2022: Fasten your inflation seatbelts

Persistent and underestimated inflation has outdistanced Central Banks and will cause volatility in all asset classes.

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As we stand on the precipice of 2022, let's take stock of the current situation. The first major pandemic in the last 100 years has generated a unique set of economic and financial circumstances that is challenging our key economic institutions. The Bank of Canada and the Federal Reserve are wrestling with increasingly stubborn inflation that was generated by expansionary monetary policy, aggressive fiscal policy, supply chain issues, and a labour market undergoing tremendous change. That inflation is fuelled by pent-up demand in the majority of markets, including capital markets.

Are Central Banks Behind the 8 Ball?

Fed Chairman Powell admitted to playing catch-up on inflation in December by removing the word "transitory" from official guidance, kicking off a round of market volatility. How far behind are Central Banks? In our view, far.

Consider:

1. **The strength of employment is understated.** Headline unemployment numbers, which are in and of themselves strong, are lagging and do not convey the strength of meaningful employment metrics such as job openings. These metrics are underpinned by a COVID-induced labour market shift that is driving wage pressure.
2. **The complexity and persistence of supply chain issues has been underestimated by Central Banks.** For example, the automotive industry is forecast to produce the fewest number of cars since 1982. There is no quick fix for the worst bottleneck – a shortage of semi-conductor chips, a capital-intensive production process that takes time to expand. The knock-on effect is a strong inflationary boost in the form of a white-hot used car market that is not captured in official Canadian inflation statistics. Auto manufacturing is one of many examples that has CEOs around the world stumped for solutions to labour shortages and clogged shipping networks that are exacerbated by surging demand.
3. **Governments continue to stoke inflationary fires with fiscal measures.** Biden's Build Back Better Plan would have injected $2 trillion into the U.S. economy, in addition to the $1.9 trillion American Rescue Plan passed in March 2021. Although the Build Back Better Plan was stopped, it seems likely to be replaced by other spending measures. The Liberals show no sign of pulling back on spending, announcing a new round of significant increases in mid-December and eliminating any notion of "financial guardrails".
4. **Central Banks' easy money monetary decisions continue to add to inflationary pressures.** Low interest rates and bond purchase programs that are decreasing but still operating at meaningful levels create an enviroment where inflation thrives and persists.

What are the implications?

We expect that inflation will persist above current expectations and that Central Banks and markets will have to adjust accordingly. Interest rate increases for 2022 and 2023 have been baked in by the market. If inflation exceeds expectations, so too will Central Bank actions. A round of multiple rate increases beyond theose currently expected is a distinctly real possibility.

It remains to be seen whether higher interest rates will be enough to counter government spending that will not be pulled back quickly and a wall of demand that shows no signs of abating, especially considering supply bottlenecks that threaten to become more of an issue with Omicron. There is a strong probability that macro-economic uncertainty triggered by inflation will cause volatility across risk markets. Companies and bond issuers that are more susceptible to inflation eating into profits – those who cannot pass price increases onto their customers – will see even more volatility.

Asset Class Expectations

Whether or not inflation is being underestimated by Central Banks and the market, meaningful interest rate hikes are being taken as a given. Central Banks are also paring back their bond buying programs, removing a significant volume of demand from the bond market and adding to risk of further declines in bond values. For 2022 and beyond, traditional long-only bond strategies are saddled with the threat of declining bond values and low yields.

If our inflation thesis plays out or if there is a different macro shock, equity markets will descend from current lofty valuations. Credit markets will also be impacted with spreads increasing. Even without a macro shock, return expectations across the board are low.

In other words, all major asset classes face a challenging 2022. Now is not the time to add risk or chase yields.

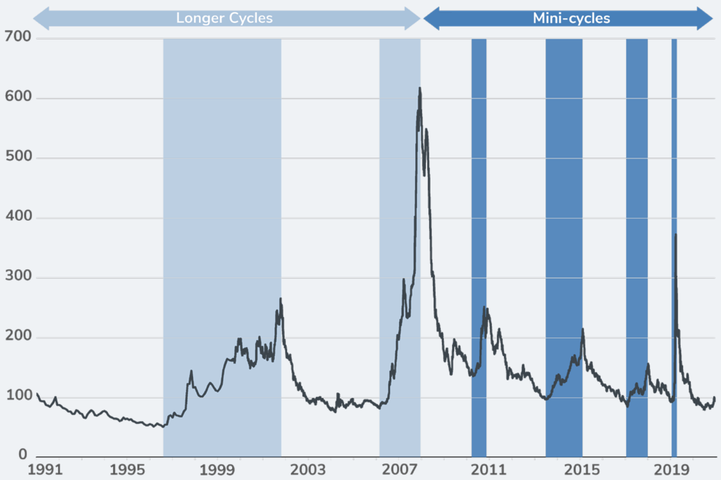
Public Credit in 2022

A major component of credit performance is a driven by default risk. Bonds issued by lower-rated issuers and bonds that have longer maturities have the highest degree of default risk and will bear the brunt of market volatility. There will be an opportunity to sidestep some risk by focusing on sectors and issuers that are less impacted by inflation, but it will not be possible to avoid it entirely.

