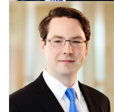
Ninepoint Diversified Bond Fund

May 2018 Commentary

May was a game of two very different halves; first we saw a rally in risk assets, with the S&P 500 and oil prices up as much as 5%, and 10 year bond yields in the U.S. flirting with 3.15%. This was quickly followed by a sharp reversal, with yields down almost 40bps and oil prices down over $7 in less than 10 trading sessions. We think that oil prices have been a significant contributor to market sentiment recently, supporting risk assets on the way up, and vice-versa on the way down. So we believe a short explanation of recent developments is important.

Investment Team

Mark Wisniewski,
Partner, Senior Portfolio Manager



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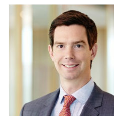

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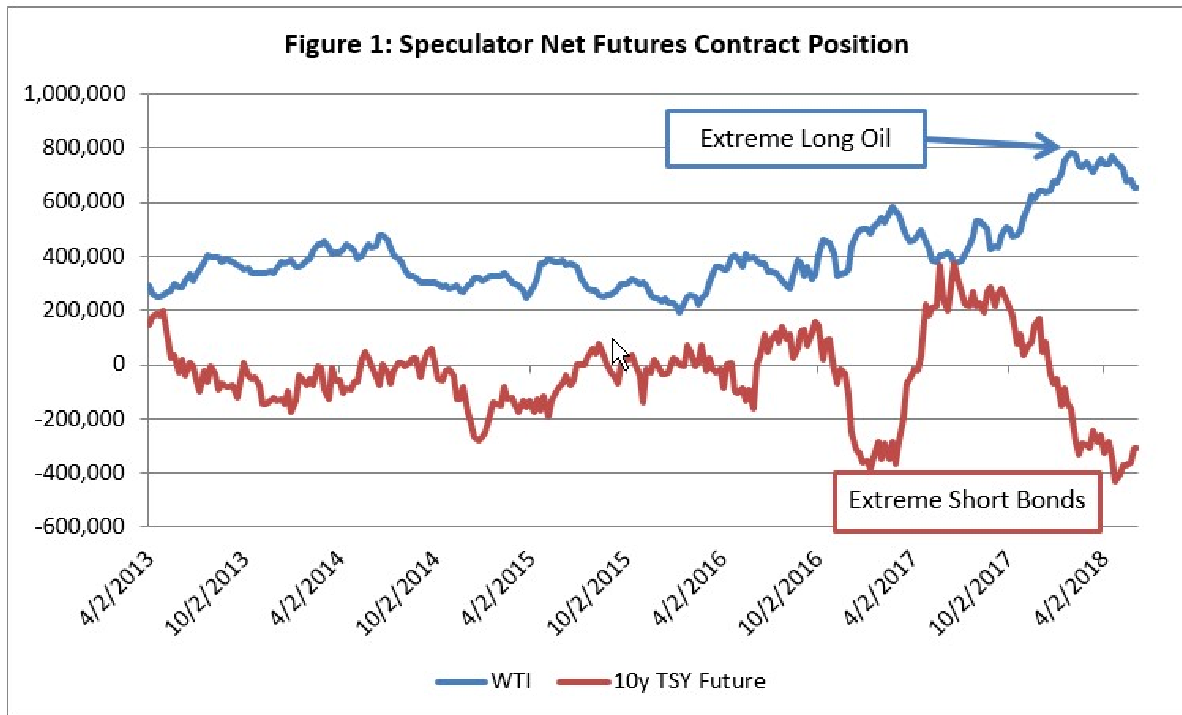
What initially happened?

It had become market consensus that oil prices needed to rise because demand was outstripping supply, that U.S. shale wouldn't be as responsive as initially feared, and that the OPEC/Russia production cuts would continue to support the market. Additionally, with Trump withdrawing from the Iran Nuclear Agreement and Venezuela descending into chaos, the risk of a serious shortage of supply on the global oil markets was becoming increasingly apparent to market participants. Accordingly, oil prices had been rallying into the $70 range, a level last seen in 2014. Having recognized this dynamic, numerous market participants had been increasing their long exposure to oil prices. As can be seen from Figure 1 below, speculative (Hedge funds, money managers, etc) positioning in oil (WTI) futures had been sitting at an all-time high since the beginning of the year, reflecting extreme bullishness.



