Ninepoint Fixed Income Strategy

September 2022 Commentary

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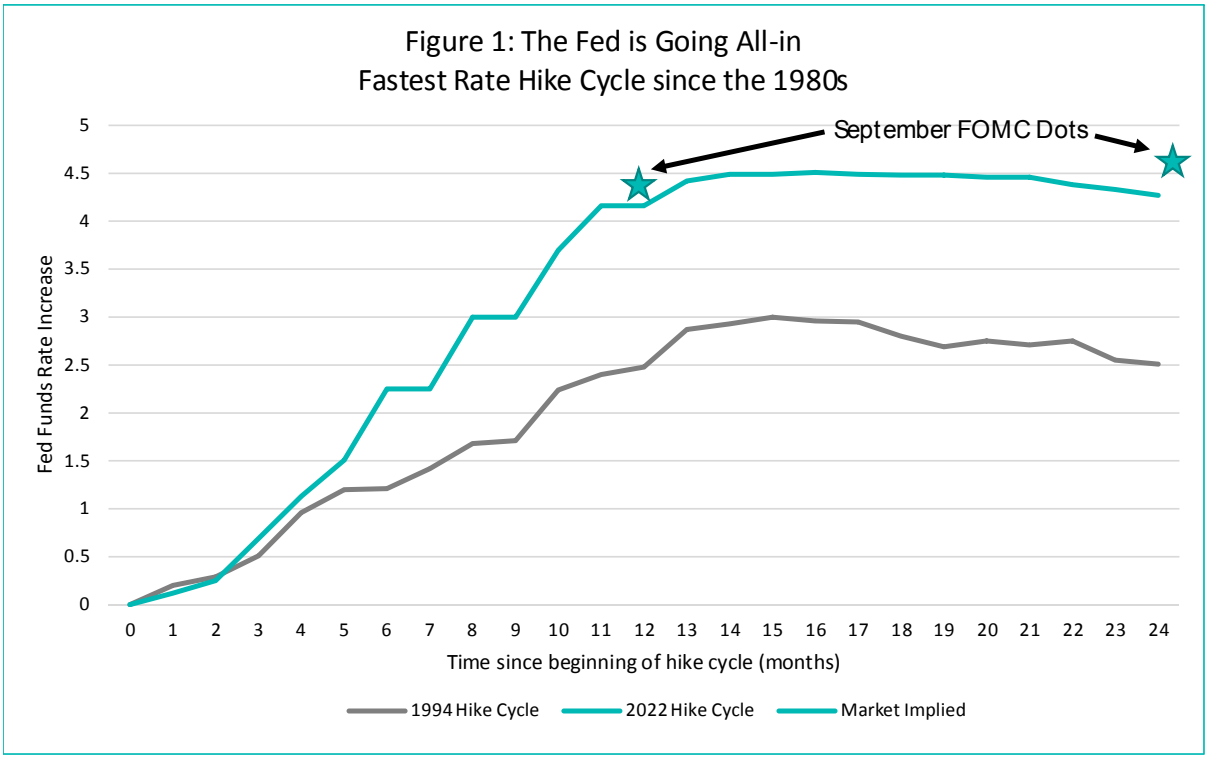
Monthly commentary discusses recent developments across the ***Diversified Bond****,* ***Alternative Credit Opportunities*** *and* ***Credit Income Opportunities Funds****.*

September 2022 saw its fair share of historically significant events, leading to another very challenging month for almost any asset class. Selloffs were widespread and of large magnitudes, which is a rare phenomenon. Equities were down materially (-9% for the S&P 500), credit spreads widened (20bps for the U.S. corporate benchmark), government bond yields (US 10-year) moved up by 60bps and, last but not least, currencies were extremely volatile.

Not since the 1990s Asian Crisis had Japan directly intervened in the foreign exchange market to stabilize the Yen, selling US dollars just ahead of the September FOMC meeting to prop up the Yen, which has so far this year lost 25% versus the dollar. It was less publicized but, the Bank of Korea has also intervened in the market to support its currency. As the Federal Reserve keeps tightening policy, the strength of the U.S. Dollar is creating problems across the world (particularly for emerging markets), and we should expect more, not less, of these types of interventions going forward.

