Ninepoint Fixed Income Strategy

September 2021 Commentary

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

Ninepoint Partners,

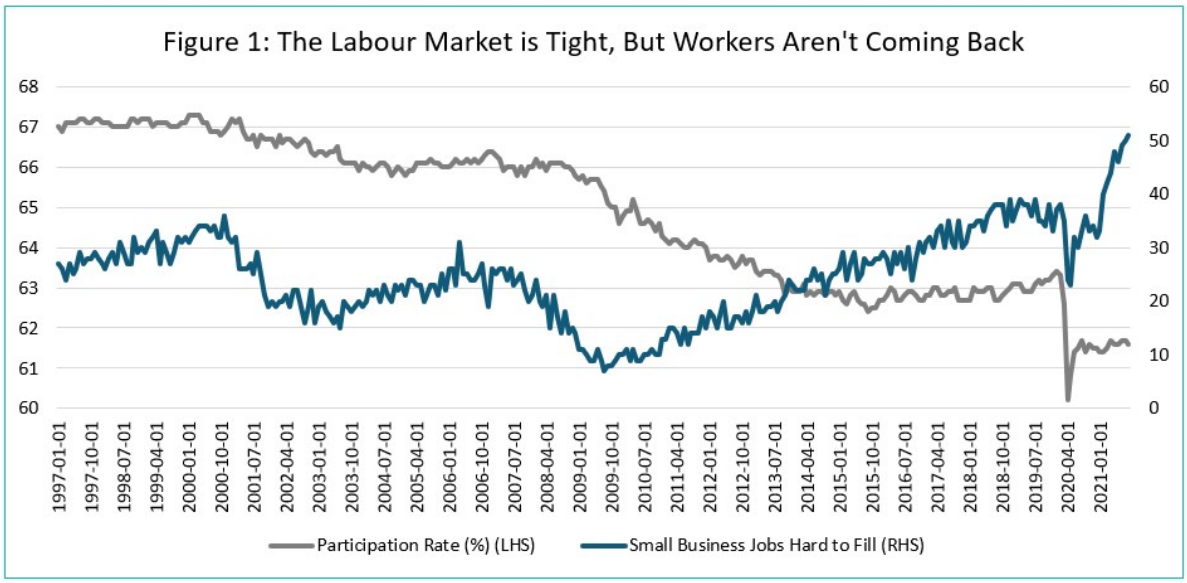
Macro

For several months now, we have been looking forward to this Fall's economic data to form our views on what the next leg of this economic cycle will look like. Vaccines are plentiful, enhanced unemployment and fiscal support is winding down, and after all this time, one would think that supply chain issues and supply/demand imbalances would have worked themselves out, giving us a clearer picture of what the "new normal" would look like.

Unfortunately, the signals that we are extracting from all this information is pointing to a few trends that could create a very tricky environment in the coming months. Ironically, just as the world economy is slowing down, western central banks, particularly the Federal Reserve, are about to tighten policy to fight persistent inflationary pressures at home. This combination of slower growth and monetary tightness from the world's most prominent central bank is the biggest risk we see on the radar now.

