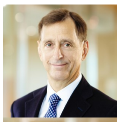
Credit Income Opportunities Fund

Q1 2018 Commentary

The Ninepoint Credit Income Opportunities Fund (Series A) was up 0.15% in Q1 2018.

After a decent year, major economies, throughout the world are starting off 2018 on a steady growth trajectory – the IMF recently upgraded their global growth forecast to 3.9% for 2018. Throughout the developed world there is record low unemployment, wage pressures are rising, commodity prices are increasing, the output gap is closing and inflation expectations are intensifying. Major central banks are telegraphing a bias to taper quantitative easing programs and raise interest rates. Newly elected populist governments are advocating greater fiscal spending, which will equate to larger deficits and with that more government bonds for sales to fund initiatives like tax cuts and infrastructure projects.

Investment Team



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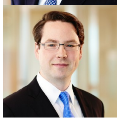

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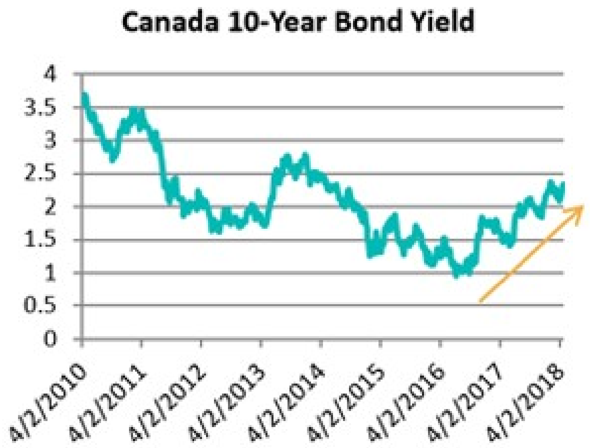
Typically, this would all be a text book concoction for higher interest rates, except President Trump decided to talk tough on trade and the US trade deficit, intensifying market volatility. If a full out global trade war was triggered, the current pace of global economic growth would be weakened, consequently there was a flight to quality in government bonds and equities and credit were under pressure for most of the quarter. It's hard to imagine that tariffs alone would be the best way to reduce the US trade deficit and protect American jobs.

Given the lack of process and transparency by Trump on these that tariffs, it appears he could be posturing, ahead of the mid-term elections and they will never be implemented to the degree and extent that he's threatened. Based on the most recent NAFTA discussions, it doesn't seem that Canada or Mexico would be hit that hard by changes to that trade agreement. What known unknowns can we expect for 2018? More Trump induced volatility!