The Bank of England also had to come to the rescue, but this time it was the UK Government Bond Market, where yields exploded higher and necessitated an emergency "Market Functioning QE". The turmoil did not stop with the English Channel, spreading to other government bond markets and taking the 10-year US yield to 4%. This volatility was triggered by the announcement of a large fiscal package orchestrated by the new Truss Government in the UK, which came on the heels of a large energy spending plan. In an economy faced with an inflation rate north of 10% and a central bank dramatically rising rates to restore price stability, it is rather unproductive to introduce large and wide-ranging fiscal easing. But the Truss government does not seem to care much about traditional economic orthodoxy. Backtracking now would be difficult, even though the IMF and several high-ranking economic officials have condemned their fiscal plan. Thankfully, after a week of turmoil in the UK and global government bond markets, it seems the BoE's "Market Functioning QE" and some token concessions by the Truss government on their package had been enough to bring back a semblance of normalcy. Only time will tell if this was an unfortunate hiccup, or if the UK will continue to be a source of fiscal risk to itself and to the global economy.

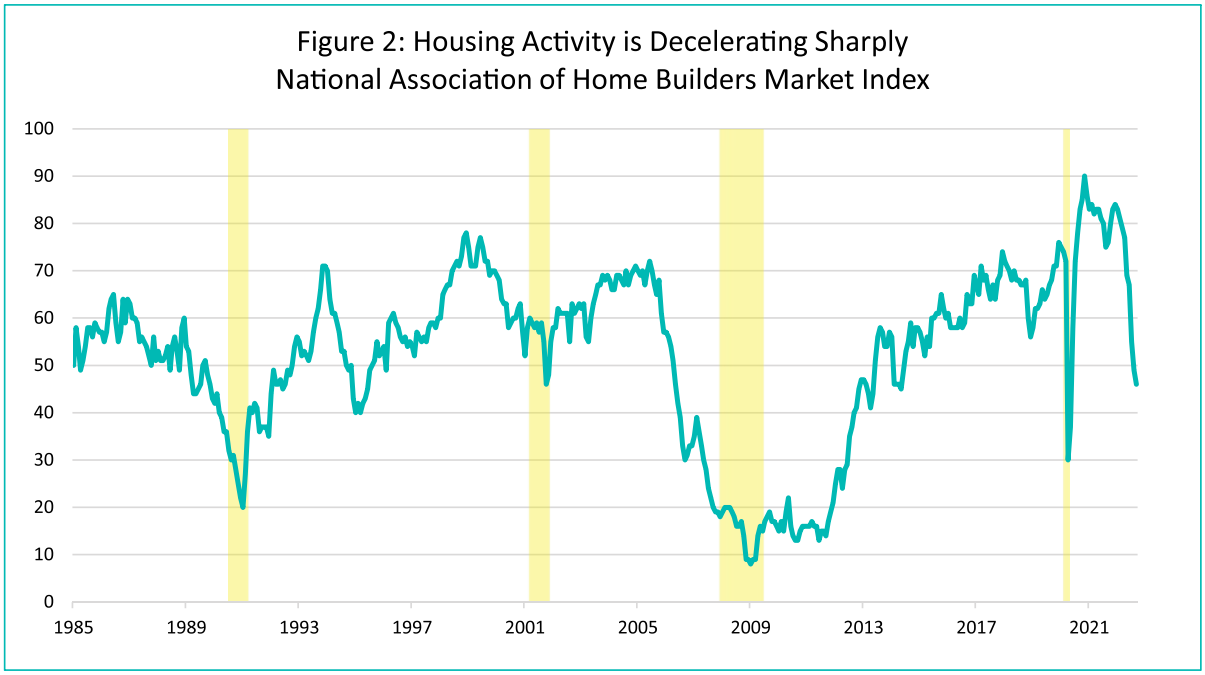
If that wasn't enough, we also had the September FOMC meeting, itself of particular importance since the Fed's new dot plot showed the Fed Funds Rate reaching 4.4% by 2022 year-end and staying around 4.6% in 2023. This could mark the fastest rate hike cycle since the infamous 1980s, where Paul Volker broke the back of inflation (and of the economy) with unprecedented rate increases. Figure 1 below shows the cumulative increase in the Funds Rate since the start of the 2022 hiking cycle, along with the current market pricing for the forward path of the Funds Rate next year (dotted line). We added stars representing the FOMC's dot plot for year-end 2022 and 2023 rates. To put this cycle in perspective, we show in grey what the 1994 hike cycle was like.



