# Credit Income Opportunities Fund

**The Sprott Credit Income Opportunities Fund (Series A) was up +0.50% in Q2 2017, +2.10% YTD.**

Investment Team

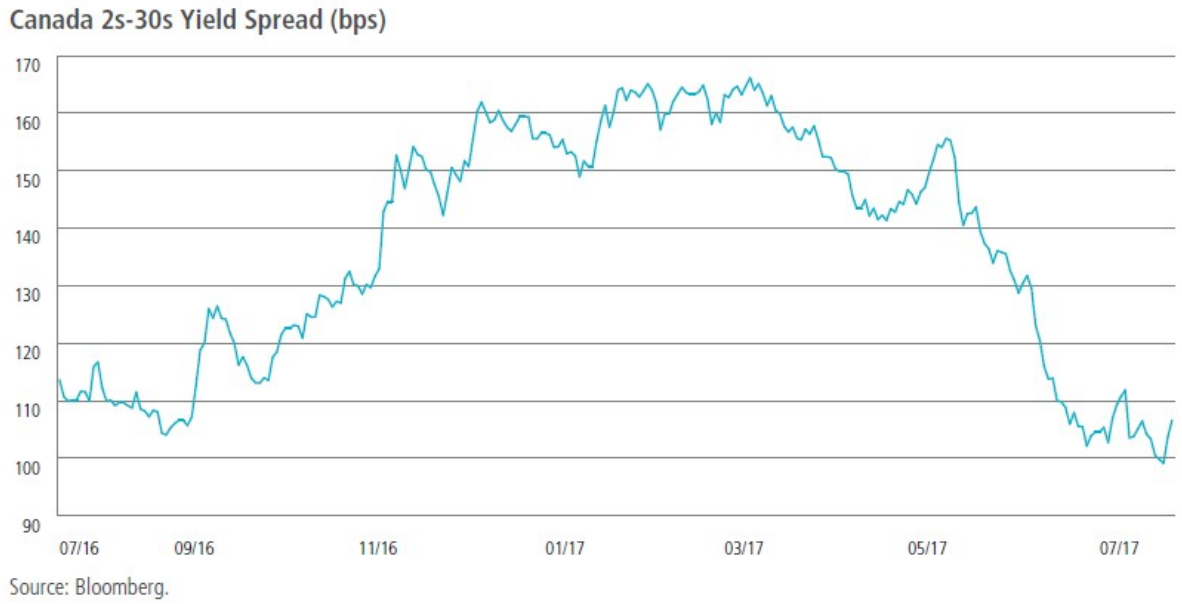
**Mark Wisniewski,**
Partner, Senior Portfolio Manager

After years of easy monetary policy, central banks around the world are positioning themselves to remove the excess stimulus and raise interest rates. The puzzling dilemma, though, has been the inability of the government bond market to let yields go sensibly higher. Despite the lack of any major economic catastrophe or political surprises, global government bond markets have rejected what looks to finally be an improving environment. Despite an eagerness by central banks to initiate the removal of stimulus they provided through 2015 and early 2016, longer dated government bond yields haven't moved higher than they were last November. This has created a significant flattening of yield curves in the US and Canada, which tends to imply a looming recession. Typically the response by riskier assets – equity and credit – to a flatter yield curve, is to re-price securities lower to reflect greater risk premium and a higher probability of recession. Regardless, equity markets, high yield bonds and investment grade credit, throughout the world, have been fairly stable, implying confidence in global economic growth. It appears, for now, the markets are becoming more upbeat on economic conditions and happy to stand pat.


Source: Bloomberg.

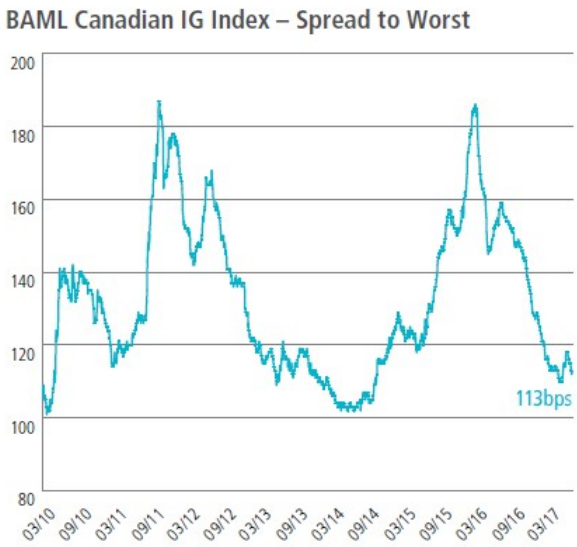
For the first time in 7 years, the Bank of Canada raised interest rates by 0.25% in July. When this intention was initially telegraphed to the market back in June, it came as a bit of a surprise, considering there had been a consistent BOC narrative of accommodative monetary policy and a desire for a weaker currency. The assessment of this reversal by the BOC was interpreted to be abrupt and premature, given the persistence of weaker oil, a low inflation rate and the financial vulnerability of borrowers in our frothing housing market. The BOC felt that the continued strength of the Canadian economy and a low unemployment rate justified "the removal of the 2015

