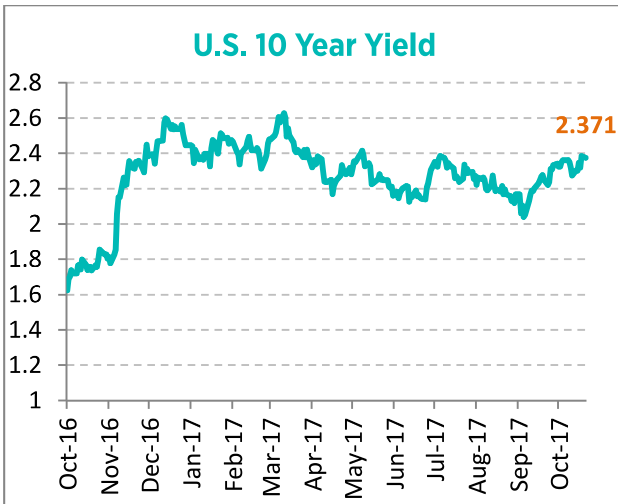
SPROTT CREDIT INCOME OPPORTUNITIES FUND

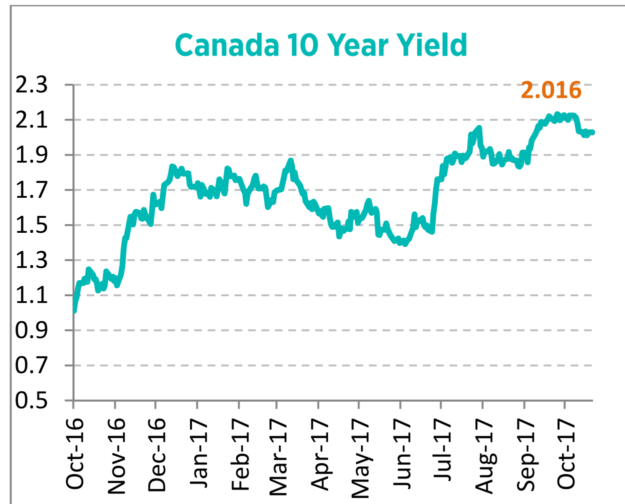
Q3 2017 Commentary

The Sprott Credit Income Opportunities Fund (Series A) was up +1.02% in Q3 2017, +3.15% YTD.

It finally feels like the world is in a better economic place. Here in Canada, we have had a decent run of good data and there is considerable improvement in the global economy. In the US, it has been a slightly different story, as they have had their challenges, mainly politically, but this is unlikely to significantly impact their economy. Despite all the government changes throughout the world, through the rise of populism, there has been a complete absence of political volatility. Globally, Central Banks are starting to signal an exit from accommodative monetary policy. Government bond markets, aside from Canada, have not bought into this enthusiasm, as they continue to be fixated on the lack of inflation and fear that higher rates will derail the global recovery. The price of corporate credit continues to be fairly stable, performing slightly better this quarter. For credit spreads on investment grade (IG) and high yield (HY) to move materially tighter, there would need to be a greater pick-up in economic activity and with that higher government yields and a re-steepening of the yield curve. At this point in the cycle, we are modestly constructive on investment grade spreads and slightly negative on the prospects for further price appreciation in high yield. We would need to see significantly higher growth in the global economy and at least some form of tax cuts in the US to consider increasing our credit exposure.