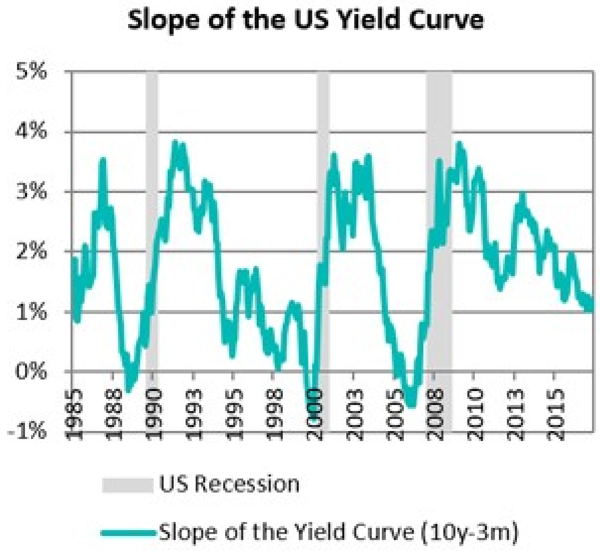
Source: Bloomberg

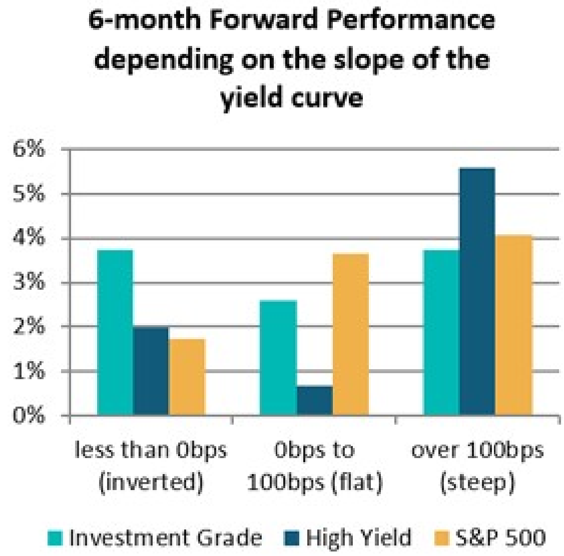
In the most recent US Federal Reserve meeting the committee discussed the potential of 3 to 4 rate increases for 2018 and a further 3 in 2019, which sounds reasonable given high employment, steady economic growth and rising inflation expectations.

In Canada, it's a different story, NAFTA negotiations have stalled the Bank of Canada's eagerness to raise interest rates, until they get more clarity on the terms of trade, even though economic conditions here remain favorable. Prior to the US trade rhetoric, the consensus was for as many as 3 increases here in 2018. The market is currently down-playing that by assigning only a 65% chance of a third rate hike by year-end. Consequently, Canadian currency had drifted back to 1.288 and the yield on the 10-year Canadian government bond had declined to 2.1% at quarter-end.

We're still very upbeat on the economy, here in Canada and believe that the improvement in global growth will continue to be supportive for commodities, off-setting the expected decline in housing activity brought on by higher mortgage rates and the new qualifying rules for borrowers. Post the NAFTA agreement, we still expect the BoC to raise rates 2 more times, bringing the benchmark rate to 1.75% which is still well below the Bank's neutral level of between 2.5% and 3.5%. The Canadian dollar in that scenario should appreciate to 1.22 and 10-year Canadian government bonds yields should approach 2.75%. In the US, we're hard-pressed to believe why 10-year treasuries don't yield greater than 3%.

Putting it all together, we're anticipating higher interest rates in 2018, a flatter yield curve, inflation that exceeds most central bank's targets, and more volatility. If economic growth surprises to the upside, we'd expect the returns on fixed income credit to be reasonable, similar to last year.





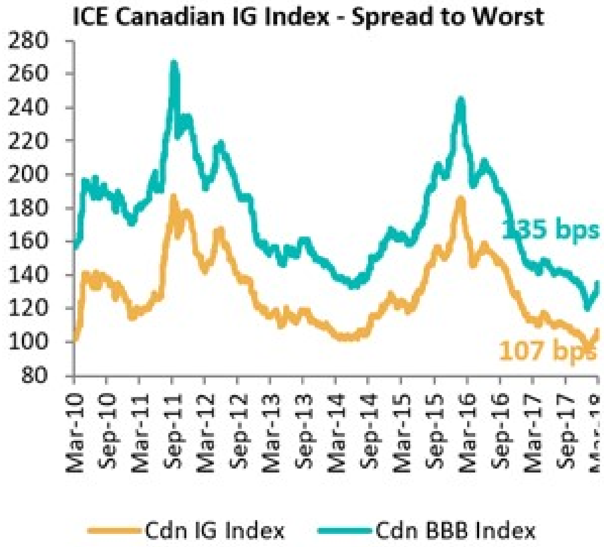
Source: Bloomberg - Ninepoint Partners Calculations

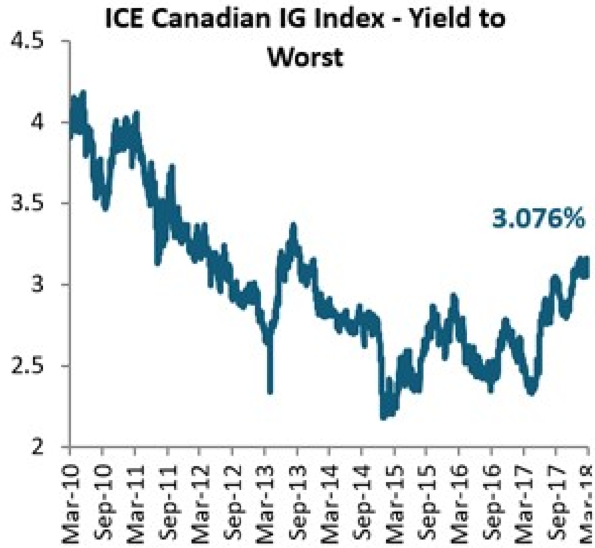
As we've expected, the slope of the yield curve here in Canada and the US continues to flatten, and the 3 month-10 year spread is narrowing. That's the result of higher short-term rates induced by central bank increases and the government bond market's pessimistic view on inflation and the duration of the business cycle, which is holding longer-term yields down.

