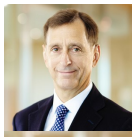
Ninepoint Fixed Income Strategy

February 2022 Commentary

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



Mark Wisniewski,
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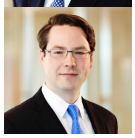

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Macro: Les Montagnes Russes

With the Russian invasion of Ukraine comes important ramifications for global geopolitics and commodity markets. While we are by no means experts on war, we will offer here our best assessment of what this means for interest rates and credit. Notwithstanding the tragic human and humanitarian costs of this invasion, Russia and Ukraine are above all commodity exporters. Russia is of course well known for its oil and gas, but it also exports many minerals and fertilizers. The vast plains of Ukraine produce agricultural commodities, which will no doubt be impacted by the war. Therefore, in a world already plagued by high inflation, this war's impact on the global economy should be above all inflationary.

Now, had inflation been low and under control, central banks might have seen the spike in commodity prices as temporary and decided to sit on their hands. But with inflation already high and inflation expectations moving up, this additional price shock is particularly unwelcome.

While higher prices are an effective tax on consumption, Canada and the U.S. are significant energy and commodities producers, which should help soften the blow on our economies. Therefore, barring a significant decline in economic growth in North America, we expect that the Fed and the BoC will continue with their rate hike plans. The BoC hiked once during the first week of March, indicating, as expected, that they are embarking on a "series of rate hikes". The Fed is set to meet mid-March as well, and we fully expect them to raise 25bps to start. Ultimately, more inflation means both central banks increase rates 5 to 6 more times this year and higher rates across the yield curve.

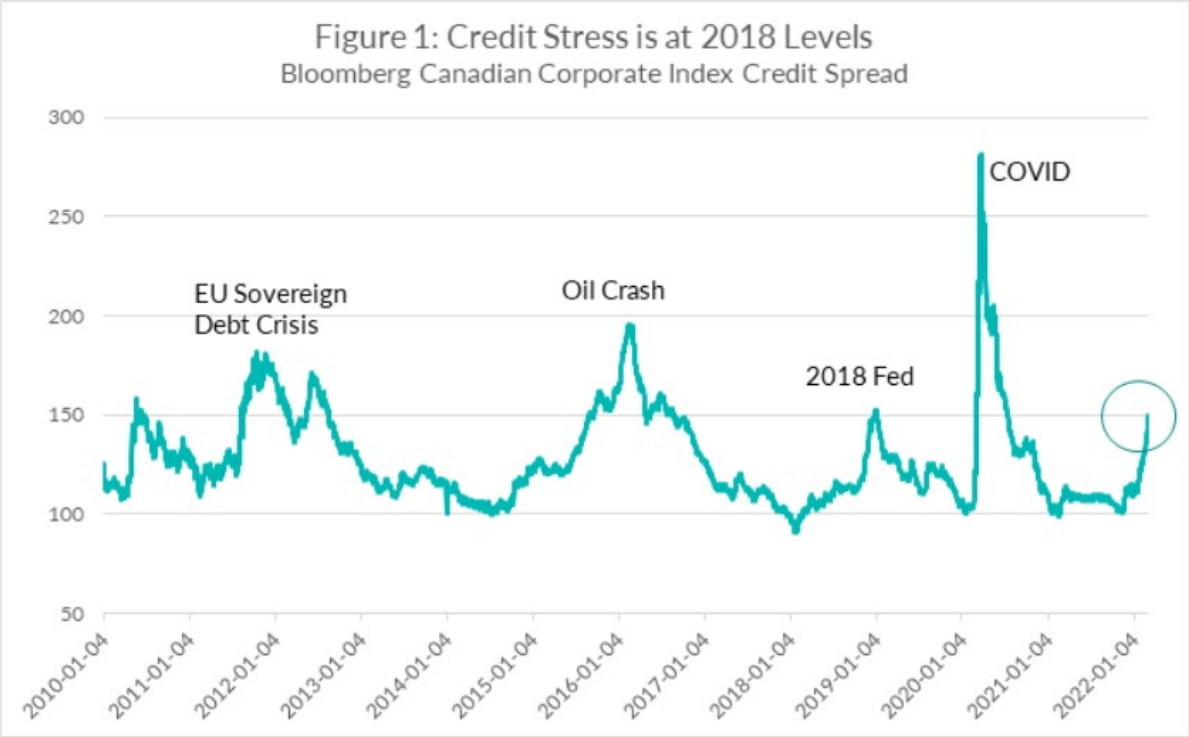
In Europe, the situation is a bit more challenging for the ECB and BoE. Europe is very reliant on Russian oil and gas and, unlike North America, is a net importer of energy. Therefore, a prolonged period of extremely elevated energy costs is more likely to lead to an economic slowdown, perhaps even a recession. In this context, we expect the ECB to delay their exit

from QE until later this year, with rate hikes very unlikely until next year. In the UK, the BoE has already hiked to 50bps, and is expected to continue given the wage-price dynamics, even as growth expectations are declining.

Credit

While both January and February have been soft for credit (credit spreads have widened), each month had different factors leading to the weakness. January's theme centered around expectations for aggressive monetary policy tightening to tame high inflation, which spooked most risk assets (credit inclusive). Come February, the market turned its attention towards the escalating concerns of a potential invasion of Ukraine by Russia, which sadly came to fruition on February 24th. Since the invasion, volatility has been very high as the market continues to digest news flow coming out of Europe, which we expect to continue until the maximum impact of current and potential future sanctions has been discounted.