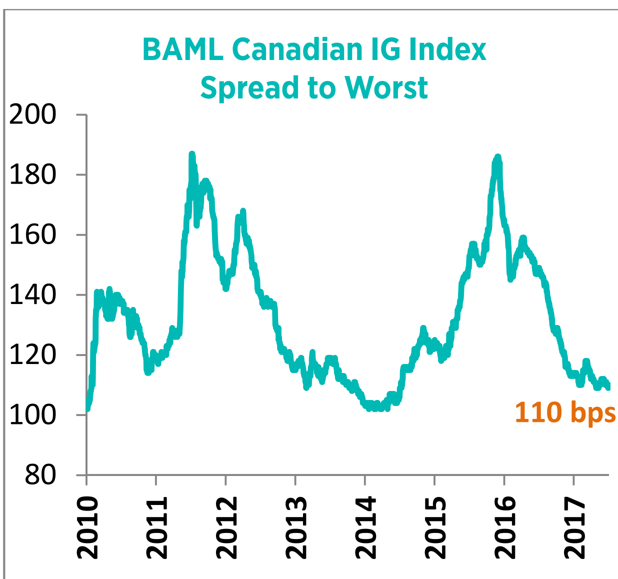
The Bank of Canada (BoC) raised rates for the second time this year, bringing the overnight rate to 1%.The odds of an increase in December are lower now, just 42% after two BoC Governors noted the appreciation of the currency and recent mixed economic reports. Here in Canada, we have experienced a big move in interest rates as yields have climbed as much as 0.70%, ten year Canada bonds now yield around 2.1% and all this with the absence of any inflation. This move has made the all-in yield on investment grade credit, especially 5 year and under, the term we prefer, much more attractive. In the US, interest rates have drifted sideways, with 10 year treasuries now at 2.34%, very close to where they started the year. Based on the most recent Fed meeting, it looks like they will likely raise interest rates one more time this year, as the market odds of a December hike have now moved to 84%. My view is that rates in the US will start to drift upward as some form of tax reform and infrastructure spending gets approved and activity pick-ups post the hurricanes destruction. By the end of this year, 10 year rates in the US and Canada probably approach 2.5% to 2.75% and with any signs of inflation probably closer to 3%. I view rising rates as the biggest risk for fixed income funds; consequently we have continued to maintain a low duration bias.

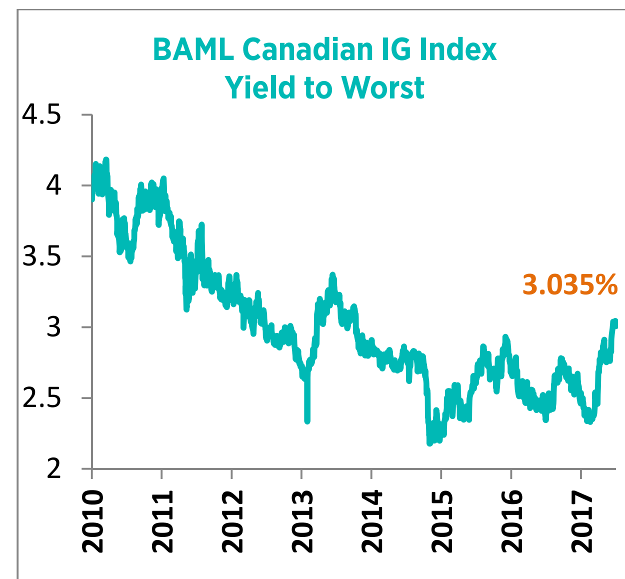




Source: Bloomberg

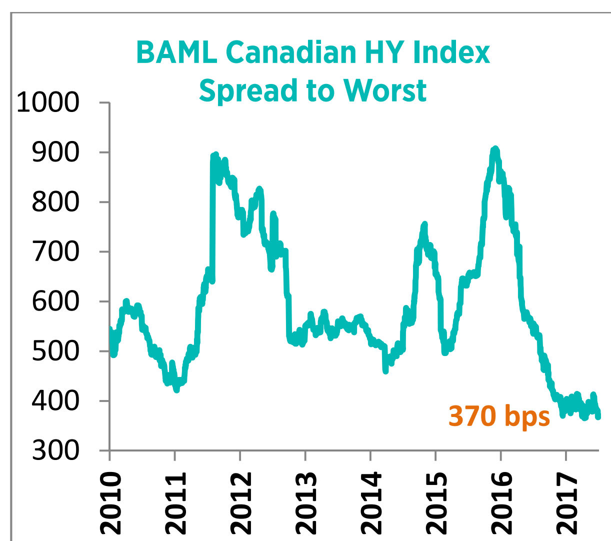
During the quarter, Canadian investment grade performed marginally better. The credit spread on the Merrill Lynch Canadian Investment Grade Index moved in a miniscule 3bp to 110bps, tighter by 19bps YTD. With Canadian government yields having risen anywhere from 0.60% to 0.75%, the return potential on investment grade credit has improved. Corporate BBB 5 year bonds with a credit spread of 127bps now generate a yield of 3.1%, much higher than the mid 2% range available earlier in the year. Consequently, we've seen many great income producing opportunities in short dated credit. Higher government bond yields do eventually produce some benefits! The best performing 5-year sectors for the quarter were Insurance, Bank NVCC, Sub-debt and Real Estate. New issue supply was around $32.1 billion last quarter, $91.9 billion YTD, roughly 21% ahead of YTD 2016's issuance. Net new additions to our investment grade portfolio were Alimentation Couche-Tard Inc., Pembina Pipeline Corp., Empire Co., Capital Power Corp., Bank Of America, CI Financial, Enbridge Inc., McDonalds Corp. and BCE Inc.