Our yield curve model suggests that the current slope of the yield curve equates to about a 10% chance of recession, in the next 12 months – not that material, yet. If the yield curve continues the current pace of flattening, we would expect that probability to grow to 35% in early 2019 and increase from that point on, possibly signaling a recession later in 2020.

I've added a chart above that illustrates different degrees of slope in the curve (from inverted to steep) and how different securities preform 6 months forward. Returns on credit or equities aren't typically that great when the curve starts to invert, as the economy is probably going into recession and credit metrics are deteriorating and default rates are increasing.

Although we are very mindful of the yield curve and its transition, we recognize that full inversion is still a ways away, as such we have not altered our low duration stance, but we have started to adjust our fund through, credit quality upgrades, credit hedges and gross exposure reductions – less portfolio leverage.



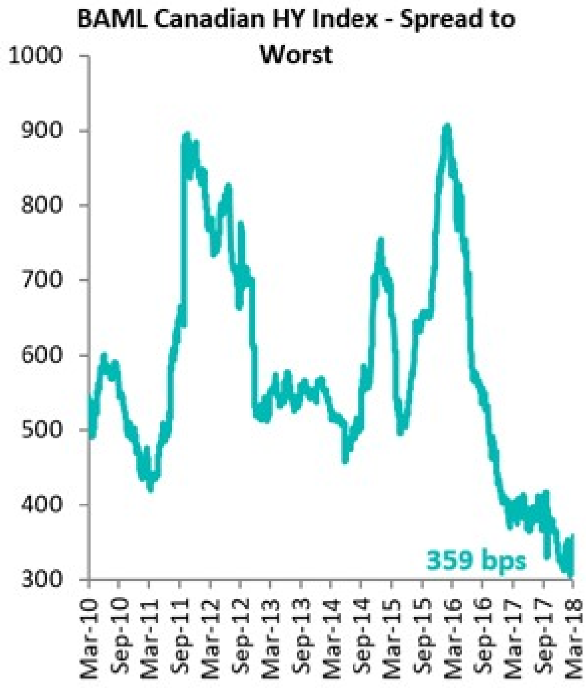


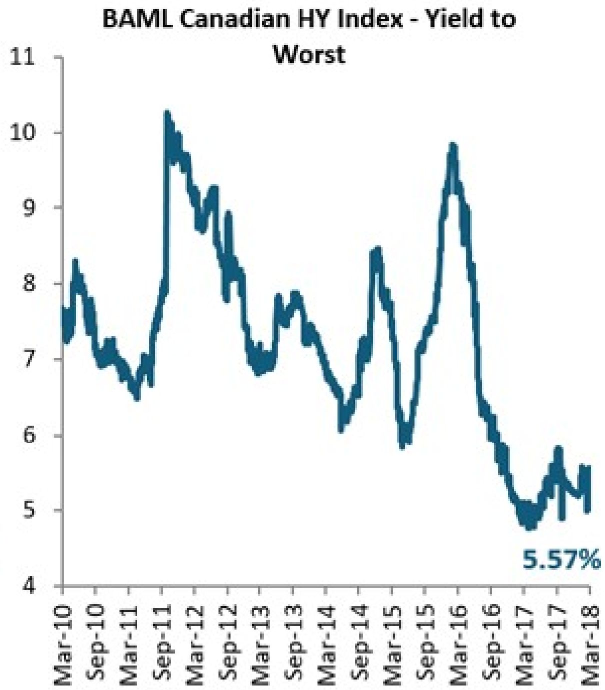
Source: Bloomberg

Regardless of the increase in volatility this quarter, investors have continued pumping money into corporate bonds. New deals are still being priced with slim concessions and continue to be well oversubscribed – average fills have been in the area of 20%.

