Ninepoint Fixed Income Strategy

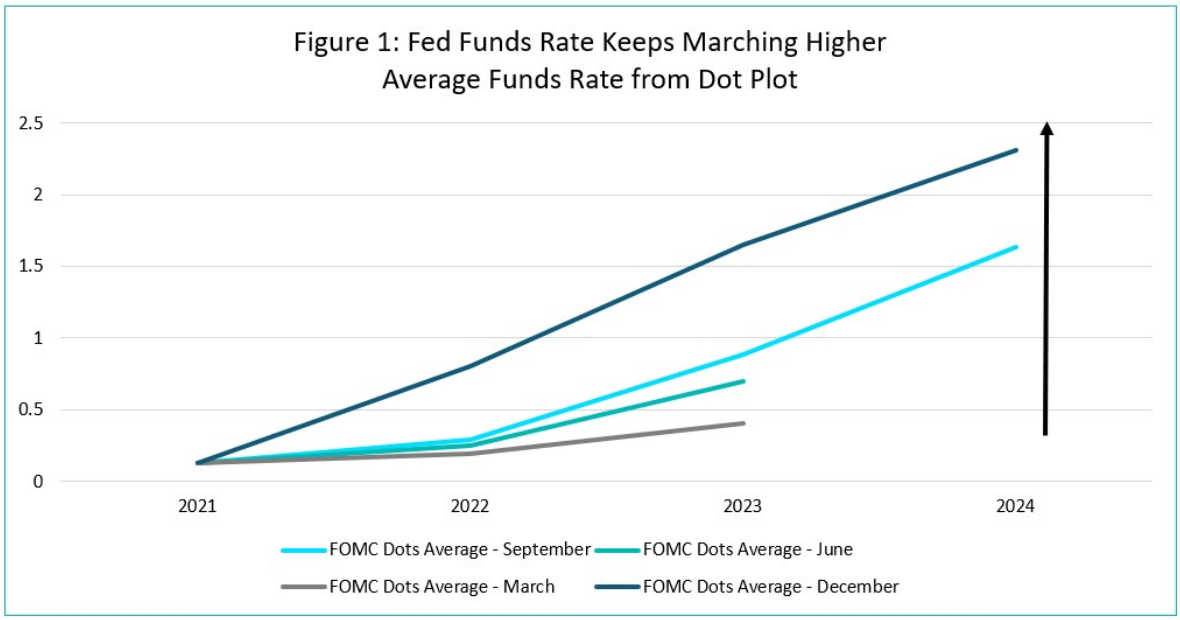
December 2021 Commentary

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

Ninepoint Partners,

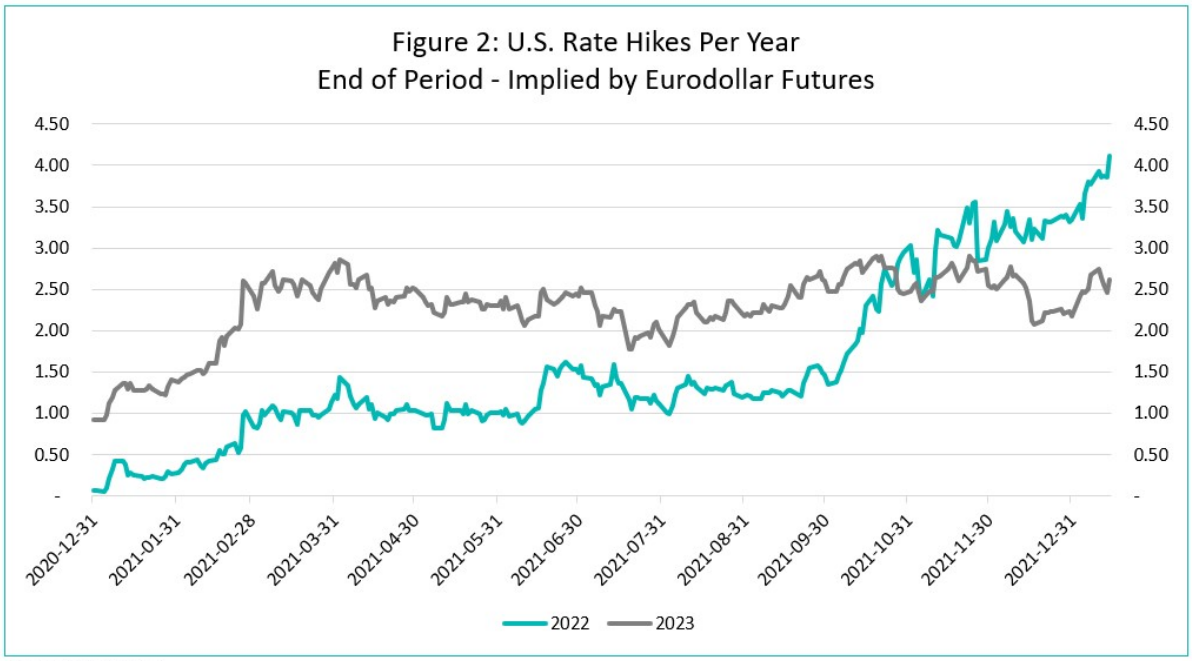
Macro

As expected, markets are looking through the temporary disruption stemming from the Omicron variant, instead focusing on a hawkish pivot from the Fed. With inflation persistently high and labour market conditions reflecting full employment, even the doves on the FOMC have shifted their narrative. As of the December FOMC meeting, the average funds rate expected by participants for 2022 now reflects 3 hikes (Figure 1), finally more in line with market pricing.



Source: Bloomberg

Since the meeting, commentary by Fed officials and more importantly by Chair Powell suggests that the first hike could come as soon as March, henceforth leaving the Fed the optionality of as many as 4 rate hikes, should inflation prove more persistent throughout the summer. At the time of writing, the bond market has now priced 4 rate hikes for 2022 (Figure 2). We do not disagree with the market's assessment of the most likely outcome, given the pace of improvement in the labour market.



