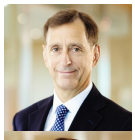
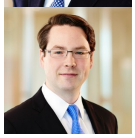
Ninepoint Fixed Income Strategy

January 2022 Commentary

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



Mark Wisniewski,
Partner, Senior Portfolio Manager



Etienne Bordeleau-Labrecque, MBA, CFA
Vice President, Portfolio Manager

Nick Warwick,
Associate Portfolio Manager (pending regulatory approval)

Macro

What a volatile start to the year… not only did interest rates reprice materially higher following hawkish surprises at the Fed, BoE and ECB, equities also suffered a serious correction (about 10% in the S&P 500), with high flying tech stocks getting hit hardest (about 16% correction in the Nasdaq 100). In sympathy with stocks, credit was also priced lower, although by less than usual, given that most of the correction in equities was the result of multiple compression (as opposed to earnings expectations being dragged lower). Nonetheless, this ugly start to 2022 serves as a reminder that, as the proverbial fiscal and monetary punchbowls gets removed, we should expect more volatility.

Starting with the BoC and the Fed, we got a very consistent message that suggests they are both ready to start a series of rate hikes at the upcoming March meeting. Inflation is uncomfortably high, the labour market is back to full employment and GDP is at potential, so there is no reason for rates to be at this lower bound. Our reading of the tea leaves is that, starting March, we will get a series (probably 3-4) of successive rate hikes, and then a pause.

This pause would coincide with the summer, where both central banks are expecting inflation to start decelerating. If that is the case, then they can afford to be more "data dependent" with the second stage of the rate hike cycle. However, if inflation is still very elevated at that time (that's the biggest risk in their minds right now), then we would expect them to continue with an aggressive path of rate hikes.

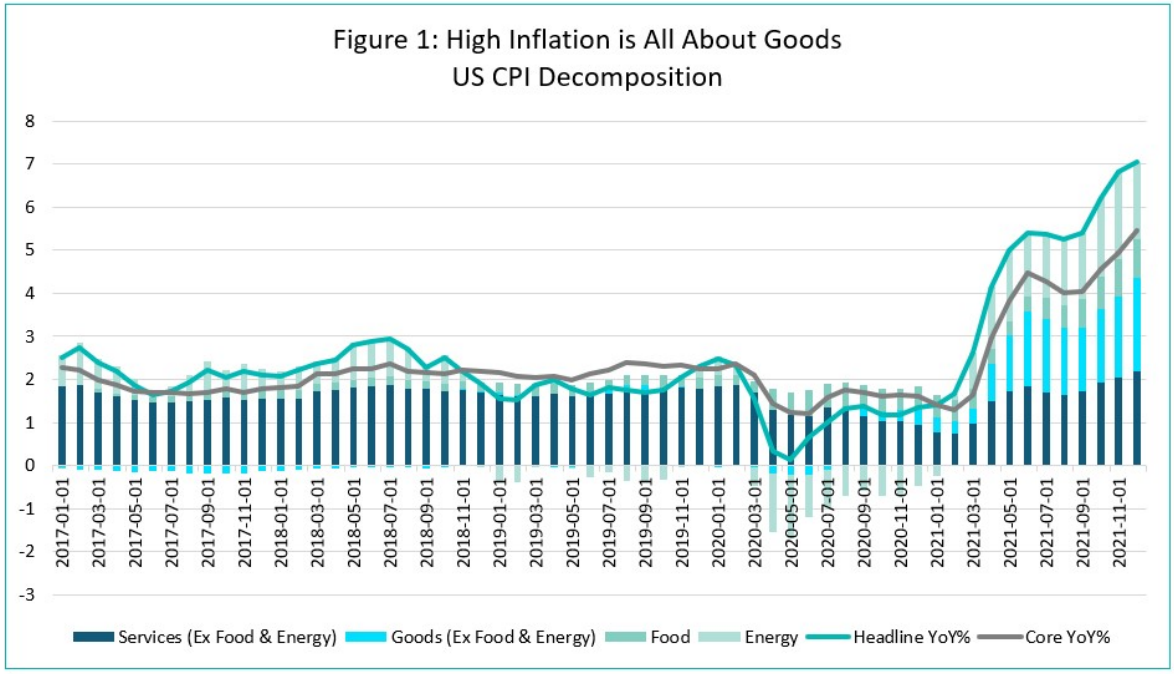
In terms of what's currently priced in; we went from a period where the Fed was behind the market, to a point now where the Fed and BoC have fully caught up with market expectations and are perhaps a little ahead of the market now. Market consensus is for 5 rate hikes in both markets in 2022, and only 2 hikes in 2023. Assuming growth holds up and inflation doesn't slow down in the summer as expected, then the market should price

something like 4 rate hikes in 2023.

