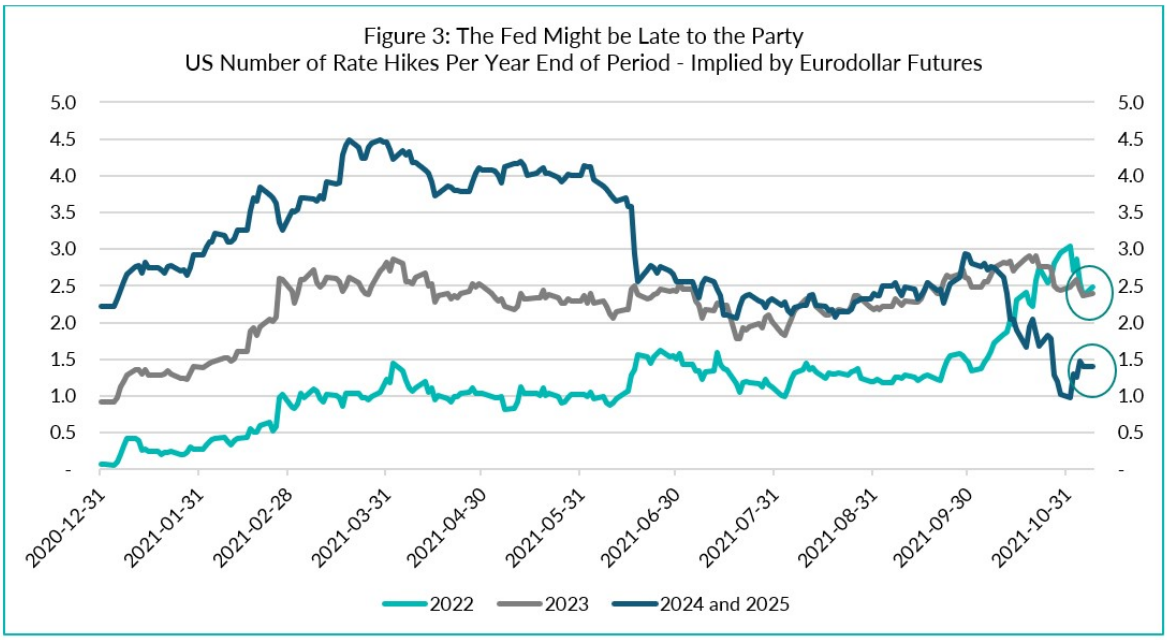
But, very high levels of realized inflation (Figure 2) are starting to make their way into inflation expectations, which is exactly what central banks do not want.



Source: Bloomberg

South of the border, as discussed last month, the Fed is slowly starting to shift its narrative towards inflation, but rather slowly compared with the other central banks mentioned above. It is quite unusual to see the US Federal Reserve seemingly behind the curve, they are typically at the forefront of most global tightening cycles. But, given their new framework, they are dragging their feet, hoping that they can squeeze a bit more gains out of the labour market before beginning with their own tightening cycle.

In early November, the Fed had finally announced the end to their QE program, which they will taper methodically from November 2021 to June 2022. Assuming that inflation continues to remain elevated, that will then open the door to their first rate hike, probably in the summer or early fall. At the time of writing, the market is pricing-in (Figure 3) 2.5 hikes in both 2022 (green line) and 2023 (grey line), and essentially nothing (1.5 hikes over 2 years) after that (blue line).



Source: Bloomberg

So, if the market is correct, we could potentially get a total of 6 hikes over the next 3-4 years. That isn't significant considering that last cycle (2016/2018) saw a total of 9 rate hikes. The final destination on rates matters a lot to the slope of the yield curve. If, as the market is currently pricing, the Fed is only able to reach 1.5-1.75% on the Funds Rate, this should provide support for longer dated treasuries and act as a ceiling (i.e. prevent the 10y from going much past 2%), further flattening the yield curve. For now, this is our base case scenario.

One factor that's currently weighting on the Fed (and market pricing of their potential actions) is the fate of the Chairman, Jerome Powell. His term is up in January and so far, we do not know if he will remain at the helm for another term. The vice-chair and vice-chair for supervision roles are also up for grabs. So if it was so inclined, the Biden Administration could staff the Fed with doves, delaying the rate hike cycle and allowing elevated inflation to continue to feed into expectations. This is a dangerous tail risk that we are monitoring. For now, the path of least resistance seems to be for Powell to be reappointed, but who knows with this Administration.

