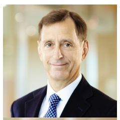
Ninepoint Credit Income Opportunities Fund

Q4 2018 Commentary

Investment Team



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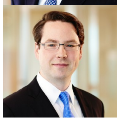

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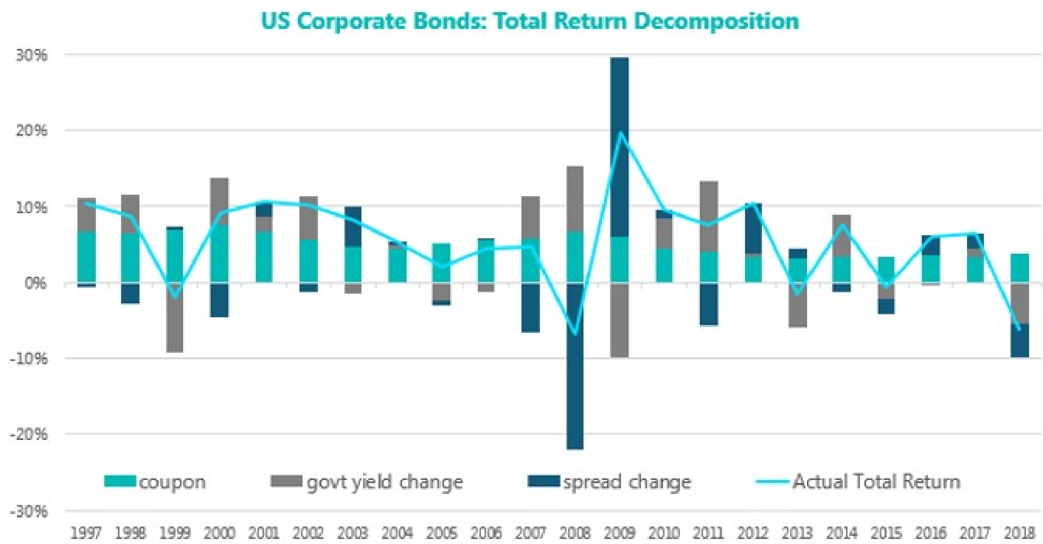
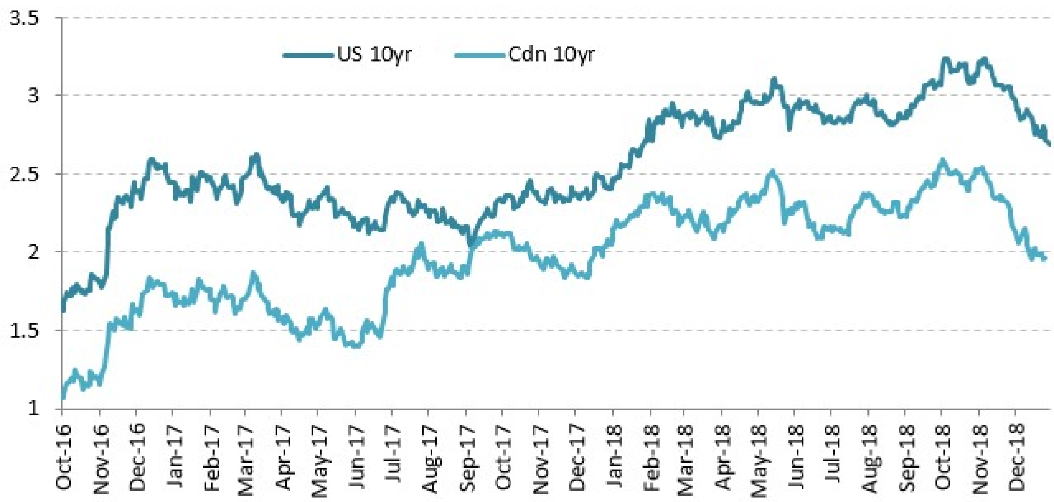
What an incredible reversal in the market's perception of economic growth and the duration of the business cycle. For most of 2018 you would have been hard pressed to identify an economic strategist that saw a recession or significant slowdown in economic activity in the foreseeable future. Record low unemployment, steady growth, rising inflation and looming wage pressure would have surely pressured the Bank of Canada and the Federal Reserve to raise rates at least two times in 2019. The yield on 10 year government bonds was expected to drift higher, approaching a neutral rate that was in the range of 3% to 3.5% in the US and 2.5% to 3% here in Canada. That was the play book for the first 10 months of the year, but optimism soon transitioned into the fear of a widespread economic slowdown or even worse, a global recession. During November and December, global equity markets declined, volatility escalated and investment grade credit experienced its worst year since the late 1990's.