Across the pond, the BoE and the ECB also had same-day meetings, and they didn't disappoint. First, the BoE raised rates by 25bps (as expected), but the decision was far from unanimous, with 4 out of 9 governors voting instead for a 50bps rate hike! A few minutes later, during the ECB press conference, President Lagarde pivoted to a particularly hawkish tone, noting significant progress in the labour market and elevated inflation as a concern. She did not push back against the idea of rate hikes and ending QE in 2022, something that only a month ago was brushed aside at the December ECB meeting.

Needless to say, all this hawkishness from central banks surprised markets and forced a painful repricing of rate hike expectations. Are we at "peak" hawkishness, or do we have further to go? We believe that we are nearing an inflection point on inflation, which is the key economic indicator right now.

Figure 1 below shows the US CPI, decomposed into its main components (Services, Goods, Food and Energy). As a reminder, Core CPI is Services and Goods, Headline CPI adds Food and Energy. It is clear from this chart that the main contributor to Core CPI over the past year has been from the goods side of the economy. The services CPI contribution has been fairly stable around 2%.



Source: Bloomberg

Now, the fear in Central Banking circles is that elevated headline inflation ends up spreading to other components, such as services. That remains to be seen, but on the goods side of the equation, we are starting to see signs of easing. Inventories are accumulating at a fast pace (more than half of the Q4 GDP was from inventory accumulation) and retail sales are being slowed down by high inflation, declining real disposable incomes. Therefore, we

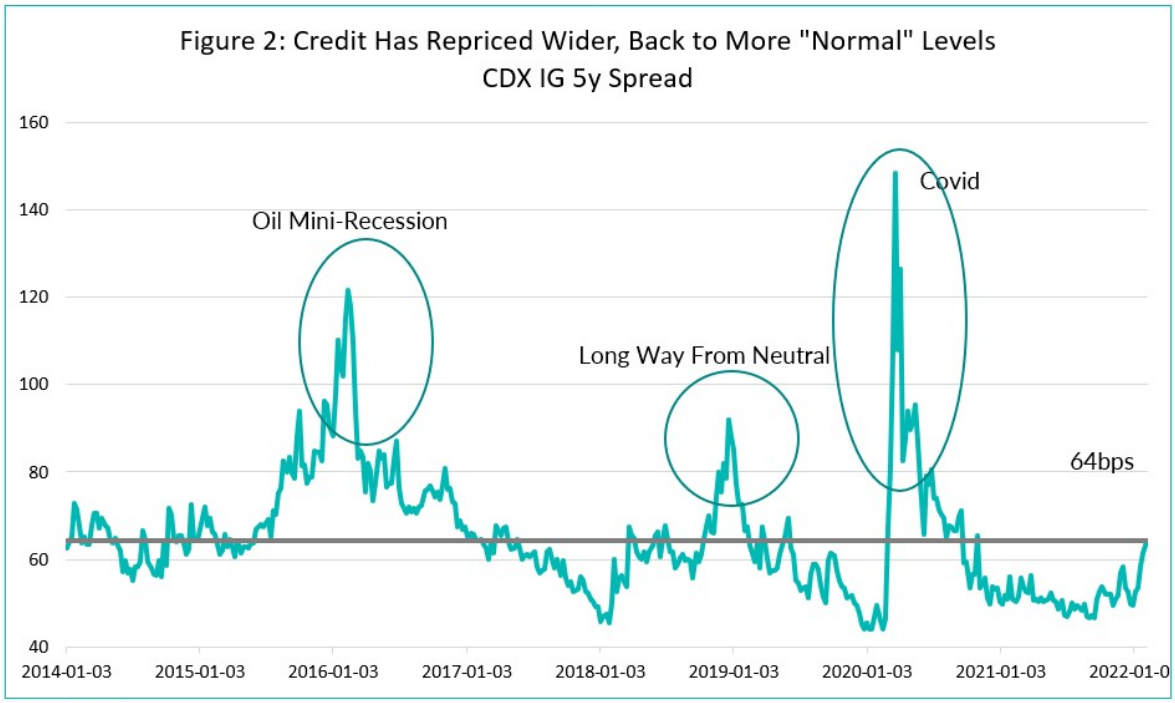
believe that the next few months' worth of PMI and CPI readings will hold the key to the inflation puzzle, and thus to the path of rate hikes in the second half of the year (and beyond).

In the meantime, we remain cautious, keeping duration low across mandates and holding elevated levels of cash.