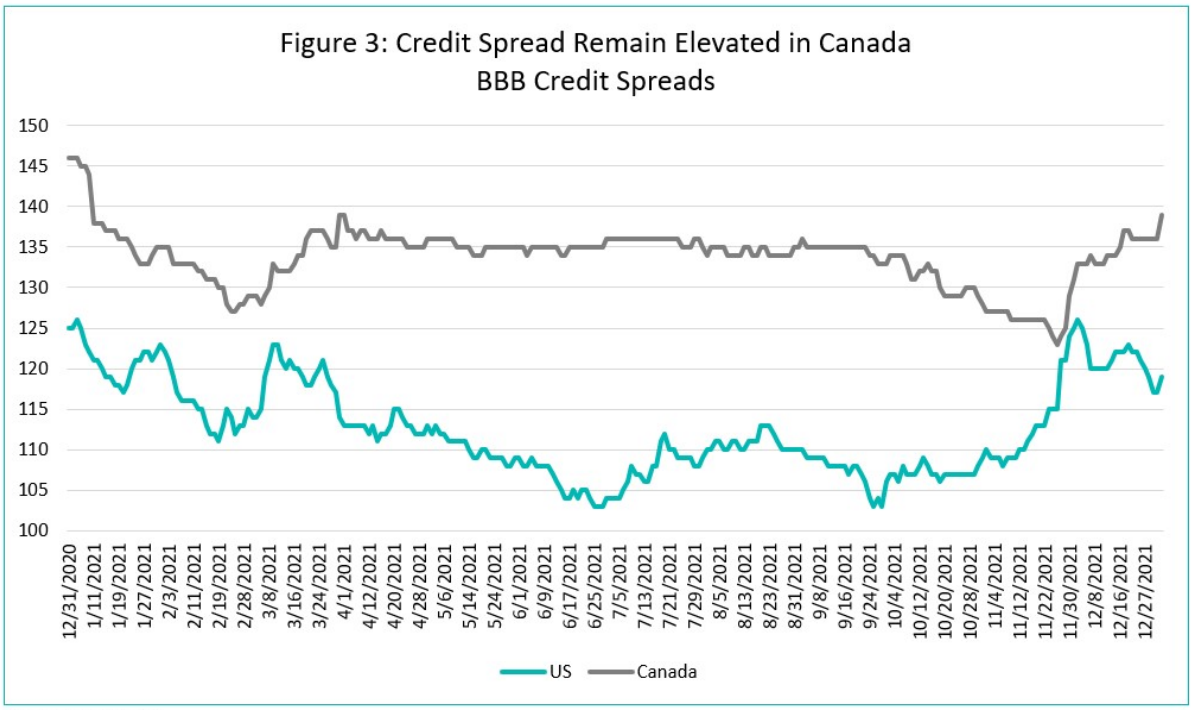
Source: Bloomberg

In Canada and the U.S., the rate hike cycle is poised to start in the first quarter of 2022, and should be rapid, with 4 hikes in the U.S. and as many as 5 in Canada (according to market pricing). Historically, the beginning of rate hike cycles does not result in materially adverse effects for credit or equity markets. It is later, once rates enter restrictive territory and earnings start to deteriorate, that markets get choppier. Economic growth is forecasted to be solid again in 2022 (4% and 3.8% in Canada and the US, respectively), reflecting a strong consumer and easy financial conditions. So, for the time being, markets shouldn't be overly worried about the end of the economic cycle. But, depending on the pace of the hike cycle, its impact on the economic dynamics going into 2023, we will have to remain vigilant, particularly in the second half of 2022.

Given our view on interest rates, our portfolios are all positioned with very low duration.

Credit

While equities are still hovering near all time highs, credit was somewhat weaker in December and so far in 2022. We are faced with an interesting situation, whereas US credit has mostly recovered the Omicron induced selloff, Canadian credit spreads remain slightly elevated. The chart below shows Canadian and US credit spreads for corporate bonds of BBB rating (what we dabble the most in).