Source: Bloomberg, Authors' Calculations. As of September 27, 2022.

Why 1994? Because that the last time that the Fed raised rates aggressively, and also the last time that they managed to engineer a soft landing. Up until early summer, there were clear parallels to be drawn between the two historical episodes. However, following the upside surprises to inflation this summer and the accelerated pace of hikes since then (75bps at every meeting), the 2022 hike cycle is now clearly more comparable to the 1980s. With that, the odds of a so-called soft landing have now greatly diminished. The Fed is finally acknowledging it as well, with Chair Powell citing the pain businesses and households will have to bear to finally tame inflation.

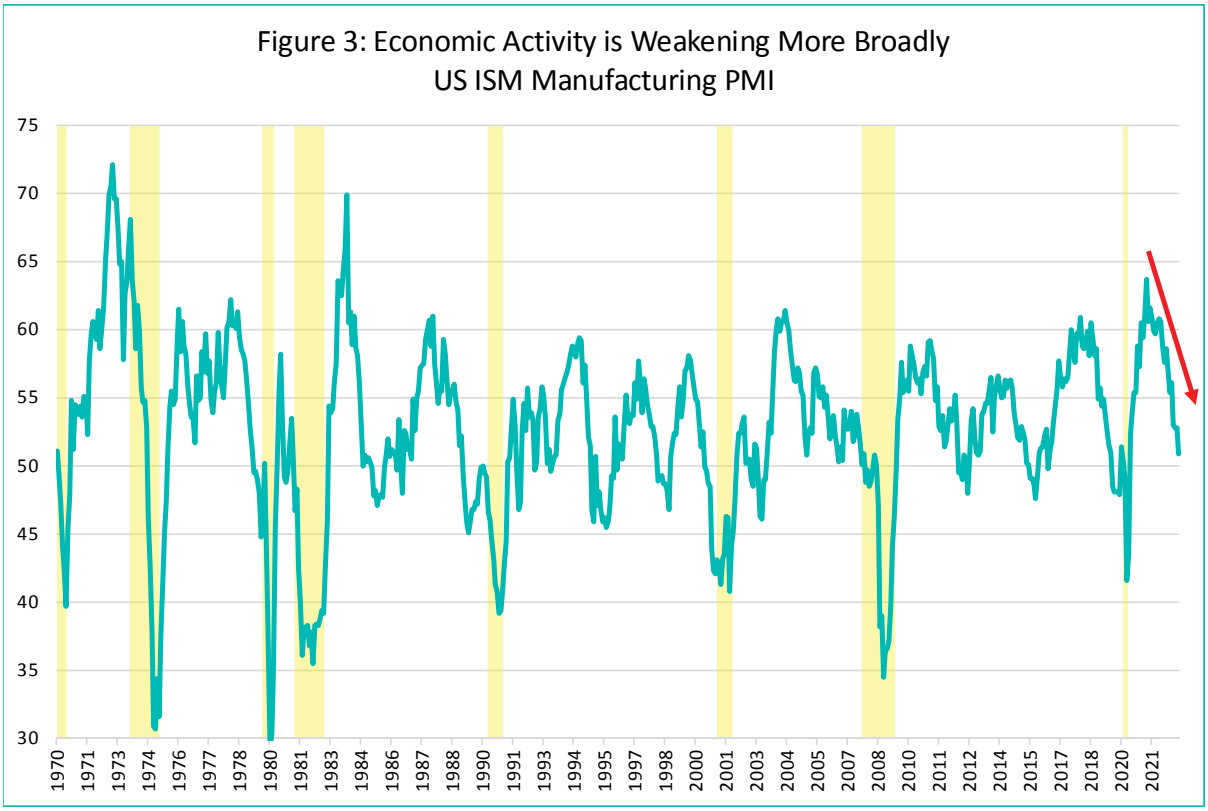
As discussed previously, monetary policy acts with a lag (typically 6-12 months), and given the very rapid pace of rate increases, it is now increasingly likely that the Fed (and the BoC) will end up overshooting to the upside (if they haven't already), dragging their respective economies into recession. We are already seeing clear signs of deceleration. Housing, the most interest rate sensitive sector of the economy, is clearly trending down. New and existing home sales are plummeting, prices are going down and surveys of homebuilders are very weak (Figure 2).



