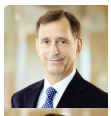
Ninepoint Fixed Income Strategy

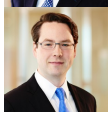
February 2021 Commentary

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

Investment Team



Mark Wisniewski,
Partner, Senior Portfolio Manager



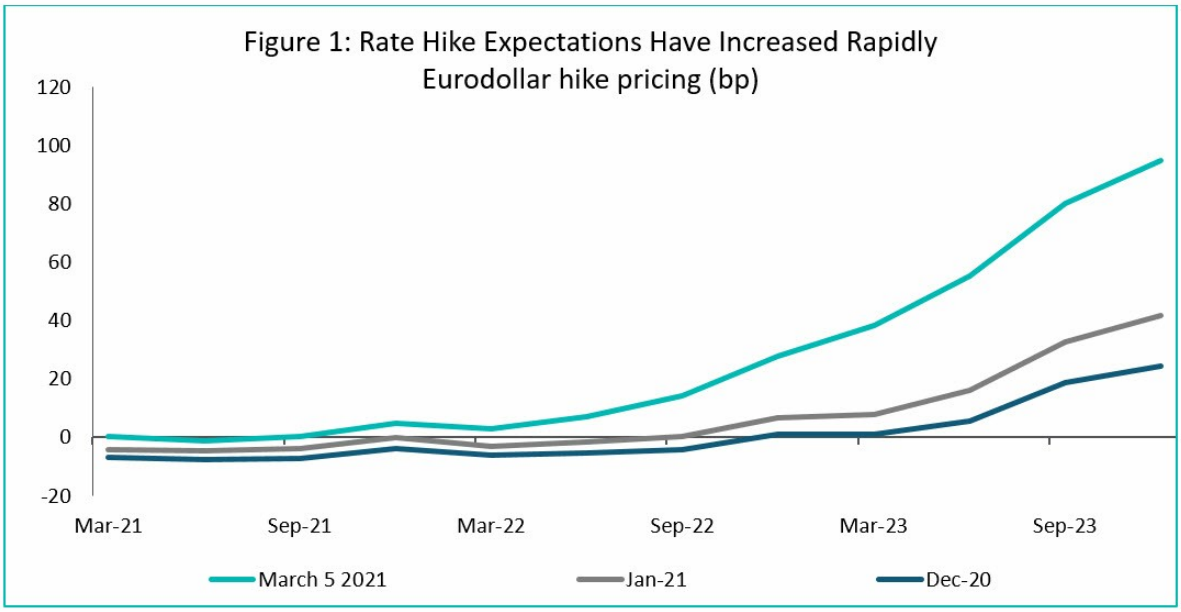
Etienne Bordeleau-Labrecque, MBA, CFA
Vice President, Portfolio Manager

Macro

Entering 2021, the biggest risk we had on our radar was a policy mistake driven by the interaction between fiscal and monetary policy. To us, a strong fiscal impulse in Canada and the US could drive economic activity too high too fast and force Central Banks to walk back their historically accommodative monetary stance. The outcome we feared was a repeat of the 2013 "Taper Tantrum", where interest rates shot up and risk assets sold off as the Chairman then Ben Bernanke signalled an end to the Fed's QE program.

This time the market did not wait for the Fed to start talking about tapering or raising rates, it simply started moving interest rates higher well ahead of any new policy changes. In other words, the bond market is telling the Fed that it does not believe in its new framework and that the most recent (December 2020) guidance on QE and the dot plots, which show no rate hikes until 2024, will be proven wrong. This is a big test of the Fed's new framework, which was unveiled at the Jackson Hole Symposium in August 2020, less than 6 months ago.