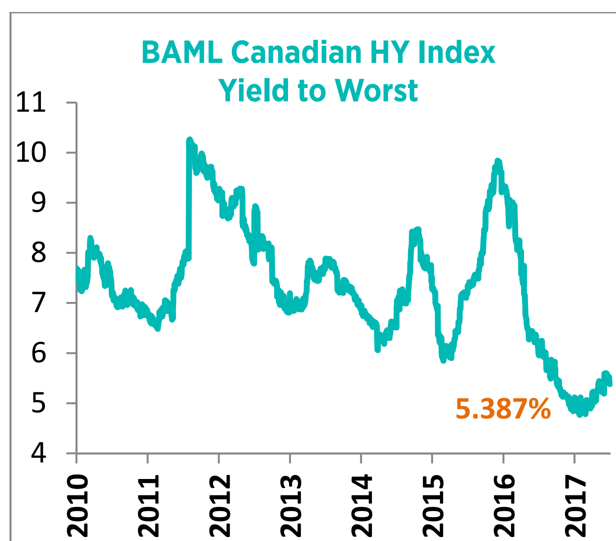




Source: Bloomberg

The Merrill Lynch Canadian High Yield Master Index closed out the quarter at a spread of 370bps, with an all in yield of 5.39%, tighter by 21bps and in 59bps from the start of the year. Although the credit spread on high yield today is reasonable, from a historic perspective (it was 202bps back in July 2007), the all-in yield is at a multiyear low yield of 5.39%. Relative to investment grade credit, we view HY as moderately expensive, regardless of how low default rates are, improved economic growth and an absence of inflation. Given the current low volatility environment, it is possible that spreads remain unchanged or grind in slightly. If we adopt this as our base case scenario, adjusting the HY spread (3.7%) for a default rate of 2.4% and a recovery 53%, one could expect to earn an excess 2.5% relative to governments. That is a skinny buffer for high yield, considering we are in the late stages of the credit cycle, where spreads are more prone to widen.