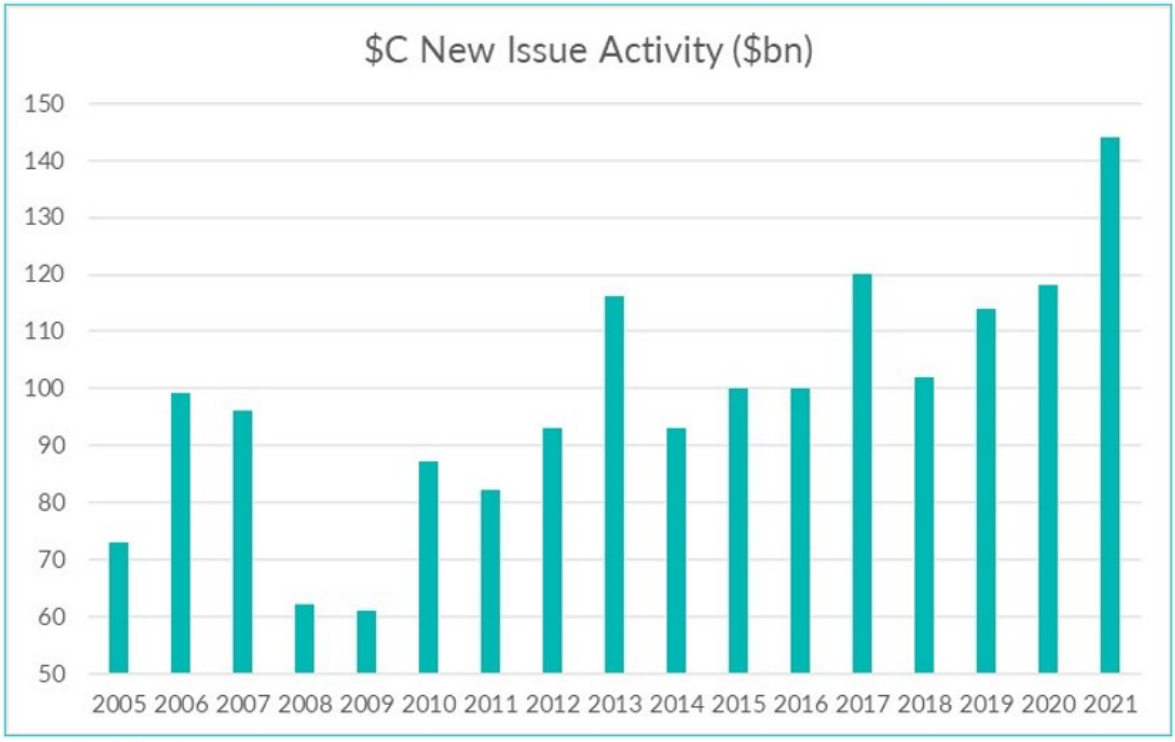


Source: Bloomberg

Credit spreads for both countries are typically very correlated. But sometimes they diverge, and that was particularly relevant late 2021, and the same is happening so far in 2022. The US has retraced most of the Omicron induced volatility from November, but Canada hasn't.

Why are they diverging? We think that it is mostly due to new issue activity.

When new issues come to market, those bonds need to go somewhere. If investors have cash, no problem, but if they don't, they need to sell something else to make room. 2021 has been a record year for new issues in Canada, far outpacing even the most optimistic forecasts and 22% more than 2020. (Chart below)



Source: Scotiabank

With Canada being a relatively small market, a slew of new issues can result in a supply indigestion, where spreads widen even though the overall market and fundamentals remain solid. This phenomenon has happened several times over the past year, particularly in the late spring to fall period. This is what explains the divergence in spreads between the two markets, which are usually very correlated.

These episodes are usually temporary and tend to reverse themselves as cross currency buyers emerge, normalizing credit spreads across jurisdictions.

Diversified Bond Fund (DBF)

As you all know, 2021 was a challenging year for traditional fixed income investors; yields were very volatile throughout the year and increased significantly. Still, our flagship Diversified Bond Fund managed to produce an after-fee positive return for the year of 0.26% (F-series).

