



Portfolio Managers' Quarterly

Q4 2021: Volatility Reduced Opportunity for Outperformance

Dear Fellow Investor:

The Bond Market in 2021 had one of its worst years since the rising interest rate environment of 1994, as the Bloomberg US Aggregate Bond Index declined 1.54%. The U.S. High Yield bond market did comparatively well against the Aggregate Index, gaining roughly 5% over the course of 2021. However, the High Yield market experienced considerable drawdown at junctures where the outlook was highly negative, causing indicators to issue sell signals to preserve capital.

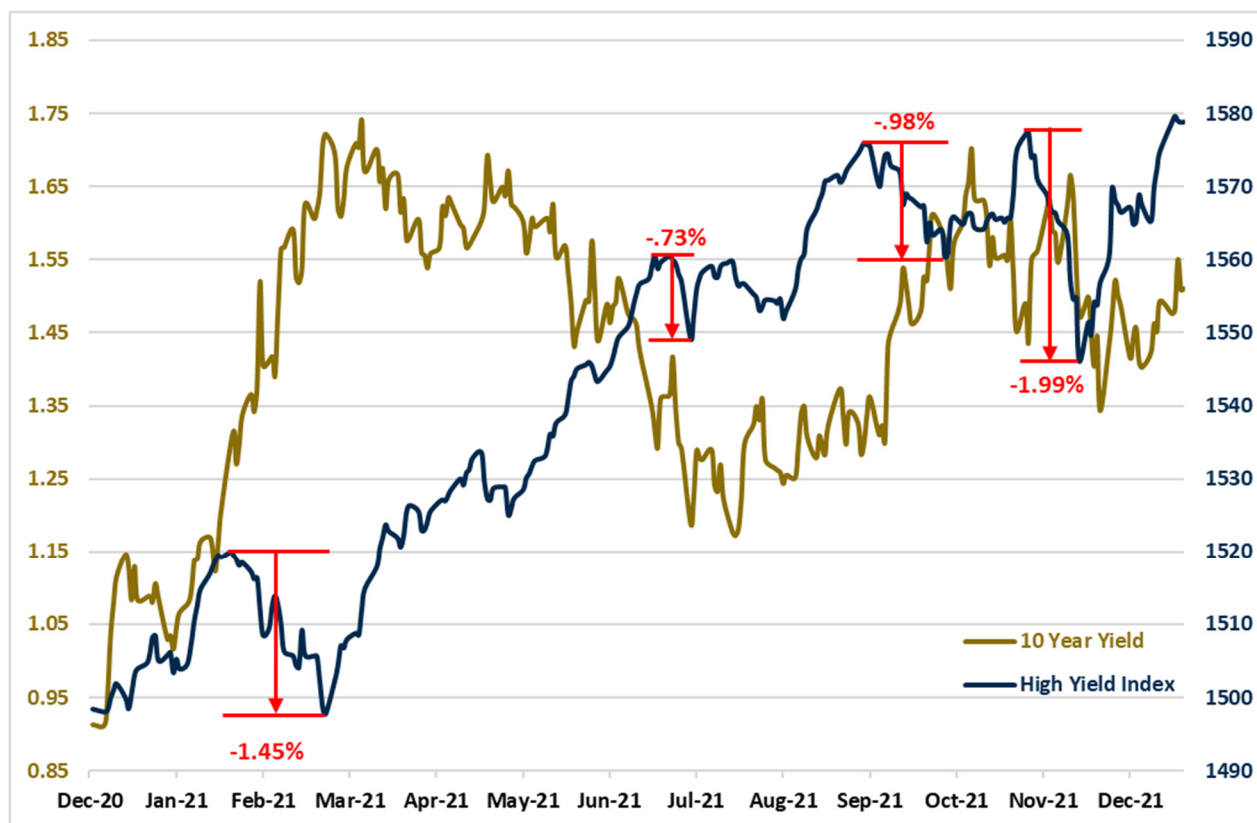
Bloomberg US Aggregate Bond Index (12/31/2020 - 12/31/2021)



Source: Bloomberg

The biggest story of 2021 was a rapid rise in inflation led primarily by supply chain disruptions and an extended period of dovish Federal Reserve monetary policy from the pandemic. With inflation came rapid increases in interest rates, as market participants determined whether inflation would be transitory or not, a debate still ongoing. Overlaying yield increases in the 10-Year Treasury note with drawdown periods in the High Yield market showcases this volatility.