Credit

The correction in the equity markets coupled with negative total return in most bonds funds due to higher interest rates has not been a conducive environment for credit. Additionally, supply in the primary market has remained high, with January new issues reaching $12bn in Canada, about 30% more than at the same time last year. Thankfully, this was mostly front end loaded and new issue activity had slowed down materially in the later half of the month.

Since the worst of the equity selloff, we have seen credit valuations stabilize, although at wider levels. Investors have start picking away at their favourite bonds at more attractive levels. In the grand scheme of things, generic credit spreads are now back to levels that are consistent with moderate economic growth. Figure 2 shows the credit spread on the Markit CDX Investment Grade 5y Index, a tradable index of credit default swaps, with the grey line showing the current level of the index. Outside of periods of great market stress (2015/2016 oil mini-recession, 2018 "Long way From Neutral" Fed mistake and 2020 Covid Crisis), the CDX index typically doesn't widen to much more than 70bps. Therefore, barring a more material change to growth expectations and with that interest rates, it feels like this repricing is in its late stages.



Source: Bloomberg

Diversified Bond Fund (DBF)

With credit spreads widening and interest rate increasing, there was nowhere to hide this past month. While our duration was low (as low as 2.2 years throughout the month, before we monetized some hedges), it wasn't enough to offset close to 40bps of rate increases across the board.

About 35% of our portfolio exposure is floating rates, and with rate hikes expected shortly, we should see an increase in overall portfolio yield (currently 3%) over the coming months. We don't have any concerns about recession or an escalation in defaults, so we are staying the course; our credit quality remains good (BBB average) and we are mindful of liquidity and duration going into what should be an interesting year.

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	Jan 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%	63%	↔
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	20%	↔
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	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%	1%	1%	↓
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%	0%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	14%	14%	↓
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	2.7	↔
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	4.4	↔
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)

As NACO is a credit focused fund, returns were obviously under pressure in January as credit spreads widened. We took advantage of the selloff to deploy a bit of capital, increasing leverage by 0.2x to 1.2x. Additionally, we reduced overall duration in the fund to 1.7 years (from 2.7) by layering floating rate exposure to about 25% of the Core portfolio.

We would like to remind investors that mark-to market losses from leverage in fixed income is not the same as leverage in equities. Barring a default, which is extremely rare in investment grade bonds, mark-to-market losses tend to be mean reverting, as bond prices gravitate back towards $100 as they get closer to maturity. Thus, while the recent selloff marks a compelling entry point for new investors, existing investors shouldn't fret, as new investments and the "pull to par" in our portfolio enhance the running yield (5.5%), boding well for the balance of the year.

Alternative Credit Opportunities Portfolio Characteristics

	Limits	May 2021	June 2021	July 2021	August 2021	September 2021	October 2021	November 2021	December 2021	January 2022	Outlook
Government Bonds	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	66%	53%	49%	44%	48%	52%	44%	46%	↑
High Yield	40%	36%	32%	29%	24%	22%	28%	29%	29%	33%	↓
ABS	20%	0%	4%	1%	8%	6%	7%	7%	7%	9%	↔
Loans	10%	0%	0%	0%	3%	3%	3%	6%	5%	5%	↑
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	2%	2%	2%	↔
Common Equities & ETFs	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0%	0%	0%	0%	0%	0%	0%	0%	0%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	6%	13%	7%	↔
Total		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	↔
Leverage	0-3x	1.4x	1.37x	1.13x	1.06x	1.09x	1.10x	1.10x	1.00x	1.20x	↔
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

As the Credit Opportunities is a credit focused fund, returns were obviously under pressure in January, as credit spreads widened. To further mitigate interest rate risk, we reduced overall duration in the fund to 1.6 years (from 2.5) by layering floating rate exposure to about 28% of the Core portfolio.

While the recent selloff marks an interesting entry point for new investors, existing investors shouldn't fret, as new investments and the "pull to par" in our portfolio enhance the running yield (6.7%), which should bode well for the balance of the year.

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	Jan 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%	32%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	36%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	13%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	10%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	2%	↓
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%	1%	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%	0.5%	↔

Source: Ninepoint Partners

Conclusion

We are pleased to welcome Nick Warwick, who is on the fixed income team as an Associate Portfolio Manager (pending regulatory approval). Nick brings more than 10 years of experience in fixed income sales and credit research.

Until next month,

Mark & Etienne and now Nick
Ninepoint Partners

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

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-1.6%	-1.6%	-0.6%	-1.9%	-1.1%	2.9%	2.9%	4.0%	4.0%

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

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-1.6%	-1.6%	-1.2%	0.2%	3.7%	7.8%	5.7%	5.5%

[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 January 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 January 31, 2022.

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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