Source: Bloomberg. As of September 30, 2022.

In Canada, we are already starting to see lower housing prices feed through inflation figures, which is encouraging, given that "shelter" constitutes about 30% of the CPI basket. It is impossible for overall inflation to moderate without some help from housing. In the U.S., given that house prices have just started to come down and the way house and rent prices feed through inflation calculations (i.e. with a big lag), it should take few more months for "shelter" to start impacting U.S. inflation in the right direction.

Elsewhere in the economy, U.S. PMIs have also decelerated sharply (Figure 3), falling to 50.9 in September. As the chart below shows, outside of recessions (yellow shading), we very rarely see the ISM under 50. The composition of the report was also poor, with new orders and employment weakening most and entering contraction territory.



Source: Bloomberg. As of September 30, 2022.

The bottom line for the Fed and BoC is that monetary policy is starting to work; the economy is slowing down, house prices are going down, demand is decreasing, and the labor market is starting to get weaker, taking pressure off wages. All this will eventually lead to the intended outcome: lower inflation. Unfortunately, just like Powell has warned, this will come at a cost, and it seems increasingly likely that this cost will be a recession.

How severe? It is difficult to say, but usually, the areas of greatest excess suffer the most. Given the massive boom in Canadian real estate over the past decade and higher household leverage, we would expect the downturn to be more acute here than the U.S.

Turning to credit markets, these macroeconomic developments undoubtedly made their way to financial markets. The Bloomberg Barclays Canada Corporate Bond Index widened by a material 15bps in September, while the US Corporate Bond Index widened by 20bps, taking them both to their highest level since the pandemic. US High Yield continues to sell-off, declining by 4% over the course of the month. A rising rate environment along with decelerating growth, tends to expose weaker companies. At this stage of the cycle, company and sector selection becomes increasingly important, and with wider spreads all around, moving up in quality isn't as punitive it once was.

Obviously, these macroeconomic and financial market developments have implications for our funds. As we approach the end of this stage of the economic cycle, we are taking several steps to position our portfolios for what we believe will be an economic downturn, the significance of which is difficult to estimate at this point.

1. Duration: typically, when the economy enters a recession, longer term government bonds rally as investors take flight for safety and start pricing-in rate cuts. As part of our macro playbook, at this point in the cycle, we look to prudently layer in duration to the funds through the purchase of 10 and 30-year government bonds. Since this cycle has been so unpredictable, we have decided to increase government bond exposure through the use of call options on TLT (the highly liquid U.S. long-term government bond ETF). If we are wrong on recession, the most we can lose is the premium spent, and while the position is currently relatively small, if/when government bonds rally, our exposure will grow meaningfully.

2. Credit Duration: since the yield curve has been inverted for most of the past few months, we have been actively reducing credit duration by selling 7 to 10-year corporate bonds and buying 2 to 3-year corporate bonds, with very little impact on overall portfolio yield. This reduces the overall amount of credit risk in the portfolios, making them more defensive.

3. Sector Exposure: for several months now, we have been actively reducing our exposure to real estate and other consumer facing businesses. Large cap bank bonds have been cheap due to elevated funding needs, so we have been taking advantage of this relative value opportunity to sell real estate and buy banks, which is accretive to credit quality and liquidity.

4. High Yield Exposure: continues to decline. Our HY is primarily of higher quality (BB and BB+) and of low duration (3.6 to 3.9 years, depending on the fund). Expect us to continue to reduce exposure in this category.