ICE BofA US High Yield Index (white) and U.S. 10-Year Note Yield (yellow) (12/31/2020 - 12/31/2021)



Source: Bloomberg

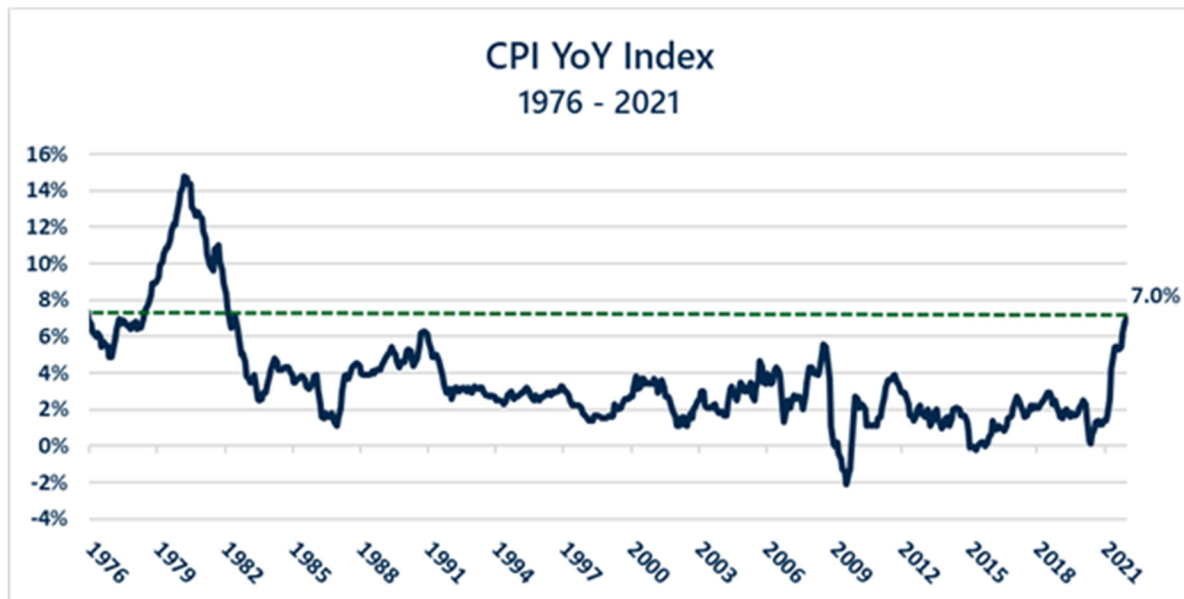
During these drawdown periods, our price-driven indicators reacted to risk and signaled prolonged caution, which delayed our re-entry to risk positions and led to our underperformance at times. Risk factors, such as new COVID-19 variants and early Federal Reserve tightening decisions, negatively impacted price, which led to strong momentum reactions from our technical indicators that remained negative despite positive price rebounds.

Outlook for 2022

BTS held the view last year that inflation would not be as transitory as many market participants thought it would be going into the latter half of 2021 and beyond. This view was given some credence as the Federal Reserve removed their transitory wording and sentiment regarding current inflationary pressures at their December meeting. Now the questions are: How high may inflation go? How long will it remain heightened? And; most importantly, will the Fed's response be aligned with the expectations that are already priced into the markets?