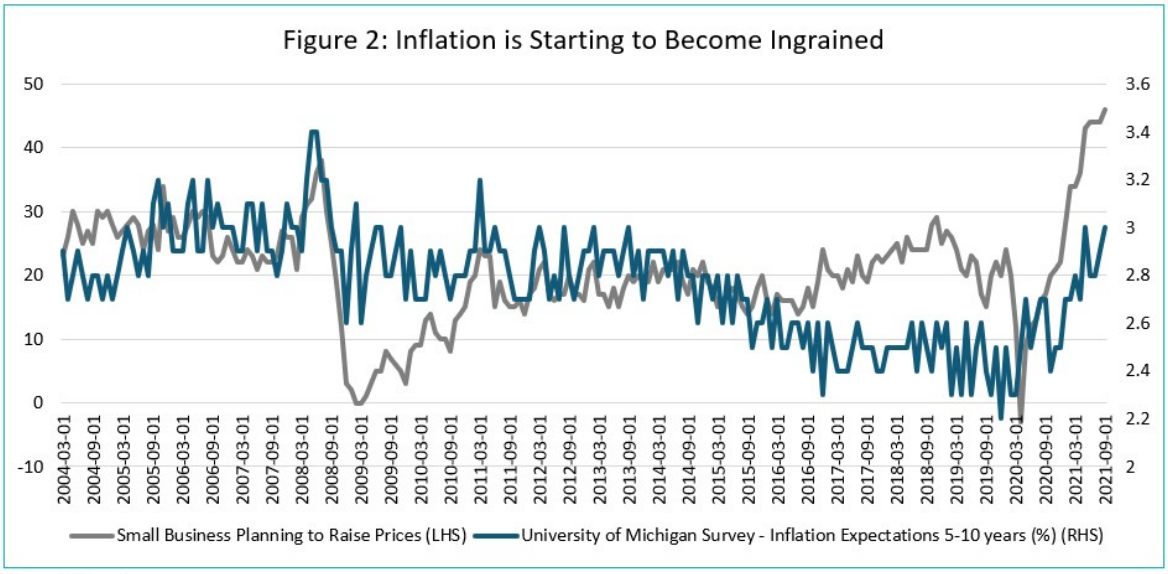
How could this come to pass?

Domestically, the US continues to experience extreme tightness in the labour market, creating labour shortages and wage pressures. Since the onset of the pandemic, the participation rate has declined materially, even though jobs are now as plentiful as they have ever been (Figure 1).



Source: Bloomberg

Concurrently, the US, like many other countries, is faced with elevated inflation due to a variety of factors (supply chain issues, worker shortages, supply/demand imbalances and now energy prices). Consumers and businesses are now beginning to budget for higher prices (Figure 2).



Source: Bloomberg

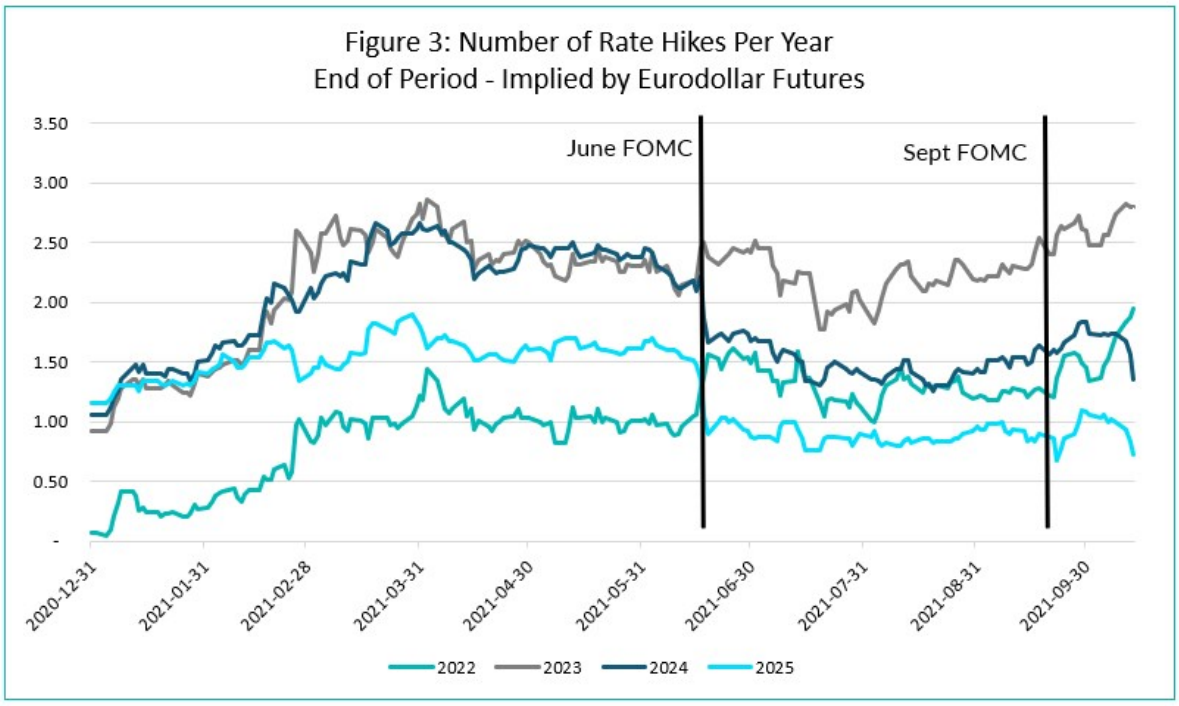
Until recently, the narrative coming from the Fed was that, if the inflation bump was transitory, they were willing to look through it, as it was unlikely to affect consumer and business inflation expectations. As the theory goes, as long as inflation expectations are well anchored around 2%, we shouldn't have an inflation problem. However, the June FOMC meeting marked a notable change in messaging, more and more Fed officials seemed more concerned with inflation (as opposed to labour market conditions). Since then, we have seen an important shift from within the FOMC towards a normalization of