Source: Bloomberg

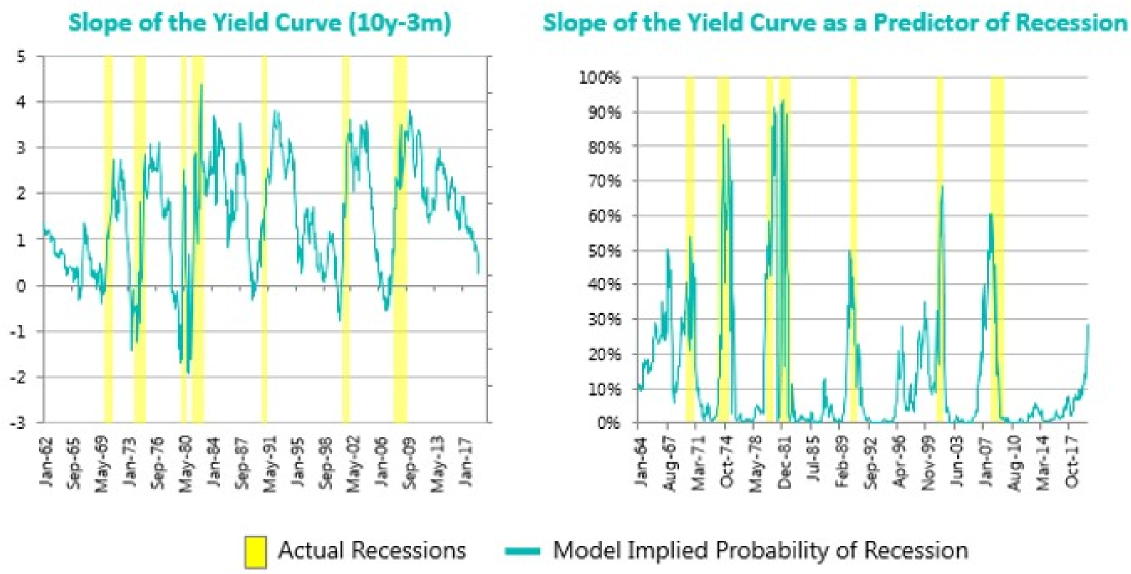
As the year progressed, the market's worry list continued to build and optimism faded to pessimism as geopolitical risks continued to rise. If central banks, specifically the Federal Reserve, continued to raise interest rates and decrease quantitative easing on their planned trajectory, this would eventually push the global economy into recession. This became a material source of unease for the market and likely the greatest catalyst for the year end sell-off. Although valuation metrics for equities, investment grade credit and high yield did suggest an oversold condition relative to growth, a recession in 2019 would escalate the volatility and apply more downward pressure on the markets. Once again, as in the past, the FED and the Bank of Canada responded to the markets by acknowledging the weakness in recent data and the potential of an economic slow-down. They both softened their stance on interest rate increases and backed off an intended neutral rate that was much higher. That shift in tone by the FED eased the markets greatest fear and subsequently reversed the year end sell-off.

