Enhanced Equity Strategy

February 2018 Commentary

Investment Team

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The Fast and the Furious

The return of volatility in February was both fast and furious during an action-packed month for global financial markets. The first real equity market correction since early 2016 began due to the big (and largely unanticipated) upward move in long-term interest rates but quickly picked up speed as volatility spiked causing several retail "short VIX" products to implode. There was a bit of a "flash crash" feel to the two large daily declines (both days saw declines of over 4% in the broad equity market indices) which occurred over the span of a week but as has been the case for the past few years, markets rallied back sharply and recovered losses very quickly.

While the February spike in volatility was certainly extreme (the VIX rose from roughly 13 to over 37 in just a couple of days at the start of the month), the current 15-20 range for the VIX feels about "normal". We see the 2017 environment of less than 12 on the VIX (and even below 10 for a sustained period) as the anomaly given long-term VIX average of about 15. We also feel that with rates normalizing, global pension funds and large systematic funds are no longer as starved for low-risk carry strategies. These funds can now invest in higher yielding short-term treasuries as opposed to taking more risk by selling insurance on markets (shorting volatility).

For the month, the S&P 500 declined by 3.7% while the TSX fared slightly better, dropping 3%. The U.S. dollar had a big rally, rising 4.4% in February, more than offsetting the S&P 500's monthly decline for a Canadian investor as long as you were unhedged on your USD exposure. Our Canadian dollar denominated funds are always at least partially hedged on our USD exposure to help limit losses in times when the USD declines relative to the CAD and this past month was no different. Although we have some USD exposure, we have limited it at roughly 10% of our fund due to our risk limits (as opposed to our 50/50 S&P500/TSX benchmark which is 50% long the USD). For February, our benchmark declined 1.2% but would have declined 3.4% without the benefit of the stronger U.S. dollar. Our funds performed quite well during the stress test of the two large daily declines and overall, we were quite pleased with the performance of our hedging strategy over this period. Our overall performance was down on the month, though better than our benchmark once you consider the impact of our currency hedging.

The stronger U.S. dollar also hit commodities as oil (WTI down 4.5%) and gold (down 2%) both declined in February following a strong January. The 10-year U.S. Treasury yield climbed sharply last month, rising from 2.70% to peak at 2.95% before falling back to close the month at 2.86%. To give you an idea of the size of the recent run in yields, the U.S. 10-year yield was near 2% as recently as when school started last September.

Macro Outlook

We have held the view for the past several months that understated expectations for Federal Reserve rate hikes were the largest risk factor for equities, but the market acknowledgement of

those risks occurred much more quickly than we expected. Fed Fund futures have moved from pricing in only a single rate hike in 2018 as recently as last December to pricing in four currently. Meanwhile, inflation expectations have moved back to 2.15% and, while still below the ~2.6% average of the preceding decade, are still well off the 2016 lows of 1.4%. We are now less concerned on the market's positioning relative to 2018 rates given the recent repricing of inflation expectations and higher actual real rates. We think 2.8%-3% is likely to be a point where bond markets consolidate short term, likely taking some pressure off equities.

One possible scenario we are monitoring as we enter the spring (and are partially hedged against with market protection), is the likely near-term reacceleration in core inflation due to both energy prices and wages rising, at a time when we expect to see a deceleration in economic surprises. The optics around this may reinforce bond markets concerns on inflation risks leading to higher rates at a time when equity markets are observing a deceleration in macro-economic data. We think fixed income markets are already reflecting an acceleration in inflation (given current inflation breakeven pricing) suggesting this might be less of a bearish catalyst than some perceive.