Year-over-year % change in the Consumer Price Index (CPI, a common measure of inflation) as of 12/31/21 was 7%, its highest level since 1982, as seen in the chart below. The worst-case scenario for markets is that the current increase ends up being more comparable to 1978 when inflation was still sharply on the rise, than to 1982 when conditions were settling back to a more normal range. If this

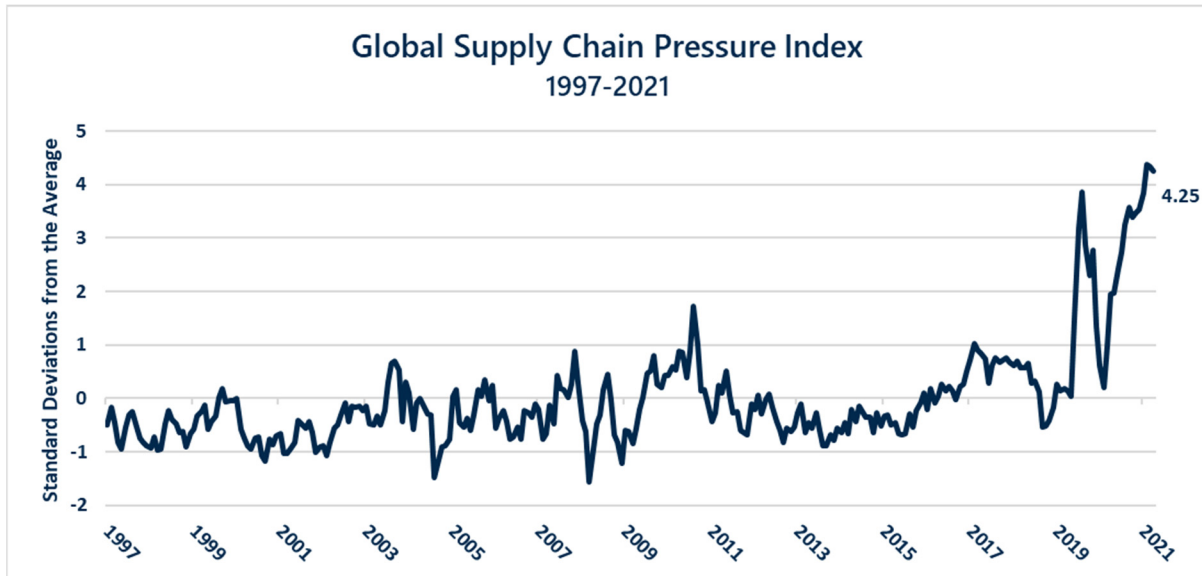
pattern were to repeat, further depression of real yields and erosion of consumer purchasing power could wreak havoc.



Source: Bloomberg

More optimistically, there are some signs that inflation pressures are beginning to abate independently of any intervention by the Fed. On the demand side, personal savings rates that reached all-time highs during the pandemic have dropped dramatically in the last few months. We often cited these elevated rates as an indication of pent-up demand that would lead to persistent inflation, and we now see this return to pre-pandemic levels as a sign of more sustainable aggregate demand moving forward.

As for aggregate supply, disruptions and shortages remain rampant; however, we are starting to see signs that supply chain pressures could be peaking. **A newly developed metric by the New York Federal Reserve called The Global Supply Chain Pressure Index combines several of Wall Street's favorite supply-chain measures into one integrated tool.** A reading of 0 indicates an average level of global supply chain pressure, while positive readings indicate standard deviations above the average, and vice versa. Recently, the index had increased for four straight months to reach nearly 4.5 standard deviations above average, signifying an astronomical level of supply chain pressures. However, as a much-needed sign of relief, the index has now declined for two consecutive months for the first time since October 2020.



Source: Gianluca Benigno, Julian di Giovanni, Jan J. J. Groen, and Adam I. Noble, "A New Barometer of Global Supply Chain Pressures" Federal Reserve Bank of New York Liberty Street Economics, January 4, 2022, <https://libertystreeteconomics.newyorkfed.org/2022/01/a-new-barometer-of-global-supply-chain-pressures/>.