Ten year bond yields in Canada and the US topped out at 2.6% and 3.25% respectively, but finished the year at 1.97% and 2.68%, lower YOY here in Canada and only slightly higher on the year in the US. The change in tone by the FED and the BOC completely re-priced the markets odds of any rate increases to basically zero for 2019 and 2020. This and the decrease in inflation expectations, resulting from the steep decline in oil prices, triggered a huge rally in government bonds that recalibrated 10 year yields to a much lower neutral level. Given how low rates have gone in such a short time span, the move lower looks to us, to be overdone. Yes growth is slowing, GDP is expected to be around 1.6% in Canada and close to 2% in the US, but that's not a recession. Also as oil prices stabilize at higher prices this year we would expect inflation expectations to rise to more normalized levels. Putting it all together our thoughts are for one rate increase this year in Canada and the US, which would move our bank rate to 2% (below the old BOC target neutral range of 2.5% to 3%) and 2.75% there (at the low end of the FED target neutral range of 2.5% to 3. 5%). This would equate to a high in 10 year bonds yields of 2.25% in Canada and 3% in the US, lower in yield than the highs of last year, but consistent with lower GDP growth projections and the late stages of the current business cycle.



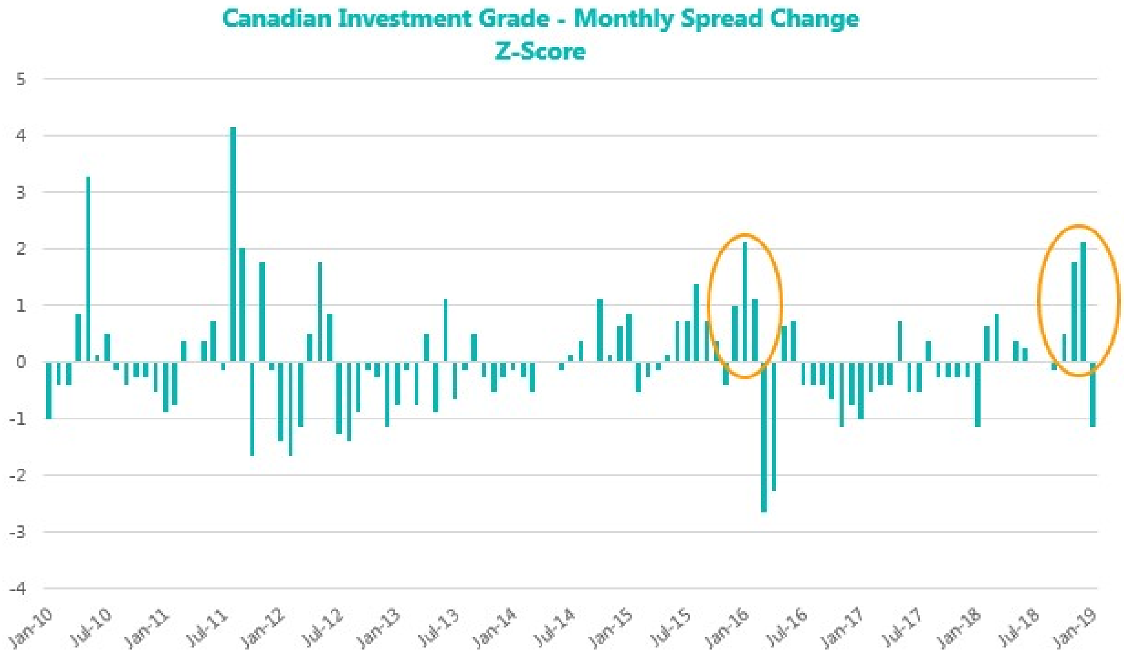
Source: Bloomberg

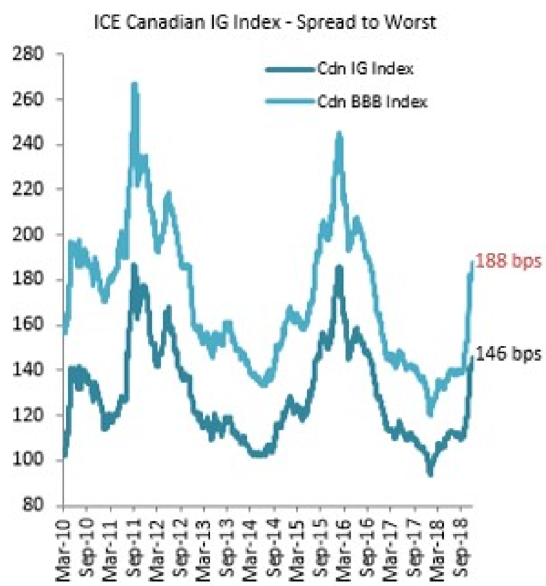
Throughout most of last year the yield curve flattened. Short-term rates had risen as the market factored in more rate hikes, but increases in longer-term rates stalled, reflecting the bond markets pessimism on economic growth. Late last year our yield curve model was indicating a 30% chance of recession in the next twelve months, up from 15%. Now with less likelihood of multiple rate increases by the FED and the BOC we see a slight extension of the business cycle and recession risk abating. Looking across most asset classes, the recent outperformance of cyclical equities (industrials, energy, financials), commodities and emerging markets all suggest to us that longer-term interest rates should likely move higher from here with this "reflation" narrative. With short-term rates now anchored lower, the yield curve should re-steepen in early to mid-2019, before pausing later in the year.



Source: Ninepoint Partners, as at January 31, 2019

There was $11 billion of Canadian investment grade credit issued in 4Q18 ($98 billion YTD), which was one of lowest volume quarters in years. The lack of liquidity and poor market tone made it almost impossible to do a bond transaction. Lower rated companies were completely shut out of the market, only the highest quality of issuer had any access. The ICE (formerly the Merrill Lynch) Canadian Investment Grade Index, widened out materially, increasing