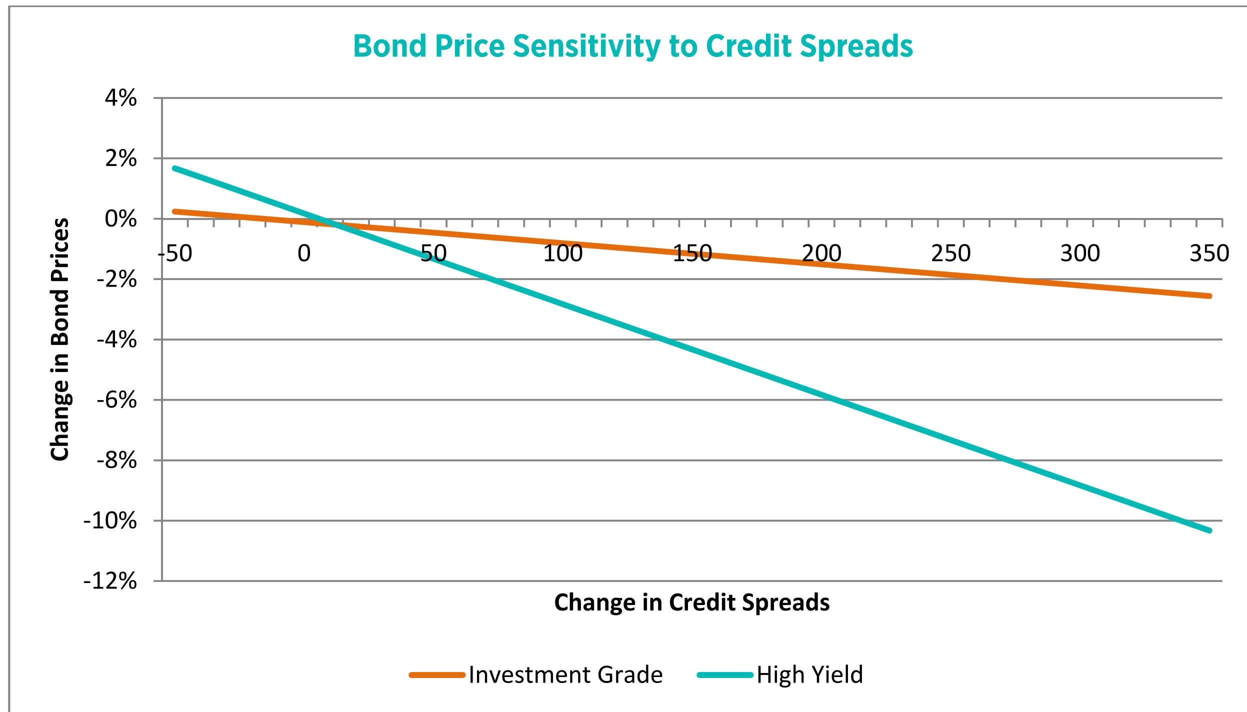


Source: Bloomberg

This is illustrated in the chart on the next page, which presents the historical relationship between U.S. HY and IG bond prices and credit spreads, in periods of very low spreads (bottom quartile of their historical distribution).

The intuition is as follows: in periods of very low spreads, they have nowhere to go but up. Additionally, spreads have a tendency to go up when interest rates go down (a typical risk-off environment). Higher spreads impact HY disproportionately, as shown in the chart below (steep green curve), because they are pure credit instruments. By contrast, investment grade is more sensitive to interest rates, offsetting wider spreads (red, flatter relationship in the chart below).

Consequently, we are currently reducing high yield exposure and exploring other ways to add better yield with better risk-reward characteristics. New high yield additions to our portfolio over 3Q17 were Element Fleet Management Corp convertibles and Gibson Energy Inc.



Note: The graph represents regression lines estimated from BAML Investment grade and High Yield indices using price and spread to worst over the period 1996 to 2017. The subsample used represents times when spreads were below their 25th percentile (i.e. very low).

Source: BAML bond indices through Bloomberg LP & Ninepoint Partners calculations.

Over the last quarter we've been investigating alternative income strategies for the portfolio, such as using blue chip, dividend paying equities and options to generate bond-like income. As equities have significantly more downside price risk than bonds, utilizing options allow us to alter the risk in the position. For example, a few months ago, one could have bought Royal Bank stock at $91.93, and using January 2020 options, sell an at-the-money ($92) call to finance the purchase of a $88 to $80 put spread, collecting $2 of premium. In addition to the option premium, the investor collects the expected dividend of $8 per share to expiry in January 2020.The table below presents the expected P/L of this strategy under different Royal stock price scenarios. In every case, except where RY stock goes down 20% to 30% we earn a better return than equivalent duration RY bonds. If we executed a trade of this type it would be scaled in size to mimic a typical bond position and be limited to high quality companies, at this point mainly banks.