Alternative scenarios arise when you consider how the Fed may approach monetary policy in response to inflation. There are two distinct risks at play:

1. Immediate Tightening

On the one hand, the Fed may move too aggressively to tighten monetary policy at a time when conditions were beginning to ease anyways, potentially undercutting growth and earnings momentum. Bond markets can typically cope with some modest tightening if inflation does appear to be receding, with high yield bonds even less sensitive to these types of negative catalysts. Thus, this scenario wouldn't necessarily spell disaster for bonds, but the level of tightening could be pivotal.

Moreover, another risk in this scenario is that of an inverted yield curve, wherein long-term rates decline under short term rates, which has been a reliable indicator of predicting future recessions. Inversion of the yield curve is still possible given the marginal differences between short and long-term rates. Stocks may react to an inverted yield curve well before recession because the bond market is often a leading indicator. An inverted yield curve would suggest that bonds are discounting weaker inflation due to tightening monetary conditions which would slow economic growth.

2. Delayed Aggressive Tightening

On the other hand, the Fed may remain overly supportive of economic growth, allowing rates to stay low until price pressures eventually build to levels that necessitate more aggressive tightening than initially expected. This is, in our view, the biggest risk in the markets and one that could lead to a recession sooner than many expect.

Rising rates, as always, remain a risk to bonds, especially those with high duration. As mentioned earlier, the worst bond market year on record, 1994, was at least partially a result of overly aggressive rate hikes by the Fed. With the yield on 10-year notes recently surpassing 1.7%, and with the pressure on the

Fed to manage inflation, it will be important to see if this momentum may carry yields across the 2% threshold and beyond. For high yield bonds, resilience towards rising rates, solid corporate profitability, relatively attractive yields, and extremely favorable default and recovery rates, are all encouraging signs that there are still opportunities in that market, albeit with increased volatility due to rising rates.

Thus, to summarize, BTS expects inflation that could be roughly 2-3% above typical core inflation in 2022. The realization of this reality, which would be supported by a further increase in treasury yields, increases the probability of a 10-15% correction in stocks.

A tactical approach may reduce the risk and volatility associated with this possibility, while potentially offering a hedge to the stock side of one's portfolio.

Moreover, from our view, both bond and stock market gains may be limited in the next few years with volatile return streams. Therefore, we think strategies with mandates of preservation of capital may add value to a portfolio during this period.

At BTS, we remain ready to adapt to ever-changing market conditions. Thank you for the opportunity to manage your assets.

Sincerely,

Vilis Pastis
Matthew Pastis, CMT
Isaac Braley
Co-Portfolio Managers

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IMPORTANT RISK INFORMATION

Investing, including investing in mutual funds, involves risk, including possible loss of principal. There is no assurance that any strategy will achieve its investment objective. The value of fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower quality bonds known as "high yield" or "junk" bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds and reduce the Portfolio Manager's ability to sell its bonds. The use of leverage within a strategy will indirectly cause additional expenses and could potentially magnify the gains or losses.

The S&P 500 includes 500 leading companies in leading industries of the US economy and is a proxy for the total stock market.

Bloomberg Aggregate Bond Index - An index used by bond funds as a benchmark to measure their relative performance. The index includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

The Lipper High Yield Index is an unmanaged index of the 30 largest high yield mutual funds based on total year-end net asset value. It assumes the reinvestment of dividends and capital gains, as well as management fees and expenses, but does not include any actual management fees or expenses associated with a fund.

ICE BofAML US High Yield tracks the performance of US dollar-denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one-year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$100 million. Also, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe, or territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway, and Sweden.

Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market of consumer goods and services.

Global Supply Chain Pressure Index is a tool from the New York Federal Reserve that integrates several commonly used metrics with an aim to provide a more comprehensive summary of potential disruptions affecting global supply chains.

**Index returns are for illustrative purposes only and should not be construed as BTS model performance or performance achieved by any BTS client. More specifically, any reference to index returns during isolated or defined periods in time is for reference only and is not meant to imply index returns are indicative of actual returns achieved in client portfolios. Investors cannot invest directly in an index, and index returns do not reflect management fees, custodial fees or brokerage commissions, which vary depending upon the custodian chosen.*

Source: **Morningstar (for index returns)**

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