by 35bp to 146bps in 4Q18. That's wider by 52bps from the tightest level of the year. Of note, the spread on the ICE IG BBB Index widened out 48bps to 188bps and now yields 3.9%. This discounting in the price of corporate bonds was consistent with our market thesis, but we thought this was going to happen as a result of higher interest rates not the fear of elevated default risk or a global economic slowdown The all-in yield for high quality companies currently looks attractive, but it's not a slam dunk quite yet. In the current slower growth environment we expect credit spreads to narrow marginally. That's our base case, but if growth slows, IG credit will become more discounted. We've taken advantage of the recent move by buying only a small amount of mid-term IG credit, but continue to believe that the best risk-reward is short-dated credit. In December we purchased some new low duration positions that yield in the range of 4% to 5%. Over the last quarter net new additions to the portfolio were: Crombie REIT, Enercare Solutions Inc., GE, Manulife Financial Capital Trust, Reliance L.P. and VW.





Source: Bloomberg

Last year there was a complete lack of supply in the high yield bond market. In December, there was absolutely no issuance in Canada or the US, the first time in many years. During the recent quarter the ICE Canadian High Yield Index widened out 103bps, to a spread of 431bps and an all-in yield of 6.28%. Although the spread and yield are moving in the right direction, we still don't feel there is enough buffer in spreads relative to investment grade credit or the risk of higher defaults to justify a greater allocation to HY. To put the numbers in perspective, during 2016 when oil prices tanked and the market's fear of recession escalated, high yield spreads moved out to 900bps and bonds yielded 10% or greater. So we are patiently waiting for a better entry point to add HY. Our portfolio currently has a 25% weight in high yield, half which is lower duration. During the quarter the only new additions to the portfolio was MEG Energy Corp.

Source: Bloomberg

Valuations are moving in the right direction and higher interest rates will be less of an issue this year. So for now, it feels like 2019 will be more of a normal year for bonds returns. Our challenge will be balancing the portfolio risks against the duration of this new reflation narrative and the timing of next recession.

Regards,

Mark, Etienne and Chris

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1]
AS OF JANUARY 31, 2020 (SERIES A NPP506)

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.6%	0.6%	1.1%	1.3%	5.1%	3.4%	4.1%	4.8%

[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 January 31, 2019. 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 Ninepoint 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

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