To put things in perspective, with corporate credit spreads at 150bps (Figure 1 below), they are as wide as the late 2018 selloff (equities down 20%), 25bps from the peaks around the Europe Sovereign Debt Crisis of 2012 and about 50bps from the levels reached during the 2015/2016 oil crash. Of course, things could get worse before they get better, but credit spreads, at current levels, are discounting a lot of bad news already. Our expectation would be for them to mean revert at some point, retracing back to a narrower level.



Source: Bloomberg

Turning to sectors, there has been nowhere to hide from the spread widening YTD, every single sector has been affected. As crude oil continues to make new highs, the oil and gas

producer segment has fared relatively well, only widening ~20bps YTD. For context, REITs, another high-beta sector, have seen spreads drift ~40bps wider. We have used the strength in the energy sector to trim some of our positions that were initiated back in early 2020, at a time of extreme market dislocation. Suncor and Canadian Natural Resources are just two examples of some of the energy companies we have trimmed across the portfolios. While commodities prices may still rise from here on continued Russia/Ukraine uncertainty, we believe that most of the potential upside on energy companies will now accrue to shareholders, as opposed to bondholders. The industry wide de-leveraging theme is largely behind us.

Turning to the primary market, the continued market uncertainty has weighed on bond supply as both issuers and investors remain cautious. For context, YTD Canadian dollar new issue supply is down 14% versus last year, with the new issue market being essentially closed for the last week of February. As always, we continue to be prudent when assessing new issues and try to use the opportunities to add to names we like.

Lastly, while market uncertainty creates short term volatility, it also creates opportunities. The most recent earnings season in Canada and the US have been solid, company fundamentals remain strong, which provides attractive entry points into companies we like. So far this month, we have executed on some compelling relative value opportunities in the pipeline sector, and with the underperformance of the REIT sector year-to-date, we are on the hunt for company specific catalysts within the sector.

Diversified Bond Fund (DBF):

While government bond yields in Canada began February on the rise, the Russia/Ukraine crisis reversed that trend which led to yields being essentially flat on the month. While credit spreads did widen in February as discussed above, the lack of upward movement in government yields helped lead to stronger performance in February vs January in the portfolio. Even though our duration remains very low, upward moves in yields still detracted from our performance. As a reminder, about 35% of our portfolio's exposure is to floating rates, which should prove beneficial with additional rate hikes expected this year. The back up in yields YTD, coupled with credit cheapening, provides a compelling entry point. The portfolio yield is now 3.8%, 30bps higher than just one month ago.

	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	Feb 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%	75%	↑
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%	0%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	5%	3%	1%	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%	↔
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%	2%	↔
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	4.7	↔
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 strategy, with no government bonds, the widening in credit spreads so far this year has resulted in a negative mark-to-market. Every single sector in Canada and the US has widened between ~20bps to ~40bps (with continued widening in March), so there has been nowhere to hide. That being said, we have taken advantage of some of the sector divergences to capitalize on the relative winners to reposition the portfolio for additional opportunities throughout the year as they arise. We continue to believe the current environment is an attractive entry point as the portfolio's yield now sits at 6.1% as of February month end. Duration and average credit rating are 1.9 years and BBB respectively.

As a reminder, earlier this year we layered in some additional interest rate hedging, converting fixed rate bonds to floating, in anticipation of higher yields. This helped reduce the portfolio's duration from 3 to 1.9 years which has been beneficial YTD, especially since the Bank of Canada began their interest rate hike cycle in March.

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

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Ops):

The Credit Ops is a credit focused strategy, so wider credit spreads lead to mark-to-market losses. So far this year, the fund is down 3.36%, which is similar in magnitude to past experience (table below). Although, we can't predict when credit spreads reverse their trend, but the table below illustrates post performance when spreads narrow, in similar and more significant MTM environments.

Therefore, the fund is behaving as expected.

Peak Drawdown Date	Cumulative Drawdown	Following 12 months performance
2013m6	-3.2%	11.4%
2016m2	-5.9%	15.6%
2018m12	-3.1%	6.0%
2020m3	-6.8%	24.6%

Source: Ninepoint Partners

So far this year the bad news has been credit spreads widening, leading to mark-to-market losses. The good news is: credit spreads are wider, therefore, the fund yields a lot more (7.6% at month end) with very low duration exposure (1.4 years) and stable credit quality (BBB average rating, clustered around BBB).

	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	Feb 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%	30%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	34%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	17%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	9%	↔
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	3%	↓
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%	0%	↑
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	1.5	↔
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	1.40x	↓
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	1%	0%	0%	0.5%	0.3%	↔

Source: Ninepoint Partners

Conclusion

It has been a challenging start to the year; between inflation, rate hikes, war and commodity prices, volatility has been very elevated. All things considered; the funds have performed in line with their risk parameters. Thankfully, barring any defaults (which we do not foresee in the portfolios), bonds will mature at par. So just like all the other down markets that we have gone through over the years, patience should eventually be rewarded.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF FEBRUARY 28, 2022 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-1.2%	-2.8%	-2.0%	-3.2%	-1.4%	2.3%	2.4%	3.6%	3.9%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF FEBRUARY 28, 2022 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-1.8%	-3.4%	-2.9%	-1.9%	1.3%	6.8%	5.0%	5.2%

[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, 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 February 28, 2022.

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