monetary policy. At the September meeting, Fed officials told us that QE would end soon (it now looks like mid-November or mid-December) and that the pace of tapering would be relatively brisk (end by mid 2022). Furthermore, half of FOMC participants now expects at least one rate hike next year and several more in 2023.

In our experience, central banks are akin to large cargo ships, it takes them a while to change direction, but once the process has started, there is very strong inertia. As strange as it may seem, economic conditions are now similar to what we would expect late in the cycle. With the labour market so tight and inflation pressures becoming harder to qualify as "transitory", it isn't a big surprise to see the Fed moving in a hawkish direction.

The bond market has started to reflect this reality in an aggressive fashion; Figure 3 below shows the number of rate hikes per year that the Futures market for short term rates is implying. The first observation on the chart is December 31 2020, where the market was assuming no hikes in 2022 and about one hike a year (of 25bps) for 2022 through 2025. Things have changed quite drastically since then! At the time of writing, there are now 2 hikes pencilled in for 2022 and a further 3 hikes in 2023. Interestingly though, the lines for 2024 and 2025 are moving down, implying maybe only one hike in 2024 and none in 2025. This means that the bond market thinks that a fast pace of hikes in 2022 and 2023 will slow things down enough that the Fed won't have to keep hiking past then. In other words, we could have reached the top of the cycle by the end of 2023. That would make for a very short cycle.

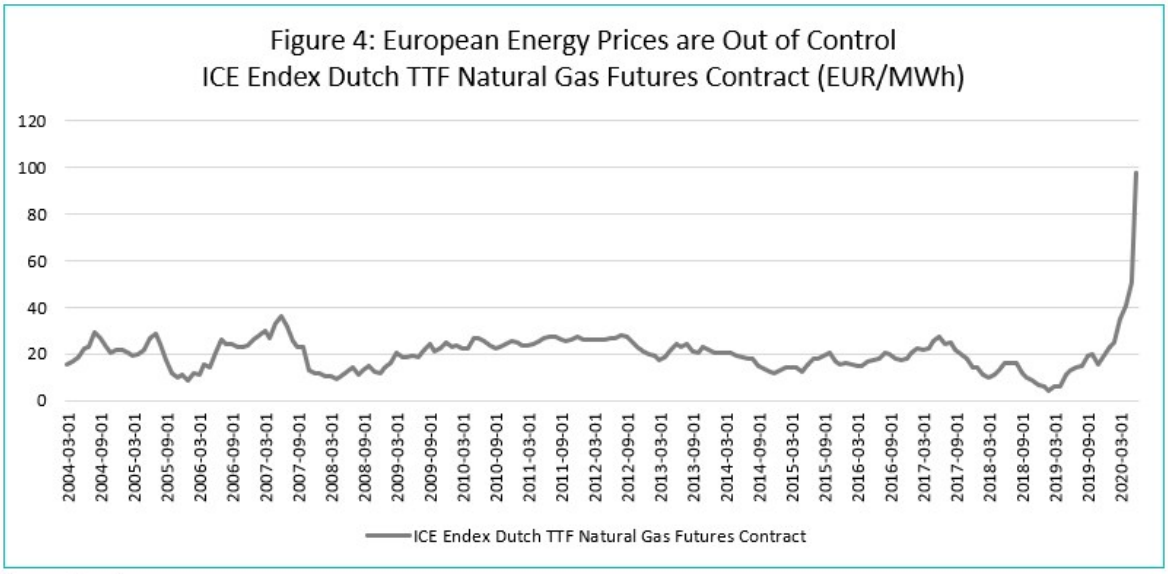
Typically, risk assets start to care about rate hikes as we near the late innings of the hiking cycle. Obviously, this could be a very short hiking cycle (1.5-2 years), so, as with everything else in this economic cycle, things could unravel relatively quickly. Already, the yield curve (our favourite recession indicator) has started to flatten. While we are nowhere near recession trigger levels, it is worth watching the reaction in the term structure of yields as the Fed starts to remove accommodation later this year.