Stock Price Move (%)	Historical Probability of Outcome (since 1990)	Strategy Total Return (%)	Strategy Annualized Return (%)	Equivalent Duration RY Bond Yield
-30%	0.3%	-10%	-4.4%	2.12%
-20%	1.7%	0%	-0.2%	2.12%
-10%	36%	7%	2.8%	2.12%
0%	58%	11%	4.6%	2.12%
+10%	5%	11%	4.7%	2.12%
+20%	0%	11%	4.7%	2.12%

For illustrative purposes only

Throughout the last quarter, we have continued to be conservatively biased. The core portfolio has 33% cash (mostly BA's), 30% investment grade, 25% high yield, 2% secured loans, and 10% equities, primarily preferred shares. Portfolio duration is at 1.4 years and leverage is 0.8 times. The overlay portfolio (the leverage) is entirely investment grade credit, interest rate-hedged with government bonds with an average rating of BBB. From a currency perspective, we have a USD weight of 16%. Our fund's yield is around 5%, not bad considering the risk characteristics of the portfolio and the fact that a 10 year Canada bonds yields 2.1%. For the balance of the year our plan is to maintain our low leverage, add investment grade credit to the core, reduce our high yield exposure, increase our loan positions and initiate some different options positions that generate income and provide tail hedges to mitigate a correction in credit.

Government bond yields and the flattening of the yield curve suggest caution and a looming economic slowdown somewhere on the horizon. There is a fair bit of complacency in the credit markets and frankly, if history is any guide, we could trend in a sideways direction for another year. We continue to see many interesting opportunities in the credit markets, but we are becoming more selective. With a yield of 5% and a 33% cash position we believe we are well positioned to patiently wait.

Regards,

Mark, Chris & Etienne
The Fixed Income Team

SPROTT CREDIT INCOME OPPORTUNITIES FUND

Q3 Commentary

MONTHLY RETURNS (%) AS AT SEPTEMBER 28, 2017 [1]

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2017	-0.12	1.42	0.29	0.67	0.08	-0.25	0.22	-0.14	0.94				**3.15**
2016	-2.29	-2.00	3.18	1.19	2.05	0.62	1.73	1.04	0.52	1.11	0.74	1.15	**9.27**
2015	1.81	1.11	1.23	0.15	0.65	-0.68	-0.06	-0.84	-0.40	-0.30	0.65	-0.12	**3.20**
2014	1.26	1.50	1.16	0.59	1.19	0.45	0.50	-0.23	0.41	-0.54	-0.11	0.98	**5.30**
2013	1.62	-0.29	-0.17	1.00	2.45	-3.15	1.80	0.23	0.13	1.05	1.11	0.42	**6.25**

COMPOUNDED RETURNS (%) [1]

	1 MTH	YTD	3 MTH	6 MTH	1 YR	3 YR	ANNUALIZED INCEPTION (01/16/13)
SPROTT CREDIT INCOME OPPORTUNITIES FUND	0.94	3.15	1.02	1.53	6.27	4.60	5.75
FTSE TMX CANADA ALL CORPORATE BOND INDEX	-1.09	1.49	-1.34	-0.33	-0.36	3.28	3.45

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† Formerly Davis Rea Enhanced Income Fund. Effective June 1, 2015, Davis Rea Enhanced Income Fund became Sprott Credit Income Opportunities Fund.
[1] All returns and fund details are a) based on Class A units (closed to subscriptions); b) net of fees; c) annualized if period is greater than one year; d) as at September 28, 2017. The index is 100% FTSE TMX Canada All Corporate Bond Index and is computed by Ninepoint Partners LP based on publicly available index information.

The Sprott Credit Income Opportunities Fund is generally exposed to the following risks. See the offering memorandum of the Fund for a description of these risks: speculative investment; general economic and market conditions; assessment of the market; not a public mutual fund; limited operating history for the fund; class risk; charges to the fund; changes in investment objective; strategies and restrictions; unitholders not entitled to participate in management; dependence of the manager on key personnel; reliance on the manager; resale restrictions; illiquidity; possible effect of redemptions; liability of unitholders; potential indemnification obligations; lack of independent experts representing unitholders; no involvement of unaffiliated selling agent; valuation of the fund's investments; concentration; foreign investment risk; illiquidity of underlying investments; part X.2 tax; litigation; fixed income securities; equity securities; idle cash; currency risk; suspension of trading.

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