Early in the quarter, IG credit was initially under some pressure as volatility escalated for the first time since the summer of 2015. Remarkably, investment grade credit spreads improved later in the quarter, closing out March modestly wider – ICE, formerly the Merrill Lynch Canadian Investment Grade Index, moved out 3bps to 107bps. As the yield on Canadian government bonds continues to rise, we still see shorter dated BBB corporate bonds, yielding between 3.25% and 4% as our favorite investment. As well we have been adding floating rate securities to the portfolio - about a 9% weight. These bonds now yield around 3.1% and with every increase in rates by the BoC or the FED we get paid a higher coupon rate.

New net additions to the portfolio over the quarter were: Choice Properties Real Estate, Ford Motor Credit Floating Rate, Goldman Sachs Floating Rate, Lloyds Banking Group, National Bank of Canada, Bruce Power LP., SNC Lavalin Group Inc., Home Capital Group, Pembina Pipeline and CIBC.





Source: Bloomberg

With all the volatility in the equity markets we can't believe that high yield bond spreads haven't increased more than they have. This could be partially explained by higher energy prices that have improved the valuations of oil E&P Co.'s and servicer's bonds, which make up about 26% of the high yield index.

During the recent quarter the ICE Canadian High Yield Index widened out 22bps, to a spread of 359bps and an all-in yield of 5.57%. At a spread differential of about 2.2%, between high yield and BBB investment grade credit, we feel an investor isn't being adequately compensated for the greater credit risk in junk bonds. For high yield bonds to make more sense for us, we'd prefer yields to be in the range of 7% to 8%. Although we still own about a 27% weight in high yield, we added credit hedges to mitigate some of the risk on these securities. During the quarter we tiled our exposure towards natural gas – net new additions to the portfolio were: Superior Plus LP. and NuVista Energy Ltd.

As discussed in previous quarterly commentaries, we are utilizing options as another tool to alter our positioning. Options provide us with a liquid, low cost way to adjust credit exposure or duration. In January, when HY spreads were at their tightest level and the JNK ETF was trading very close to its recent high price ($36.96), we initiated options positions on that ETF to hedge some of our HY exposure. We sold a call spread to fully finance the purchase of a put spread with a 9-month maturity. The net effect of this trade was equivalent to hedging 15% of our fund's HY exposure, at no cost.

So far this year, we haven't altered our conservative positioning bias and it's paying off. Our core portfolio has 28% cash, 33% investment grade (of which 9% are floating rate), 27% high yield (partially hedged), 7% secured loans and 5% preferred equities. The average credit quality of the portfolio is BBB – and leverage continues to be low at 0.77 times. The overlay portfolio (the leverage) is entirely investment grade credit with an average duration of 5 years, interest rate-hedged with government bonds. From a currency perspective our USD weight, consistent with our positive view on Canada, is 0%. With the addition of the portfolio options positions, we have effectively lowered our aggregate duration to zero and the fund yields 5%.

I'm not expecting outsized returns in credit this year. My opinion is primarily based on valuations. Right now, the majority of the securities that we are invested in look to be adequately priced relative to the economic environment and the expected duration of the current business cycle. Although the yield on government bonds is making higher quality credit look much more attractive, lower rated credit, the juicy stuff, isn't looking like great risk-reward. So for now, we're content to stick with our conservative positioning bias and wait for higher interest rates and inflation to elevate volatility and produce attractive opportunities that are better suited to us.

Regards,
Mark, Etienne and Chris

[1] Formerly Davis Rea Enhanced Income Fund. Effective June 1, 2015, Davis Rea Enhanced Income Fund became Ninepoint Credit Income Opportunities Fund.

[2] 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 April 30, 2018. The index is 100% FTSE TMX Canada All Corporate Bond Index and is computed by Ninepoint Partners LP based on publicly available index information.

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