Ninepoint H1 2023 Market Review and Outlook

Focus on Fixed-Income - August 1, 2023

Link: https://www.ninepoint.com/commentary/commentaries/2023/072023/fixed-income-h1-2023-market-review-and-outlook/

Transcript

Mark Wisniewski: Hi there. It's Mark Wisniewski and Etienne Bordeleau talking about the performance of the funds this year, the Diversified Bond Fund, our Liquid Alternative fund, and the Credit Income Opportunities fund. We're also going to provide a first half review and what we expect for the balance of the year and next year. I guess it's fair to say that inflation is still incredibly topical. So we are going to talk about inflation and also about rate hikes.

So the game plan for today is to discuss the performance of the funds, and then unpackage that into what our expectations are for this year and a little bit of next year. With that, I'll get Etienne to kick it off and talk a little bit about the inflation situation here in Canada and the US.

Etienne Bordeleau: Yes, thanks, Mark. Thanks for taking the time, everybody. Inflation has continued to decline this year. That's the good news. It was always going to be an uneven process, Earlier this year we've had the tailwind of lower energy prices. We've also had lower goods prices. The demand for goods and goods supply chains have normalized post the pandemic. Those two factors have contributed to lower inflation in Canada, the US, the Eurozone and even in the UK, but it's taking longer there.

There are still other large drivers of inflation which is why inflation is still double what the Bank of Canada and the Federal Reserve would like it to be. One of those is shelter inflation which is the price of lodging or housing. The good news is that house prices have stabilized and rents have actually declined, particularly in the US where about a million apartments are currently in the process of being finished. Supply of apartments is going to increase materially in the US. Everybody. including us, sees the shelter component of inflation, which is pretty meaningful, starting to contribute to the decline in overall inflation.

Mark: It's fair to say that shelter has been a big sticking point for inflation. However, shelter is finally moving, so that's the good news.

Etienne: Yes. Goods are finally no longer inflating, energy prices have stabilized, hard to say for how long and then shelter contributing to the downside. We'll continue to see improvement in inflation towards the Fed and the Bank of Canada's 2% target. The last piece of the puzzle for inflation is really the service sector excluding housing. What's particular about that is a lot of this value chain is driven by wages. It's very people-intensive and so the wage dynamics in the economy have a large impact on that part of the inflation conundrum.

Mark: The real surprise obviously is that even with all of these rate increases and the expectation of recession is that we've had no material move in the unemployment rate, which is putting a lot of pressure on wages.

Etienne: That's the issue, and if you look at the Fed's dot plot, they're forecasting unemployment to move up almost a full percent by the end of next year. We need the labor market to soften to finish this fight against inflation. In our minds, it's completely unrealistic to expect inflation to go back to the 2% target if we don't get a significant reduction in the tightness of the labor market and by extension, a significant economic slowdown. Historically, since the Second World War, there's never been a time where the unemployment rate in the US or Canada goes up by more than 50 basis points and we don't have a recession.

It would be quite unusual if this time around we managed to do that. That's why we still believe that a slowdown is coming. It just takes time, and the cracks are starting to appear. We saw some cracks in March with the banking turmoil. Lending conditions are very tight. We're starting to see some defaults in lower-quality companies in the loan space. Delinquency rates in consumer credit is starting to perk up. Personal bankruptcies are back above pre-COVID levels in Canada.

There's many little things that we are identifying that are telling us that we're at the end of the credit cycle. These data points don't jive for us when we look at the rich valuations in the high yield market.

Mark: Yes, high-yield spreads are incredibly low right now. High yield valuations resemble equity market valuations in that they both are pricing in a fairly rosy scenario (i.e. not much of a recession and probably a soft landing). With that, our expectation is that, again, we think inflation probably doesn't get to that 2% level this year. There's a shot at it next year, depending on what happens with the recession severity. The good news is that we're pretty well done in terms of additional interest rate hikes. Could we get an interest rate increase in Canada this year? Probably unlikely, but possible. I think interest rate hikes are pretty well done, and it's the same thing in the US.

So the good news is from an interest rate increase perspective, we're pretty well done. I guess the bad news is that it looks to us like rates are going to be higher for longer until we get that desired slowdown next year that moves the unemployment rate up and basically finishes off things with inflation.

Etienne: There's not a chance in the world that they'll cut rates if unemployment rate is at cycle lows. This is a fantasy. They will cut rates when the downturn happens.

Mark: Right now, for the first six months of the year, performance has been pretty good across all our funds, the Diversified Bond Fund, our Liquid Alternative strategy, and the Credit Income Opportunities fund all have relatively low duration. All the funds, depending on which one you look at, are up in the low to mid single digits area. They're annualizing to potentially make mid to high single digits this year, which is in line with our prior expectations.

Investment-grade credit moved out to 175 basis points over during that banking crisis earlier this year, and as of today stand at 143 basis points, which is a pretty significant reversal. As we touched on, high yield spreads right now are down to about 390 over, which to us makes absolutely no sense. If you think that at some point we do get this slowdown, default rates will go up. Certainly, if we go back to some of the last episodes where we had a recession, high yield spreads went to the 800 basis point range.

Mark:. We don't really like high yield right now. We're still concentrated in investment grade credit. We think that's the best place to invest on the planet right now. Good quality companies are trading in the range of 5% to 6%. You'd only have to go back a year and a half ago, and we'd be lucky to get 2% or 3% on a good quality company. We're really being given a gift right now. Everybody knows we've talked a lot about discount bonds to improve the tax efficiency of the fund. We continue to buy discount bonds anywhere we can with any companies that we feel really good about.