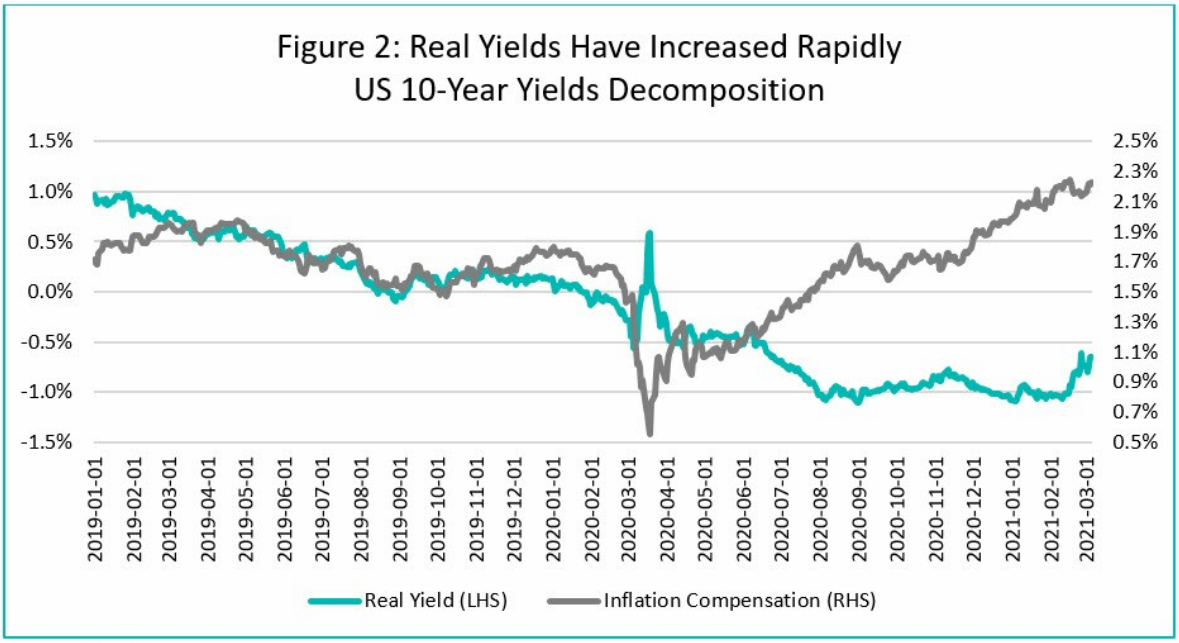
At the time of writing, the bond market had fully priced 100bps of rate hikes between now and year-end 2023, with lift-off occurring early 2022 (Figure 1). This is more than two years ahead of the Fed's most recent communication and guidance.



Source: Citi Rates Trading

This rapid repricing of rate hike expectations (and monetary tightening) has led to a large and rapid increase in interest rates (except for the very front end of the curve, which remains anchored by the Central Bank). What is different this year is that the increase in rates has been driven by rising real yields (Figure 2 below) as opposed

to late last year, which was driven by higher inflation expectations supporting the "reflation" narrative. This matters because higher real yields directly and immediately tighten financial conditions. Indeed, since the rate selloff, equities have sold off meaningfully, particularly high-flying tech stocks with little cash flows and large terminal values. Since the peak, the Nasdaq 100 index has declined 11%, more than twice the decline in the more diversified S&P 500.



Source: Bloomberg

Given the obvious contradiction between the market's expectations and the Fed's communication, one would have expected Fed officials to push back against market pricing. But surprisingly, this has not been the case; speeches and other communications have been very dismissive of the recent move in rates, leaving us to ponder whether the Fed's past guidance is really credible, or if they have abruptly changed their minds on the most likely path of the economy.