Source: Bloomberg

So why are we so worried about the Fed removing accommodation at this juncture, after all, raising rates by the middle of next year is still a long way to go.

While the Fed manages the monetary policy of the worlds reserve currency; it rarely seems to bother about the consequences of its actions to overseas economies. On top of the pandemic, Europe and Asia are also faced with a very serious energy crisis. Natural gas, which is used for heating, electricity production and many industrial processes, is in very short supply. Prices have increased three to fourfold ahead of winter (Figure 4). As a result, some factories have been forced to suspend operations and governments are scrambling to secure supplies.



Source: Bloomberg

China is also partly to blame for the shortage of natural gas; emissions reduction initiatives have forced several coal mines and power plants to shut down, forcing a greater switch to gas as a means of electricity generation. That has increased demand for natural gas there, reducing availability of supply elsewhere.

Domestically, China is also grappling with a bubble in its massive property market. Its most indebted developer, Evergrande, has defaulted on their debt and expectations are for others to follow. For several years now, the property market in China has seen tremendous growth, leading to excesses and speculation. It seems like the government has now decided to put a stop to these excesses. According to estimates by Goldman Sachs, real estate, property services and construction related activities account for about a quarter of Chinese GDP. That is substantial, when one considers that China is also about 20% of Global GDP.

So, slowing growth in Asia and Europe due to a large negative supply shock (energy crisis) coupled with an idiosyncratic slowdown in China's property market (25% of 20% of Global GDP), in the context of the Fed (amongst other) tapping the monetary brakes, we feel like the table is set of a bit of volatility over the next 6-12 months.

This is becoming a tricky environment and because the catalyst for the past recession was a pandemic, one that not a lot of us have ever experienced, there isn't an established playbook. Consequently, we have decided to start moving towards a more defensive posture as we don't see great opportunity out there. What does that mean for our funds' positioning?

We still like investment grade credit. Now isn't the time to add government bonds to the mix. They do not yield enough; we don't require that ballast yet and if the trend in

interest rates persists there will be a better entry point to add them.

To hedge the portfolio, we have been slowly adding tail hedges in credit. They are still relatively cheap and won't detract too much from performance, the time to buy hedges is when they are cheap.

For duration, as the yield curve flattens, it will make sense to hedge some duration in the belly (4-7y) as this is where rates have the most potential to increase (we have barely any exposure in the 3y and under space). The 10 to 30 year sector should outperform as the curve flattens. (this is mostly relevant for the DBF)

Diversified Bond Fund (DBF)

September was a challenging month for fixed income; interest rates went up about 30bps (5-10y) and credit spreads widened modestly, in sympathy to the broader risk off environment. Comparatively, the DBF did well, returning -45bps, whereas most broad bond indices were down by 2-3x as much.

During the month, we added credit hedges through December, consistent with our overall view discussed above. We continue to modestly increase our weight in HY, but this is mostly a reflection of higher allocation to hybrid bonds of IG companies. Preferred shares we own continue to get called, even some of the fixed coupons from the insurance companies. We have also been sellers in the secondary market, since some prices are through what we consider fair value.