insurance policy." Yields on longer dated Canadian government bonds are higher now, but not above where they were last November. Consequently, the yield curve here in Canada has flattened. The government bond market isn't convinced, yet, that better economic times are here or that higher interest rates are justified. It's a similar situation in the US. After 3 rate increases by the US Federal Reserve, 10 year interest rates are below where they were last November and their yield curve has flattened, consistent with our experience here in Canada. And this September it's expected that the FED will start to sell off $2 trillion in assets from its balance sheet. So they will no longer be a buyer of treasuries and mortgage bonds. It's a complicated conundrum, as improving global economic growth, lower levels of unemployment and the defeat of deflation, will require tighter monetary policy and with that higher interest rates across the curve. Yet the ever cynical government bond market isn't buying in. I agree yields have been affected by the absence of inflation – that's a mystery and a complicated issue. It might be the method that's used to measure inflation. Perhaps it's the impact of disruptive technology or demographics, but I'm prepared to wager inflation will return as interest rates return to normal levels. Global growth is increasing and with that there will be better demand for commodities, which will be very positive for the Canadian economy. Tax cuts and infrastructure spending initiatives should eventually happen in the US, probably not till 2018. There's more planned rate increases by the BOC and the FED. Time will tell, but I stand by my conviction to higher interest rates – US 10 year treasuries probably trade closer to 3.0% by year-end, and Canadian 10 year bonds around 2.50%.

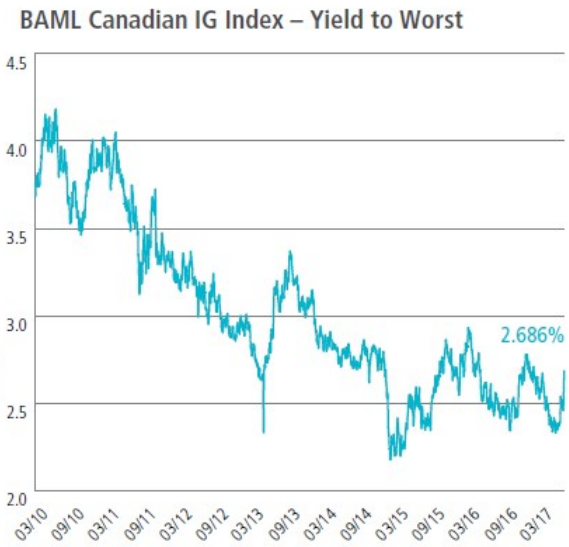



Canadian investment grade spreads have remained fairly stable. It's been one of the most uneventful quarters for the corporate bond market in years. The credit spread on the Merrill Lynch Canadian Investment Grade Index narrowed in a miniscule 1bp to 113bps, tighter by 16bps YTD. From a valuation perspective, I think Investment grade credit is fairly priced. Generic BBB credit spreads, the rating bucket I prefer to own, are at 129bps. One must apply significantly more leverage to produce the same types of returns that were achievable with very low leverage 6 months ago. In this type of environment increasing leverage beyond 1.5 times to produce a higher level of income is an unsustainable proposition – it equates to adding too much risk for the incremental yield. I've reduced leverage in our portfolio to 0.6 times, as I believe there will be a better entry point to add more credit and justify the leverage. The best performing 5-year sectors for the quarter were Insurance, Bank NVCC and Sub-debt, Energy Infrastructure and Telecom. New issue supply was

around $36.3 billion last quarter, $59.8 billion YTD and on track for $100 billion this year, roughly equivalent to 2016's issuance. Net new additions to our investment grade portfolio were Brookfield Infrastructure Partners, Allied Properties, Home Capital Co., TransCanada Pipelines, CNQ, Intact Financial, Chartwell Retirement Residences, Enbridge Inc., Laurentian Bank and BNS.