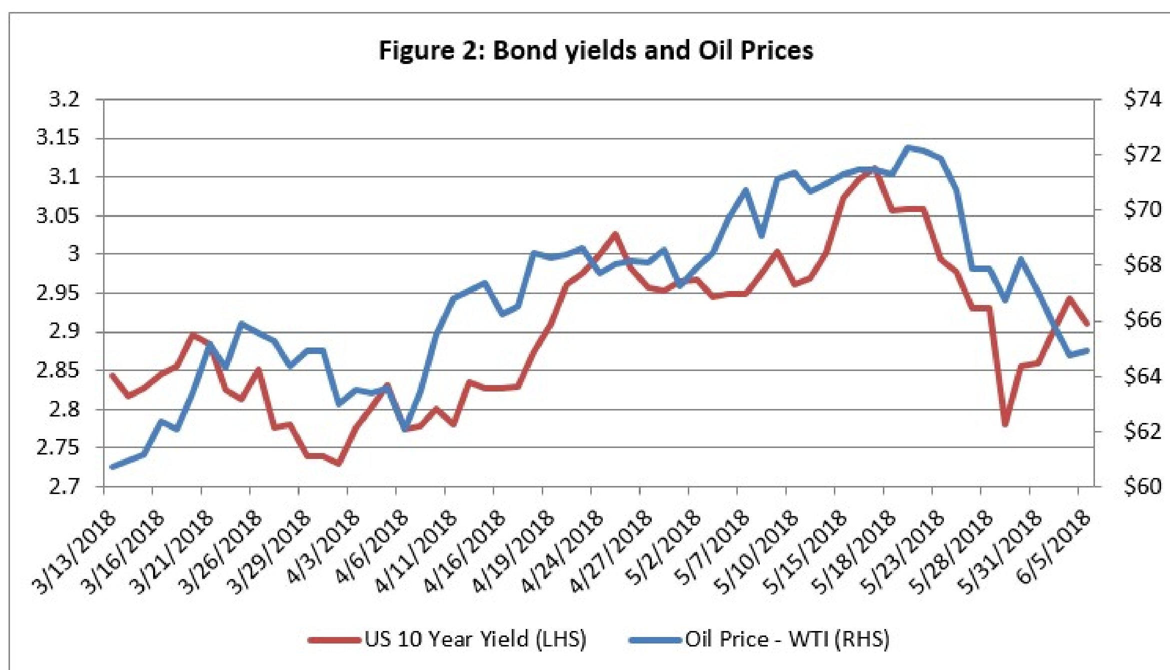
Source: Bloomberg

Higher oil prices, in general, also tend to coincide with higher inflation expectations, which subsequently drive nominal bond yields higher. This is also a very popular trade, as can be seen from the U.S. 10-year treasury futures positioning data in the chart below, which is also sitting at multi-year extremes.

Generally, we are wary of investment themes that become too broadly accepted (i.e. consensus), as they are prone to quick and painful reversals; when investors realize they are all on the same side of a trade that doesn't work anymore, they rush for the exit. With investors collectively extremely long oil and short bonds, which we see as the two sides of the same coin, we didn't need a large catalyst to trigger an unwind.

Then what happened?

First, OPEC and Russia announced that they were contemplating increasing production to offset losses from Iran and Venezuela. Remember, OPEC doesn't want prices too high as that could destabilize global growth and incentivize a production response from U.S. shale. Then came a few angry tweets by President Trump asking for OPEC to raise production by one million barrels per year. That was enough to precipitate a $5 decline in crude, dragging bond yields lower (through lower inflation expectations) (Figure 2).



Source: Bloomberg

Then came Italian politics, where a month's long negotiation between two extremist parties to form the next government fell apart, sparking fears of new elections. The Northern League, which has been gaining in the polls, has been advocating an exit from the Eurozone, and new elections would have been seen as a referendum on the country's membership to the Eurozone. Italian sovereign bond prices fell precipitously, and safe heaven assets rallied, pushing U.S. 10-year treasury yields to as low as 2.75%.

Since then, cooler heads have prevailed and the two parties have agreed to form a government. For now, the worst has been avoided, and that was enough to spark a relief rally.