That said, if we are right about negative markets, long / short credit managers have tools to deal with volatility, including eliminating interest rate risk, taking off credit risk and executing relative value opportunities and, in the worse set of circumstances, shorting credit.

A relatively recent credit market phenomenon may also provide some comfort. Since the Great Financial Crisis, credit market cycles have shortened considerably.

This chart presents U.S. spread data. The U.S. market provides insight for the Canadian investment grade market because, although the Canadian market is not as volatile, it is strongly directionally correlated to the U.S. market.



Bloomberg US Aggregate Corporate Average Option Adjusted Spread (Jan 1, 1991 - Dec 14, 2021)

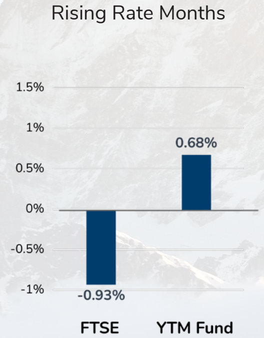
If inflation expectations are currently the main driver of volatility and if the Central Banks are able to emerge from behind the 8 ball, the possibility of a mini-credit cycle is in the mix and with it, an opportunity to position long/short credit funds for healthy returns.

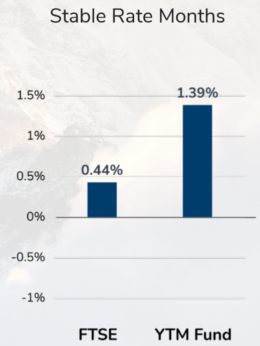
Smart choice

In this environment, investors who are looking for fixed income alternatives should identify funds that insulate against interest rate risk, emphasize higher quality issuers, protect on the downside, and provide absolute return potential. An actively managed long/short credit fund that is focused on short maturity investment grade issuers ticks a lot of boxes.

We hedge virtually all interest rate risk.

Since inception, YTM Capital Credit Opportunities Fund has outperformed long-only fixed income portfolios, as represented by the FTSE Canada Universe Bond Index, in rising rate (> 5 bps change) and stable rate environments (< 5 bps change).



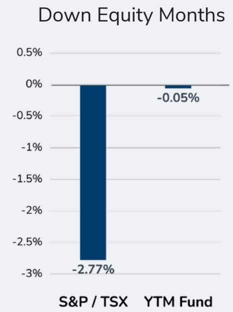


In the face of potential volatility in all asset classes, investors are considering de-risking their portfolios by moving to safer choices. For fixed-income, beyond eliminating interest rate risk, that means choosing higher credit quality with less credit duration and an active manager that has demonstrated an ability to navigate turbulence and provide positive returns in all environments.

We have anchored our Fund with a shorter maturity bias – 1.7 years on average since incepton – and we invest predominantly in investment grade issuers. Our discipline in adhering to these strategies stands out in the crowd of fixed income alternatives and is unique for long/short credit managers. And we have demonstrated an ability to manage through market turbulence.

The Fund has provided a positive return in every 12 month period since inception on July 1, 2015 and standard deviation below 5.

During that time equity markets have been down 25 of 77 months. Despite a generally positive correlation between equity and credit, the magnitude of change can be very different in an actively managed credit fund. The Fund has protected during those 25 months, as demonstrated by average monthly return compared to the S&P / TSX Index.



Private Credit in 2022

Most private credit strategies insulate investors from the immediate negative impact of interest rate increases faced by public market strategies. These funds do not mark-to-market daily and often hold debt until maturity, avoiding the crystallization of a discount when selling into a secondary market.

YTM Capital Mortgage Income Fund has 59% of its portfolio invested in insured mortages and cash. The main risks on the 41% uninsured portfolio are unemployment for its residential mortgages and an economic downturn that impacts the value of the collateral securing its New York City area mortgages. In the current overheated economy on both sides of the border neither of these risks is imminent. As we argue above, the strength of employment is understated and, despite a Canadian housing market at its peak, borrowers with jobs make their mortgage payments. In the U.S, economic growth is strong and life in the NYC area has largely returned to normal, notwithstanding COVID.

If interest rates increase in markets where the Fund lends money, the Fund has a short maturity profile of 7 months that allows it to reset mortgages at higher fixed rates. If inflation persists and the economy continues to grow, employment will continue on a positive path and the value of U.S. collateral should continue to grow, acting as a hedge against inflation. Accordingly, our expectation is that Fund will perform well in 2022.

As you establish investing plans for 2022, consider the role public and private credit can play in insulating your portfolio from the dark clouds on the horizon, as well as provide you with the potential for absolute returns.

YTM Capital Credit Opportunities Fund returns are for Class F, inital series, distributions reinvested. All Fund data is at November 30, 2021. FTSE Bond = FTSE Canada Universe Bond Index. The rate 10 year Government of Canada bond is used to determine rate environments. Past performance may not be repeated. This document is for information only and is not intended to solicit orders for the Funds. Investors should read a Fund's Offering Memorandum including the Risk Factors section before investing. **www.ytmcapital.com**

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