While 0.26% might not seem like much, we feel given the environment, that it was a clear success compared with the Canadian broad index funds that finished the year down 2 to 3%, with drawdowns throughout the year as high as 6%. **This is our 12th consecutive year of positive returns for the F-Series of the fund**.

Monthly Returns (as of December 31, 2021)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	-0.21%	-0.94%	-0.29%	0.40%	0.44%	0.31%	0.82%	0.12%	-0.45%	-0.92%	0.16%	0.83%	**0.26%**
2020	1.31%	0.99%	-1.94%	1.40%	0.76%	1.68%	1.40%	-0.22%	0.34%	-0.32%	0.84%	0.25%	**6.61%**
2019	0.78%	0.49%	0.72%	0.30%	0.86%	0.41%	0.28%	1.89%	-0.70%	-0.27%	0.11%	-0.69%	**4.24%**
2018	0.32%	0.09%	-0.14%	0.09%	-0.05%	0.07%	0.25%	0.33%	-0.11%	-0.38%	-0.40%	0.26%	**0.32%**
2017	0.49%	0.93%	0.28%	1.78%	0.44%	-0.65%	0.32%	0.27%	0.19%	1.10%	0.00%	0.10%	**5.34%**
2016	0.03%	-0.39%	1.40%	0.85%	0.36%	0.07%	1.40%	1.14%	0.05%	0.46%	-0.31%	0.95%	**6.16%**
2015	3.71%	-0.06%	0.18%	-0.29%	1.08%	-0.70%	1.29%	-0.80%	-0.47%	0.73%	-0.48%	-1.46%	**2.65%**
2014	1.22%	1.51%	0.17%	0.45%	0.78%	0.21%	-0.38%	0.40%	-1.21%	0.25%	0.67%	-0.06%	**4.05%**
2013	0.78%	0.78%	0.47%	1.72%	-1.17%	-2.47%	0.50%	-0.40%	0.45%	1.93%	0.32%	0.78%	**3.67%**
2012	2.88%	2.28%	-0.04%	0.06%	0.20%	-0.18%	1.26%	0.84%	1.40%	0.90%	0.63%	0.84%	**11.62%**
2011	1.77%	1.13%	0.83%	1.29%	0.46%	-0.84%	0.84%	-3.45%	-0.72%	0.17%	-1.71%	0.82%	**0.46%**
2010								0.45%	1.39%	1.75%	-1.04%	0.62%	**3.18%**

