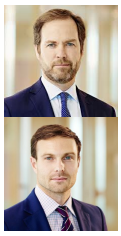
Sprott Enhanced Equity Strategy

January 2018 Commentary

Investment Team



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The U.S. equity market continued to ignore rising bond yields through the month of January as lingering optimism over tax cuts and global growth pushed U.S. stock indices to all-time highs near month end. Conversely, the Canadian equity market continued to be "out of favour" with both Canadian and global investors alike driving the TSX lower over the course of January despite higher commodity prices. Finally, the Canadian dollar rallied last month (up over 2%) on the back of both the better commodity outlook (especially oil) and the Bank of Canada rate increase. For the month, the TSX declined 1.4% while the S&P 500 climbed 5.7% or 3.3% in Canadian dollar terms. Our blended benchmark was up 0.9% for the month of January.

Although we were bullish on the outlook for equities given the improving global growth outlook and the potential for positive revisions to earnings estimates due to tax cuts (see our December monthly), the speed and amplitude of the move higher in U.S. equity prices in January surprised us. Similarly, the decline in the Canadian equity market was also surprising, especially the energy sector's lethargic reaction to sharply higher crude oil prices (WTI was up almost 7% in January to US$64.56 or almost $80 Canadian!). We continue to believe the underlying fundamentals for crude oil are improving despite the ongoing ramp in U.S. shale oil production. We expect both WTI and Brent prices to stay near or above US$60 over the course of 2018. At these crude prices we believe select energy producers and their related service companies offer tremendous value on an absolute, let alone relative, basis at current levels. In our view, energy equities are being held back by an overarching (and incorrect) belief that the combination of swelling U.S. shale production and a secular long term decline in oil demand (electric cars) mean that oil's rebound in 2017 is temporary and will imminently resume a decline to US$50 and below. Simply put, strong global growth is pushing oil demand higher than current consensus (as it did in 2017) and electric vehicles are a decade away from even beginning to reduce the size of the global fleet of gas-based vehicles. From a supply standpoint, there is a limit to how much supply the U.S. can add in a given year and even a very bullish view of shale growth is not enough to offset the substantial decline in non-OPEC offshore output that is rapidly unfolding. As to what will cause investors to wake up to the value offered in energy shares, we expect nothing less than good old fashioned beats on cash flow and balance sheets to be the catalyst – which will likely take another quarter or two to be considered more than temporary by the bears.

As for bond yields, we have highlighted in several of our past monthlies that the bond market was underestimating the pace at which the Fed was likely to increase rates in 2018 and 2019. That has begun to change as the bond market has already moved from discounting only a single rate hikes in 2018 (back in December) to almost four rate hikes today. At current levels, rising rates should not be a meaningful problem for either the stock market or the real economy. The sharp rise in volatility witnessed in early February was in our view more of a reaction to the very high levels of

complacency in place as the U.S. equity market ripped higher through late 2017 and early 2018 (and the unwinding of the resulting short volatility products that become popular). Absolute yields still remain incredibly low across the entire yield curve and we are still not back to even a "neutral" rate yet. It is a reminder of how ridiculously accommodative policy was that the unwinding of that policy is taking multiple years to even begin to approach neutral. That all said, these cycles usually end in a similar fashion – the Fed returns to neutral then keeps going higher as they realize that they have fallen "behind the curve" on an overheating economy. Eventually, the rising cost of capital surfaces bad investment decisions made when capital was very cheap and the shock of taking those losses raises the cost of capital further, driving a selloff in risk assets and the next bear market. In our view, we are still well away from that point – rates are rising but still very low, taxes are dropping raising cash flow and the economy remains fairly healthy. Our best guess would be sometime in 2019 or 2020 for the Fed to eventually get rates to the point where they impact asset prices and, eventually, cause the next recession.

Our portfolio remains well diversified across sectors with attractive cash flow producing companies at valuations we find compelling relative to what the market averages offer. Our largest sector allocations remain to financials (a mix of U.S. banks and exchanges along with a Canadian bank and insurance companys) and energy (E&P producers, a major driller and a pipeline service company). We had added significant upside exposure through call options back in the fall of 2017 (they offered similar upside to stocks with significantly less downside) but had removed almost all of those positions by early January given our view (which proved premature) that the market would not keep rising as quickly as it had in the fourth quarter of 2017).

Our hedging book remains robust and is largely based on S&P put options although we did add some Canadian market hedges in January given our energy exposure. Hedging costs are now higher than most of last year as volatility has risen in 2018 but we would note that current levels of volatility are in fact historically normal. We continue to be able to roll our hedge book at an annualized cost level in line with our historical range and our strikes currently sit 4-5% below current market levels.

All in, market action has driven an interesting start to 2018 but in the end equity markets are currently wobbling around flat for the year. We expect continued economic strength and relatively strong earnings growth (boosted by tax cuts) to support higher prices for our equity holdings in 2018 but, as always, we are well hedged in case we are wrong.

Until next month,

The Ninepoint 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 January 31, 2018; e) inception date for Ninepoint Enhanced Equity Class is 04/16/12.[2] 50% of S&P/TSX Composite TRI; 50% of S&P 500 TRI CAD and is computed by Ninepoint Partners LP based on available index information.

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