For now, this "behind the curve" Fed is seen by markets as dovish. If the economic data continues to hold or improve (with the Delta variant 4th wave behind us), the party in risk assets should continue for a little while longer. But with valuations again at cycle highs, it is challenging for us to add risk here. Looking into next year, inflation and their expectations are the key indicators to watch to get a sense of whether there is another leg up in rate hike expectations.

Diversified Bond Fund (DBF)

October was a challenging month for fixed income; interest rates went up about 40-50bps in a large bear flattening move, due to the central bank actions mentioned above. As discussed last month, it is now clear that inflation is the focus of central banks and that they are serious about not letting it get out of control, so we are taking appropriate actions in the portfolio to protect against what we see as the most likely outcome in 2022: a continual increase in short- and medium-term interest rates that will flatten the yield curve.

Ninepoint Diversified Bond Fund

	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	Oct 2021	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	1%	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	73%	↔
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	20%	↔
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	5%	3%	3%	↓
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%	2%	↔
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%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	1%	↑
Total		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	4.2	↓
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	5.3	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	↔

Source: Ninepoint Partners

Alternative Credit Opportunities Fund (NACO)

NACO's performance was negatively impacted by the large increase in short term rates. While the fund's duration is low (about 3.2 years), it is not immune from movements in short term interest rates since all its duration risk comes from holdings of corporate and HY bonds with maturities under 5 years. So when 2 to 5 year rates move up by 50bps, mathematically, the fund will face a mark-to-market headwind of 3.2 x 0.50% = 1.6%. Obviously, the fund's monthly performance is impacted by a variety of factors, but this month's small negative net return was entirely due to the large and sudden increase in front end rates.

Historically, this strategy does well in a raising rate environment. Late in the hiking cycle, credit typically does well. Moreover, because the securities that contribute duration risk to the portfolio are very short term (less than 5 years), their "pull to par" is strong (i.e. all bonds contractually mature at $100), so the mark-to-market loss is temporary.

Ninepoint Alternative Credit Opportunities Fund

	Limits	May 2021	June 2021	July 2021	August 2021	September 2021	October 2021	Outlook
Government Bonds	100%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	66%	53%	49%	44%	48%	↔
High Yield	40%	36%	32%	29%	24%	22%	28%	↔
ABS	20%	0%	4%	1%	8%	6%	7%	↑
Loans	10%	0%	0%	0%	3%	3%	3%	↑
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	↔
Common Equities & ETFs	10%	0%	0%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0%	0%	0%	0%	0%	0%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	↔
Total		100%	100%	100%	100%	100%	100%	
Duration	0 to 5 years	3.0	2.7	3.1	3.0	2.9	3.2	↔
Leverage	0-3x	1.4x	1.37x	1.13x	1.06x	1.09x	1.10x	↑
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

Even with the headwind emanating from large increase in short-term rates, the Credit Opps managed to have a good month in October, returning 68bps. Most of the outperformance of the fund vs NACO was driven by idiosyncratic gains in legacy positions such as warrants we acquired a few years ago as part of syndicated loan transactions. With the rapid increase in commodity prices such as base metals, energy and uranium, several positions are now deep in the money. We have harvested some gains to lock in the profits.

Ninepoint Credit Income Opportunities Fund

	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	Oct 2021	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	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%	30%	↔
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	36%	↔
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	↑
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	3%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	1%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	1%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	3%	↓
Total		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	3.6	↔
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	1.40x	↓
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	1%	0%	0%	0%	↔

Source: Ninepoint Partners

Conclusion

Our tactical bias is clearly towards higher short and intermediate term rates as central banks rein in policy over the next 12-18 months. Historically, rising policy rates aren't necessarily bad for risk assets, as long as it is met with solid economic growth. With the fiscal impulse vanishing in the US, higher energy prices and China deleveraging, growth risks are tilted to the downside. We are thus threading carefully.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF NOVEMBER 30, 2021 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	0.2%	-0.6%	-1.2%	0.0%	-0.3%	3.5%	3.4%	4.4%	4.2%

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1] AS OF NOVEMBER 30, 2021 (SERIES F NPP221) | INCEPTION DATE: NOVEMBER 2, 2011

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	0.2%	-0.6%	-1.2%	0.0%	-0.4%	3.3%	3.2%	4.3%	4.2%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF NOVEMBER 30, 2021 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-0.1%	5.6%	1.0%	2.2%	8.0%	8.4%	6.2%	5.8%

[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 October 31, 2021 [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 October 31, 2021.

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