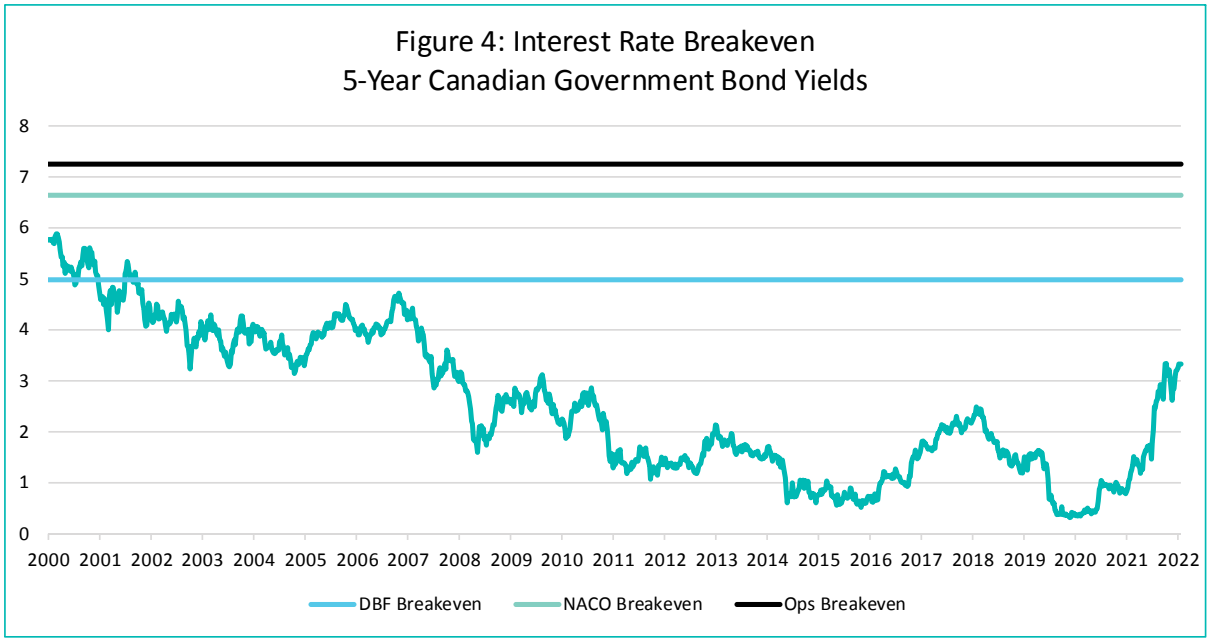
In addition to the changes discussed above, the first line of defense for a fixed income investor is always the portfolio yield. With the large interest rate and credit spread increases witnessed year to date, our funds now yield substantially more than at any time in recent memory.

In the table below, we show our three funds' yield-to-maturity, along with their interest rate (duration) and credit risk (spread duration) characteristics. As a reminder, duration is a measure of a bond's price-sensitivity to a 1% change in interest rates. Similarly, spread duration is a measure of a bond's price-sensitivity to a 1% change in credit spreads. For example, in the case of the Diversified Bond Fund, 4.0 years of duration means that, for a 1% increase in interest rates (i.e. 100bps), one would expect the fund to suffer mark-to-market losses of 4%.

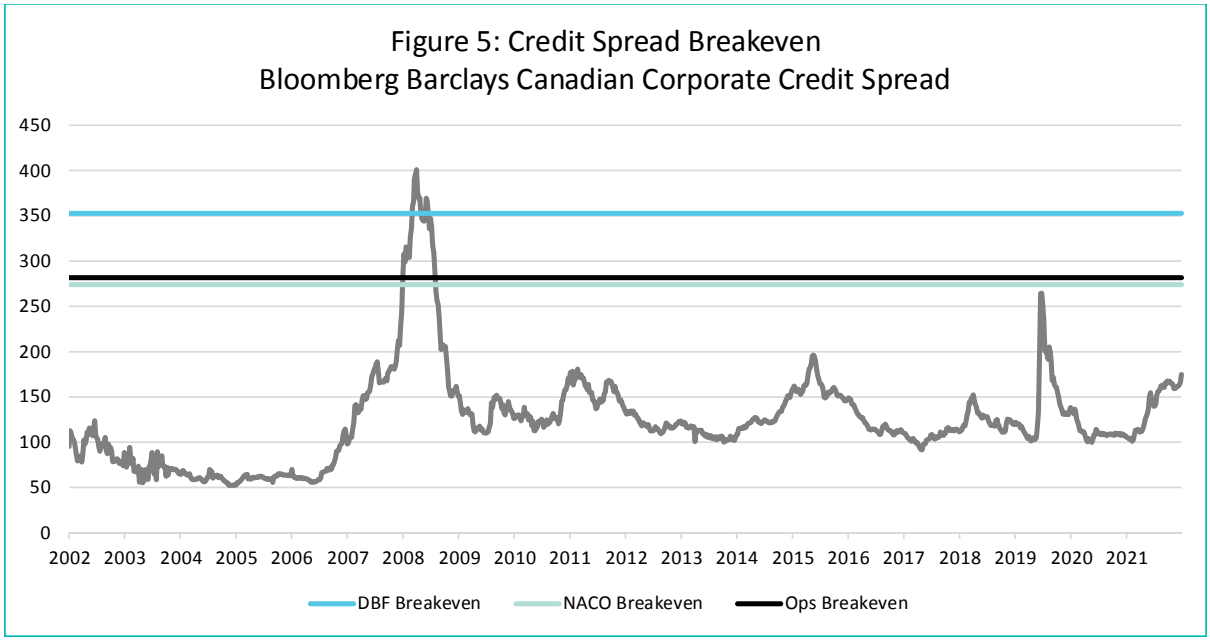
	Ninepoint Diversified Bond Fund	Ninepoint Alternative Credit Opportunities Fund	Ninepoint Credit Income Opportunities Fund
Yield-to-Maturity (%)^	**6.9%**	**10.2%**	**11.0%**
Duration (Years)*	4.0	2.9	2.7
Interest Rate Breakeven	**173bps**	**352bps**	**407bps**
Spread Duration (Years)	3.7	9.7	9.9
Credit Spread Breakeven	**186bps**	**105bps**	**111bps**
Average Credit Quality	BBB	BBB	BBB
Leverage	N/A	1.3x	1.4x