*Series F units

Inception date August 5, 2010

Source: Ninepoint Partners

With interest rates as low as they are and the massive headwind on governments, we believe that active management and a hedging program are an absolute requirement in the bond world. We prefer to be proactive on positioning and all the risk variables in our portfolio not reactive.

As discussed earlier, interest rates are poised to go up in 2022, central banks are telling this, our track record shows that we know how to listen and navigate this environment.

At the time of writing, we estimate the fund's duration at about 2 years, with an all-in yield to maturity of about 2.9%. That's better than the majority of index funds, with less than 2% income and 8 years of duration risk. We have layered-in floating rate exposure (about 35% of the fund), so as rates increase this year, our floating rate hedges will mean more yield for the portfolio with less negative mark to market that usually comes with rising rates.

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	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	-7%	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	↔
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	↔
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%	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%	↔
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%	14%	↑
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	2.9	↓
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	↔
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)

This was NACO's first year in the alternative fixed income space, we launched in the middle of May 2021. Unsurprisingly, the fund has tracked the Credit Ops reasonably well throughout the year. Since the two funds weren't created at the same time, there are some idiosyncratic positions that have decoupled performance for a few months. But overall, we expect NACO to correlate highly with the Credit Ops.

Following year end, with rates expected to go up in the front end of the yield cure, we layered some additional interest rate hedging, converting fixed rate bonds to floating, effectively reducing the fund's duration by an additional 1.2 years (to 1.5 years). Once short-term rates start to move higher, we expect to increase our allocation to investment grade bonds, at the expense of high yield.

Alternative Credit Opportunities Portfolio Characteristics

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

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

2021 was a good year for the Credit Ops, with a total return net of fees of 6.08%. Relatively range bound credit spreads coupled with high income (average of 6-7% throughout the year) allowed the strategy to do what it does best: generate income.

Following year end, with rates expected to go up in the front end, we layered some additional interest rate hedging, converting fixed rate bonds to floating, effectively reducing the fund's duration by an additional 1.1 years (to 1.4 years). Once short-term rates start to move higher, we expect to increase our allocation to investment grade bonds, at the expense of high yield.

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	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%	31%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	↓
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%	2%	↓
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%	5%	↑
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	2.5	↓
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	↓
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	1%	0%	0%	0.5%	↔

Source: Ninepoint Partners

Conclusion

2022 will be the year of monetary policy normalization. We have been preparing for it since the fall of 2021, when it became clear that inflation was no longer transitory. We've lowered our duration, raised cash and we're evaluating some credit hedges across all our funds. And we're ready for higher rates.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF DECEMBER 31, 2021 (SERIES F NPP 118) | INCEPTION DATE - AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	0.8%	0.3%	0.1%	0.6%	0.3%	3.7%	3.3%	4.5%	4.2%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF DECEMBER 31, 2021 (SERIES F NPP 507) | INCEPTION DATE - JUNE 30, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.5%	6.1%	1.1%	2.3%	6.1%	8.9%	6.0%	5.8%

[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 December 31, 2021 [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 December 31, 2021.

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