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	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	↔
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	↓
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	↑
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	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%	↓
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%	↔
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%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	↓
Total		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	↔
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	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	↔

Source: Ninepoint Partners

Alternative Credit Opportunities Fund (NACO)

NACO continues to perform according to expectations, with performance that mirrors

that of the Credit Opps. While credit spreads widened modestly in September, income from the portfolio (about 42bps per month) was enough to offset any mark to market pressures.

Similar to the DBF, we have entered into credit hedges for a portion of the portfolio at a very low cost, providing some ballast should credit volatility continue into the fourth quarter.

Following month end, we have acquired small positions in two syndicated loans. These are first lien, relatively short-term, senior secured loans that help those businesses fund their working capital. Taken together, these positions represent about 3.5% of the fund. We are also in discussions to participate in a private placement for a small size (less than $50mm) unrated debenture. All these positions carry interest in the high single digit range (8-9%), providing a nice alternative to unsecured HY (which yields 4-5%).

Alternative Credit Opportunities Portfolio Characteristics

	Limits	May 2021	June 2021	July 2021	August 2021	September 2021	Outlook
Government Bonds	100%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	70%	54%	57%	50%	↔
High Yield	40%	36%	32%	29%	24%	22%	↔
Illiquid Securities	10%	0%	0%	0%	3%	3%	↑
Preferred Equities	10%	8%	8%	4%	4%	3%	↔
Common Equities & ETFs	10%	0%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0%	0%	0%	0%	0%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	↔
Total		100%	100%	100%	100%	100%	
Duration	0 to 5 years	3.0	2.7	3.1	3.0	2.9	↔
Leverage	0-3x	1.4x	1.37x	1.13x	1.06x	1.09x	↑
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Credit Income Opportunities Fund (Credit Opps)

September was another good month for the Credit Ops, with a return of 37bps after fees. While credit spreads widened modestly during the month, that was more than offset by the fund's income (about 57bps per month). Moreover, some mining companies' warrants that we had acquired through past participations in syndicated loans have

rallied significantly, providing a further boost to returns.

Similar to the DBF and NACO, we have entered into credit hedges for a portion of the portfolio at a very low cost, providing some ballast should credit volatility continue into the fourth quarter.

Just like for NACO, following month end, we have acquired small positions in two syndicated loans. Those are short-term, first lien, senior secured loans that help those businesses fund their working capital. Taken together, these positions represent about 3% of the fund. We are also in discussions to participate in a private placement for a small size (less than $50mm) unrated debenture. All these positions carry interest in the high single digit range (8-9%), providing a nice alternative to HY (which yields 4-5%).

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	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Investment Grade	100%	58%	55%	58%	53%	68%	64%	72%	65%	77%	64%	53%	44%	43%	↔
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	↔
Private Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	↑
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	↓
Total		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	↔
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	↓
Unhedged FX Exposure	<25%	0%	0%	0%	2.7%	5.1%	-3.2%	0%	0.3%	0%	2%	1%	0%	0%	↔

Source: Ninepoint Partners

Conclusion

The macro environment is certainly becoming a lot more interesting, and with risk assets priced to perfection, we are starting to tread a bit more cautiously.

Until next month,

Mark & Etienne
Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF SEPTEMBER 30, 2021 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	-0.5%	0.2%	0.5%	1.7%	0.9%	3.5%	3.5%	4.4%	4.3%

NINEPOINT DIVERSIFIED BOND CLASS - COMPOUNDED RETURNS[1] AS OF SEPTEMBER 30, 2021 (SERIES F NPP221) | INCEPTION DATE: NOVEMBER 2, 2011

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	-0.5%	0.2%	0.5%	1.6%	0.9%	3.3%	3.4%	4.4%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF SEPTEMBER 30, 2021 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.4%	4.9%	1.2%	3.3%	10.8%	7.4%	6.4%	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 September 30, 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 September 30, 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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