^ Underlying investments * Includes duration from options exposure
As of September 30, 2022. Characteristics are indicative and subject to change without notice.

Therefore, using the portfolio yield and its risk characteristics, one can calculate the fund's breakeven rates. Using the same example as earlier, for the Diversified Bond Fund, with a yield-to-maturity of 6.9% and duration of 4 years, the fund's interest rate breakeven is 1.73% or 173bps (6.9% divided by 4). In other words, over a 12-month period, interest rates would need to increase by 173bps for the Diversified Bond Fund's yield-to-maturity to be fully eroded. We estimate the same for Credit Spread Breakeven and, for historical context, present those statistics across the funds in Figures 4 and 5 below:



Source: Bloomberg and Ninepoint Partners



Source: Bloomberg and Ninepoint Partners

Figures 4 and 5 paint a clear picture: in fixed income, portfolio yield matters.

Given the significant amount of yield in our portfolios and the active changes we have been making to prepare for what is most likely to be a recession in 2023, we believe our funds are very well positioned to help investors manage through the upcoming downturn. Active management is crucial in fixed income, but especially so in volatile and challenging market environments.

Until next month,

Mark, Etienne & Nick
Ninepoint Partners

Appendix: Portfolio Characteristics

Ninepoint Diversified Bond Fund
Changes to Portfolio

	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	March 2022	June 2022	Sept 2022	Outlook
Government Bonds	100%	-2%	0%	-4%	2%	1%	7%	22%	28%	13%	9%	9%	14%	8%	-8%	2%	0%	-7.0%	1%	2%	1%	↑
Investment Grade	80%	37%	56%	66%	73%	76%	72%	58%	61%	58%	78%	80%	71%	74%	84%	76%	73%	70%	73%	65%	70%	↑
High Yield	40%	32%	24%	17%	16%	13%	14%	9%	7%	6%	13%	11%	12%	11%	12%	14%	18%	18%	23%	29%	26%	↓
Emerging Market Governments	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	0%	0%	0%	↔
Preferred Equities	10%	6%	6%	6%	6%	2.5%	0.7%	0%	0%	0%	0%	0%	2%	4%	6%	5%	3%	1%	2%	2%	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%	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%	1%	3%	0%	N/A
Cash and Equivalents		28%	14%	15%	1.5%	6%	2%	9%	6%	22%	0%	6%	6%	5%	5%	1%	3%	14%	0%	0%	1%	↑
Total		100%	100%	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	2.2	2.4	4.0*	↑
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	4.6	4.3	3.7	↔
Unhedged FX Exposure	20%	0%	0%	0%	0%	0%	0%	6%	5%	3%	3%	5%	6%	6%	0.5%	4%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