The average price of the bonds we own across the portfolio is around $90.

Etienne: Yes, in the three funds.

Mark: We have a lot of tax efficiency. The yield in the funds right now is anywhere from 8% to 10%. They have a lot of yield, a lot of capital gain potential. We think things are positioned really, really well. The last thing I just want to touch onis the characteristics of the portfolio. We think a recession is coming, although the market thinks it's going to be a fairly soft landing. We just want to make sure the portfolio is positioned appropriately.

We are pretty well positioned and almost everything that we wanted to do in terms of positioning to tilt the funds to a more defensive posture has been done. The first thing that we've done is a few options trades, one involving governments and one involving credit. You may want to touch on that a little bit.

Etienne: Yes. As we approach the end of the cycle, and that's not a surprise for anybody, our playbook has been to have less credit exposure because the yield curve is always inverted at the end of the cycle. You can hide in the front end. Short-term bonds in credit yield quite a bit. As Mark hinted at earlier, we own a lot of very short-dated investment-grade bonds that yield anywhere from 5.5 to 7%. That’s where the bulk of the carry comes from and 30% of the portfolios have bonds that mature inside of a year.

Mark: Yes. We have a lot of liquidity that we're hoping to put to work at attractive valuations.

Etienne: The nice thing is we get paid for this liquidity because the yield curve is so inverted. That's the carry. The bulk of the portfolio is in the front end and IG and a little bit of high yield, but the high yield we have left is very, very short and very high-quality high yield. Then what we added, the other side of the barbell is a little bit of government bonds. 30-year government bond exposure in Canada and the US. In the Diversified Bond fund, we bought 30-year government bonds outright in Canada, and in all the funds, we layered TLT option exposure. TLT is the 30-year US government bond ETF.

We added exposure to long-term government bonds through a combinations of calls and puts on TLT. That affords us the ability to have a little bit of a margin of safety because of the way that the trade is structured. Also, because we do it through options, we don't need to sell a lot of highyielding short-term paper to buy more government bonds. The overall government bond exposure is about 12% in the Diversified Bond fund and 8% in the Liquid Alternative fund and OM product.

So far this year, it's added a little bit of volatility because interest rates have not rallied yet, but we know that typically as we enter recession, 10 and 30-year government bonds rally between anywhere between 100 and 150 basis points. We expect to get some good capital gains from that position when the recession finally happens. Then finally, we've also introduced a short position in HYG. HYG is the US high-yield ETF, as we mentioned earlier, high yield is priced to perfection right now.

Having this short position in high yield is also allowing us to potentially reduce the volatility of the fund and generate some capital gains once recession hits. The nice thing is right now, if you short HYG and you generate a bit of cash by shorting it, you can reinvest that cash in high-quality, short-term commercial paper, for example. It almost fully offsets the carry cost of being short HYG. We think this is a no-brainer at this point to have this almost flat carry credit hedge in the portfolio.

Mark: To summarize all across the board, our funds yield depending on the mandate, around 8% and as much as 10%. We have more liquidity in the fund because we want to be positioned if and when that recession happens. We have government bond exposure to give us a little ballast. We have hedges in credit to dampen out some of the volatility. The other thing that I'll touch on briefly is that we have also basically really minimized sectors that we think will be vulnerable.

Obviously one of the most topical things right now is real estate and we really don't have too much of that. We've reduced sectors that we think will be a little bit vulnerable. So the portfolios have lots of yield, defensively positioned, and our expectation is that this year will be more about carry than it will be about capital gains. With that said, I would also say that we're fairly optimistic about next year. Obviously we don't want to be talking about next year too early, but the way we're thinking about it right now is this year is really going to be about carry and next year will be about capital gains.

As I said, the funds are well positioned. We have good yield in them and the potential to make a pretty good return from the income in the portfolio. If we're right, next year at some point we get into recession, obviously, central banks will be cutting rates and at the point they start cutting rates, then we'll see probably a pretty significant rally in all risk markets. With that, credit will start to move. Then a lot of the corporate bonds that we bought over the years at these big discounts will start moving back up to par.

Again, we're pretty constructive this year. We're really constructive next year. Overall, I would say we're incredibly optimistic about fixed income just because we really, really get paid a lot more to invest in governments and credit than we have in 15 years. This is, to me, the best opportunity I've seen in ages. We don't have to go back that far where people would say, "Oh, geez, can you give me 2% or 3%?"

Now it's easy for us to get 5%, 6%, 7% while not taking a lot of risk. I don't think that interest rates are ever going to be as low as they were a year and a half ago because I think we're through that cycle. Anyway, that's another discussion.

Etienne: That's it for us.

Mark: Yes.

Etienne: Thank you.

Mark: Thank you so much.

Etienne: Have a good day and enjoy the rest of the summer.

NINEPOINT DIVERSIFIED BOND FUND - COMPOUNDED RETURNS[1] AS OF JUNE 30, 2023 (SERIES F NPP118) I INCEPTION DATE: AUGUST 5, 2010

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	Inception
Fund	0.1%	1.8%	0.0%	1.8%	0.6%	-2.1%	0.4%	2.4%	3.0%

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF JUNE 30, 2023 (SERIES F NPP507) I INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	Inception
Fund	0.5%	3.3%	1.4%	3.3%	3.3%	4.3%	3.8%	4.2%

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

	1M	YTD	3M	6M	1YR	Inception
Fund	0.6%	3.2%	1.5%	3.2%	2.0%	-2.4%

[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 June 30, 2023 [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 June 30, 2023. [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 June 30, 2023.

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