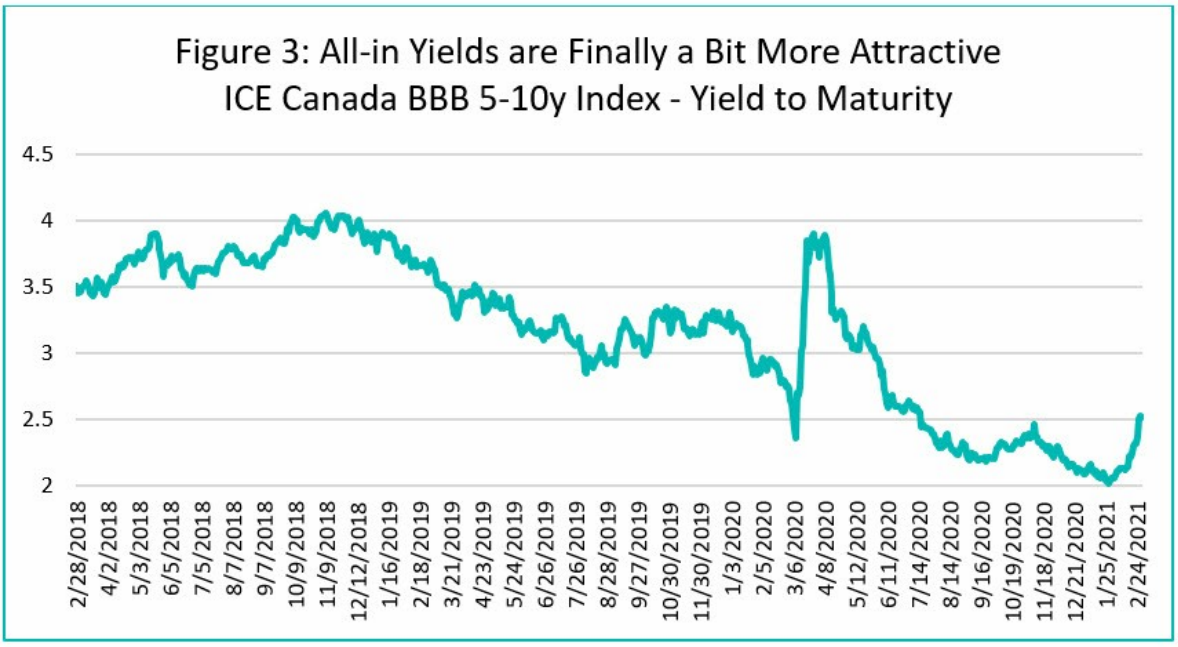
We, similar to other market participants, are anxiously waiting the March 17th FOMC meeting to get a full update on the Fed's latest thoughts, forecasts, and dot plots (their expectations of future rate hikes). Since the last meeting (December 2020), a lot of fiscal stimulus has been announced (as discussed in last month's commentary) and they will certainly incorporate these latest developments into their forecasts. What remains to be seen is whether they explicitly push back against market expectations, or if they let things play out. For now, the selloff in government bonds, equities and, to a lesser extent, credit has left financial conditions mildly tighter, but if things continue to deteriorate over the next few weeks, we expect the Fed will feel more pressure to intervene.

In a worst-case scenario, if the Fed does nothing to dispel the notion of rate hikes as early as 2022, we expect that real 10-year yields could trade as high as -50bps (another 15bps from current levels). Coupled with inflation expectations in the 2.25% range, this could mean a yield of about 1.75% and 1.65% on 10-year US and CAD bonds, respectively.

Credit

Relative to the selloff in equities, credit has continued to be quite resilient. Of course, spreads are a bit wider in sympathy with equities, but so far, the moves have been very muted at the index level. Under the surface, higher beta credit is underperforming, and new issues are more difficultly absorbed by the street. As discussed previously, credit spreads had moved abruptly tighter, relative to the economic recovery. It is never easy when interest rates move significantly higher, but the good news is all-in yields are materially higher and looking much more attractive (Figure 3). Over the next month, we will start terming out some of our short-dated

positions into higher yielding sectors. More on that later.