Ninepoint Credit Income Opportunities Fund
Changes to Portfolio

	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	March 2022	June 2022	Sept 2022	Outlook
Government Bonds	100%	0%	0%	6%	0%	18%	0%	0%	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%	31%	32%	35%	↑
High Yield	40%	29%	24%	19%	16%	10%	6%	22%	28%	26%	26%	30%	32%	37%	33%	34%	38%	32%	↓
ABS	20%	3%	3%	4%	5%	5%	5%	5%	8%	9%	15%	11%	10%	14%	14%	11%	8%	7%	↔
Loans	10%	3%	3%	2%	3%	2%	2%	4%	7%	6%	6%	3%	4%	4%	8%	9%	7%	7%	↓
Preferred Equities	10%	4%	4%	0.5%	0%	0%	0%	0%	0%	0%	5%	10%	8%	4%	2%	3%	3%	2%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	-7%	-7%	-10%	-15%	-13%	-8%	0.3%	0%	1%	1%	1%	2%	2%	↔
Derivatives	+/- 2.5%	0%	0%	0%	-0.4%	0%	0%	0%	1%	0%	1%	1%	1%	1%	1%	2%	3%	1%	N/A
Cash and Equivalents		6%	14%	15%	28%	8%	32%	12%	8%	2%	3%	-0.5%	1.2%	6%	5%	2%	1%	8%	↑
Total		100%	100%	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	1.6	1.4	2.7*	↑
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	1.30x	1.40x	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%	0.2%	-0.2%	0.1%	↔

Source: Ninepoint Partners

Ninepoint Alternative Credit Opportunities Fund

Changes to Portfolio

	Limits	May 2021	June 2021	July 2021	Aug. 2021	Sept. 2021	Oct. 2021	Nov. 2021	Dec. 2021	Jan. 2022	Feb. 2022	March 2022	April 2022	May 2022	June 2022	July 2022	Aug. 2022	Sept. 2022	Outlook
Government Bonds	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↑
Investment Grade	100%	58%	66%	53%	49%	44%	48%	52%	44%	46%	48%	51%	50%	51%	51%	49%	50%	53%	↑
High Yield	40%	36%	32%	29%	24%	22%	28%	29%	29%	33%	29%	27%	29%	28%	28%	29%	29%	24%	↓
ABS	20%	0%	4%	1%	8%	6%	7%	7%	7%	9%	10%	11%	13%	13%	15%	16%	15%	18%	↔
Loans	10%	0%	0%	0%	3%	3%	3%	6%	5%	5%	5%	5%	4%	4%	4%	4%	4%	3%	↓
Preferred Equities	10%	8%	8%	4%	4%	3%	3%	2%	2%	2%	2%	1%	1%	1%	1%	1%	1%	1%	↓
Common Equities & ETFs	10%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔
Derivatives	+/- 2.5%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	1%	1%	0%	N/A
Cash and Equivalents		-2%	-18%	11%	10%	19%	3%	6%	13%	7%	8%	5%	0%	2%	0%	0%	0%	3%	↑
Total		100%	100%	100%	100%	100%	100%	100%	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	2.1	2.2	2.0	2.0	2.6*	2.7*	2.9*	↑
Leverage	0-3x	1.4x	1.37x	1.13x	1.06x	1.09x	1.10x	1.10x	1.00x	1.20x	1.20x	1.10x	1.18x	1.17x	1.10x	1.20x	1.20x	1.30x	↓
Unhedged FX Exposure	<20%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	↔

Source: Ninepoint Partners

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF JANUARY 31, 2023 (SERIES F NPP118) | INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	INCEPTION
Fund	2.2%	2.2%	2.8%	-0.4%	-6.6%	-1.0%	0.5%	2.4%	3.2%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JANUARY 31, 2023 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	2.9%	2.9%	4.2%	2.4%	-3.1%	4.9%	3.7%	4.3%

NINEPOINT ALTERNATIVE CREDIT OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JANUARY 31, 2023 (SERIES F NPP931) | INCEPTION DATE: APRIL 30, 2021

	1M	YTD	3M	6M	1YR	INCEPTION
Fund	2.5%	2.5%	4.0%	0.5%	-5.3%	-3.4%

[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 September 30, 2022 [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 September 30, 2022. [1] All Ninepoint Alternative Credit 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 September 30, 2022.

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