Nonetheless, at this juncture we see plenty of reasons to be cautious:

- **Italy:** while the situation has stabilized, the current government's platform calls for tax cuts, increases in fiscal transfers and a roll back of structural reforms which would increase its structural deficit to over 6% of GDP. This agenda put Italy on track for a head-on collision with Brussels and Germany, who will certainly push back against such profligacy. This situation is oddly reminiscent of the Greek government led by Alexis Tsipiras in 2015: they initially played hard ball with Brussels, only to fold on most of their positions. While our base case is not for "Italexit", as some have called it, we are not out of the woods yet and expect a bumpy road ahead.
- **Oil:** Prices remain a risk to the global economy. Too low prices create solvency problems for producing countries (as in 2016) and fears of deflation. However, too little supply due to geopolitical events (Iran, Venezuela, war, etc) at a time when inventories are low means upside risk to prices could create an oil shock, engendering inflation and economic stagnation for importing countries. Thankfully, for now OPEC and Russia seem intent on managing the balance of the market. The outcome of the June 22nd OPEC meeting in Vienna will be closely watched.
- **Trade:** The risk of a trade war is heating up, after the U.S. on June 1st imposed tariffs on steel

and aluminum on Canada, Mexico and the EU, which were met with retaliatory measures. The future of NAFTA seems increasingly uncertain after the U.S. floated the idea of engaging in bilateral discussions instead. Moreover, trade negotiations with China do not appear to be progressing either. All else equal, we believe that the risks of escalation have increased. While the economic impacts of individual trade actions are small, in aggregate they not only dent business confidence, but increase inflationary pressures. While a trade war is not an investment theme in itself, it remains a significant tail risk and in the meantime has introduced a lot of FX volatility, and accordingly we maintain a fully hedged portfolio.
- **U.S. mid-term elections:** It looks increasingly probable that the Democrats will gain control of the House of Representatives in November. The Senate for now appear likely to remain Republican. Given Democrats' dislike of President Trump and his policies, it is possible they will do everything they can to block his agenda, resulting in a lame duck administration for the next two years. This is particularly important since most of the fiscal stimulus that has been put in place by recent legislation is set to expire in 2019, leaving us with another "fiscal cliff" going into 2020. Once market participants realize that growth is set to slow significantly in 2020, we expect valuations for risk assets to deteriorate significantly.

In the face of these risks, here is how we have positioned the portfolio:

- **European financials:** given the uncertainty in Italy, we will continue to avoid European bank capital instruments. We had already sold most of what little we had going into the Italian turmoil, and at this juncture the risk reward appears poor.
- **Duration:** Short and intermediate term interest rates will continue to move up as central banks raise rates, so we have kept duration low. Moreover, upside risks to inflation could mean higher and more volatile long term bond yields. At the time of writing, we initiated new duration hedges, taking the effective duration of the portfolio to 1.5 years from 2.3 years.
- **Credit risk:** Our thoughts around credit spreads and where we are in the economic cycle have not changed, so we continue to high grade the portfolio and remain defensive. For now, we are happy with our high yield, investment grade and preferred share positioning; we expect it to remain unchanged for the foreseeable future.
- **Government bonds:** in general, we are averse to owning government bonds given their combination of low yield and high duration. But, in times of stress, they offer ballast to a portfolio. As such, we are exploring ways to use options to gain upside exposure to long term government bonds in case of a large move (i.e. flight to safety).
- **FX:** with the Bank of Canada flip-flopping on rate hikes and trade wars on the horizon, we feel in no way compelled to take foreign exchange risk. Therefore, we remain fully hedged on all currency pairs.

Until next month,

The Bond Team:

Mark, Etienne and Chris

Diversified Bond Fund Portfolio Characteristics:

	Limits	Jun 2017	Sept 2017	Dec 2017	Mar 2018	May 2018	Outlook
Government Bonds	100%	0%	3%	-2%	0%	0%	↔
Investment Grade	80%	5%	15%	37%	56%	65%	↔
High Yield	40%	47%	48%	32%	24%	19%	↔
Emerging Market Governments	10%	4%	0%	0%	0%	0%	↔
Preferred Equities	10%	4%	4%	6%	6%	6%	↔
Common Equities &ETFs	10%	3%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0.0%	0.0%	-0.1%	+0.5%	0%	N/A
Cash and Equivalents		37%	29%	28%	14%	9%	↔
Total		100%	100%	100%	100%	100%	
Duration	1 to 8 years	1.7	2.4	2.1	2.3	2.3	↔
Geographic (% North America)	>75%	78%	89%	90%	89%	92%	↔

Current Net USD Exposure: 0%

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1]

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	1.3%	1.3%	0.7%	1.6%	4.8%	3.6%	3.2%	4.5%

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1]

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	1.3%	1.3%	0.7%	1.6%	4.6%	3.4%	3.1%	4.6%