Trump's nationalistic (and ridiculously simplistic) approach to trade has always been the biggest longer-term risk to both equity markets and the real economy presented by his administration. The only surprise from his recent announcement of tariffs on steel and aluminum imports in our view was that anyone was surprised he did it. A complete misunderstanding of how trade works and a resulting focus on balancing (or even better in Trump's view, winning) every bilateral trade relationship has been a hallmark of his policy agenda since the first days of his run for the presidency. It sells incredibly well with his base, which, as everyone should have learned by now, is pretty much all this President cares about. The recent departure of Gary Cohn as Chief Economic Advisor only tilts the Trump administration even more towards promoting trade conflict as the centerpiece of their foreign policy agenda. We expect retaliatory threats from major trading partners including Canada, the EU and China over the coming weeks with all three likely waiting to see if the U.S. actually moves forward with the threatened tariff action before enacting tariffs of their own. U.S. and Canadian companies with supply chains heavily reliant on NAFTA appear too risky for us in the current environment. All of this said, trade conflicts take years to unfold and so we expect rising trade tensions overall to raise equity risk premiums, likely reducing upside from what appears to be a strong corporate profit outlook for 2018.

Q1 Earnings Score Card

The first quarter earnings season was very strong for the S&P 500 with revenue and EPS growth accelerating to 7.5 and 14% respectively. While the first quarter delivered a robust performance by almost any measure, markets are more focused on guidance for 2018 and especially what the benefits of tax reform will be to EPS growth this year and beyond. This was one of the key areas of uncertainty that we outlined in our December commentary. Our analysis of quarterly earnings transcripts as well as 3rd party work suggests approximately 30% of tax savings will be reinvested in capital and labor. We've seen statistics that suggest roughly half of S&P 500 companies mentioned some sort of re-investment scheme on their first quarter earnings calls. Most discussed capital investments (good for GDP growth) but a few discussed competition risks as well. As an example of this, we are monitoring the negative competitive language among several large cap U.S. banks during earnings season. While we anticipated that banks would make considerable IT investments this year with tax reform savings (part of our near-term thesis on Fiserv's revenue momentum) we also must weigh the possibility of competition consuming more of the tax gains than we initially projected. We had assumed some and were still able to get increasing return on capital metrics for

major banks which supported our core valuation thesis. At this point we are monitoring the situation but don't see it outweighing many of the bullish considerations for 2018 and continue to be positively exposed to U.S. financials.

As we move forward we feel investors are likely to focus less on year over year EPS growth, which is distorted by current tax reform gains, and look more at performance of factors such as revenue growth and earnings before taxes to assess underlying business strength relative to expectations. We think companies and sectors that fail to maintain margin improvement or revenue momentum will be treated with further P/E multiple compression at this point in the cycle, increasing the downside risks of "getting it wrong". As we move into the summer, this will become more of focal point given the street has earnings estimates for 2019 continuing at a brisk 9% pace. If core metrics are missing in the back half it would imply that there is downside to 2019 earnings estimates which don't have incremental tax gains to fill in the gap. Not our base case but something to consider going forward. We also note that "market breadth" is likely to start narrowing out again as we move into the later stages of this cycle. Indeed, the most recent rally has seen less than half of S&P 500 companies reaccelerate back above their 50 day moving averages.

Overall the return of volatility has modestly increased the cost of our hedging program when compared to last year though not much above our historical average. As somewhat of an offset, higher volatility also enables a wider variety of option trades we can use to enhance the risk/reward profile of our equity positions. In the end, we are very comfortable with the current market setup and generally have found it easier over the past few quarters to both manage risk and to get paid for value.

Until next month,

The Enhanced Team

[1] All returns and fund details are a) based on Class/Series F shares/units; b) net of fees; c) annualized if period is greater than one year; d) as at February 28, 2018; e) inception date for Ninepoint Enhanced Equity Class is 04/16/12. The index for the Ninepoint Enhanced Equity Class; Ninepoint Enhanced Long Short; and Ninepoint Enhanced Long Short RSP is 50% TSX & 50% S&P 500 (CAD) Blended Index and is computed by Ninepoint Partners LP based on publicly available index information. The index for the Ninepoint Enhanced US Equity Class is S&P 500 TR USD and is computed by Ninepoint Partners LP based on publicly available index information.

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