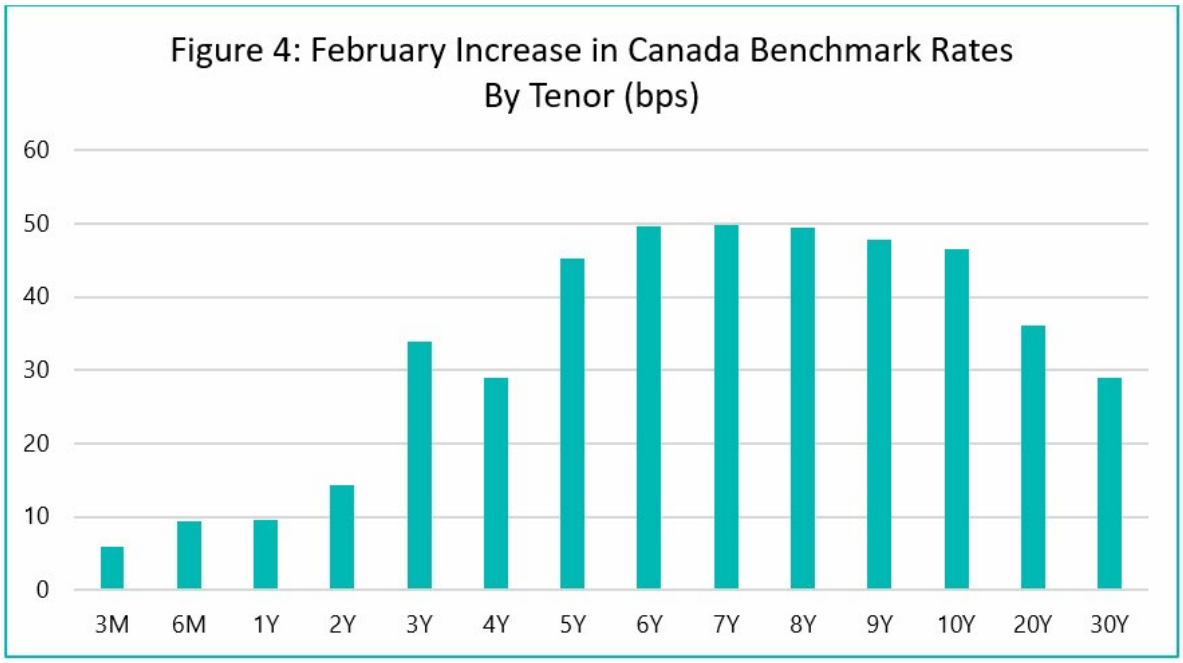


Source: Bloomberg

Speaking of new issues, the first week of March has been extraordinarily busy, and the street is starting to feel a bit over-extended. Accordingly, we believe the new issues market will return to normal where new deals come with better concessions. This will come in handy as we term out our IG book.

Diversified Bond Fund (DBF)

February had been a challenging month for bond funds, and the DBF is no exception. With interest rates increasing anywhere from 30 to 50bps in a month (Figure 4), there was nowhere to hide. Still, the changes we had made early in January, selling all our government bonds, TLT options, and short positions in 10 and 30-year Canada and US government bonds allowed us to dampen the volatility of the portfolio (~30% downside capture vs broad indices). At the time of writing, we essentially own no government bonds and most of our longer duration IG positions have been hedged against interest rate risk. While we are by no means happy with a -0.94% month, we believe, given the circumstances, we managed as well as we could have through this bout of market volatility, and our current portfolio positioning will allow us to benefit from this higher level of rates and wider credit spreads.



Source: Bloomberg

To put the interest rate move into perspective we've added a chart that shows the move in rates by term. Our fund owns a lot of 1 to 3-year credit, that we will slowly be recycling into higher yielding alternatives in the belly (5-10 year) area of the credit curve. We aren't completely out of the woods yet, but the government bond market is starting to show signs of stabilization, so the worst of the selloff might now be behind us.

Diversified Bond Fund 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	Feb 2021	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-5%	↓
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	80%	↔
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	↔
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	↔
Common Equities & ETFs	10%	0%	0%	0%	1.5%	1.5%	4.3%	2.4%	-1.3%	0%	0%	-6%	-5%	-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%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	6%	↔
Total		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	3.5	↓
Spread Duration		-	-	-	3.4	2.9	3.0	2.3	3.1	3.0	2.2	4.1	3.8	3.9	4.6	↑
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	2%	↓

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

The Credit Opps performed well in February, returning 55bps. Slightly wider credit spreads were more than offset by the income the fund generates, and with its very low duration, the fund was not materially impacted by the sell-off in government bonds. This is exactly the type of environment this strategy outperforms traditional bond funds; having greater access to more tools to hedge risks (in this case interest rate risk) and a greater variety of income producing securities allowed the fund to navigate this turmoil unscathed.

To manage any unexpected credit event the fund has a solid book of tail hedges using options on the HYG ETF. Should credit start to be more volatile, we will have some ballast to help us navigate the environment.

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	Feb 2021	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	55%	58%	53%	68%	64%	72%	65%	77%	64%	57%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	24%	↔
Private Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	4%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	9%	↔
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	0.1%	↔
Total		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	3.3	↓
Leverage	0-4x	0.7x	0.7x	1.0x	1.0x	0.77x	1.04x	0.87x	1.67x	1.15x	1.04x	1.06x	↔
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	3%	↔

Source: Ninepoint Partners

Conclusion

It has been a rocky start to the year, and the early signs of the "Taper Tantrum" we feared has materialized much sooner than we expected. Thankfully, we had positioned the portfolios to be more defensive, waiting for a better entry point to add duration and credit risk. We are now getting closer to levels where things are looking more attractive, which should bode well for future returns.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1]
AS OF FEBRUARY 28, 2021 (SERIES F NPP221)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-0.9%	-1.2%	-0.9%	-0.1%	2.8%	3.0%	4.2%	4.5%

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1]
AS OF FEBRUARY 28, 2021 (SERIES F NPP118)

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-0.9%	-1.1%	-0.9%	-0.1%	3.0%	3.2%	4.3%	4.0%	4.4%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1]
AS OF FEBRUARY 28, 2021 (SERIES F NPP507)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.6%	1.2%	3.6%	6.9%	14.9%	6.3%	7.8%	5.9%

[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 February 28, 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 February 28, 2021.

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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