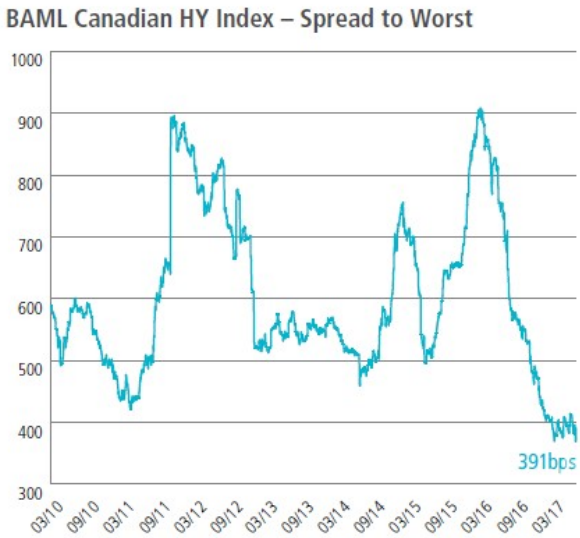


Source: Bank of America Merrill Lynch.

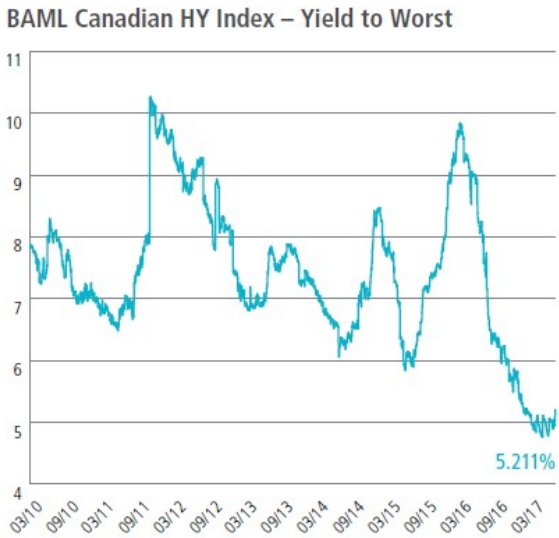


Source: Bank of America Merrill Lynch.

The Merrill Lynch Canadian High Yield Master Index closed out the quarter with a spread of 391bps, tighter by 11bps and in 38bps from the start of the year. With the high yield index spread at a multi-year low of 391bps and an all in yield of 5.21%, I think high yield credit is getting pricey, even with improving credit fundamentals and low default rates. Purchasing bonds that have a coupon of between 5% and 6% isn't that attractive relative to other investments like loans or equities. And an investor doesn't have nearly the buffer they had a year ago, to protect against the threat of higher interest rates, an economic shock or an earnings disappointment by a company. The spread on the Merrill Lynch US High Yield Energy Index was at 526bps, wider by 84bps. Many Energy and E&P bonds have traded in the mid to high 90's, which is starting to look somewhat reasonable, but not a real deal considering where they traded in early 2016 and the fact that the equity of many energy companies are down as much as 50%. I have however seen selective opportunities in secured loans – companies that aren't ready for the public bond market yet. Secured loans trade at a yield that is double that of high yield, 9.5% to 12% and they are secured by assets. New loan additions to the portfolio are TMAC Resources and Champion Iron. High yield additions to our portfolio over 2Q17 were Parkland Fuel Corp. and Energold Drilling Corp.




Source: Bank of America Merrill Lynch.




Source: Bank of America Merrill Lynch.

Throughout the last quarter, we have increased our conservative positioning bias. Our core portfolio has 45% cash, 23% investment grade, 19% high yield, 2% secured loans, and 11% equities – we added a position in Element Fleet Management preferred. The average BBB credit quality of the portfolio hasn't changed, duration is at 3.0 years and leverage is 0.6 times. The overlay portfolio (the leverage) is entirely investment grade credit with an average duration of 6.3 years, interest rate-hedged with government bonds. From a currency perspective we have continued to maintain a USD weight of 19%. Our fund's yield is around 4% and given the low risk characteristics of the portfolio, I believe it is delivering adequate compensation as we wait to add more credit. Corporate bonds have been on an amazing year and a half run, so some form of a correction shouldn't be that far away.

The bond market is very comfortable with interest rates that are still uncharacteristically low, despite better economic growth and the removal of ultra-easy monetary stimulus. With the yield curve flattening there's a greater expectation of recession by the bond market, yet no sign of concern by the equity markets or credit. It's too early to tell who's right, but if economic growth does surprise to the upside, validating equities and credit valuations, all will be good. If not, we'll be in for more volatility and a healthy market correction.

Regards,

Mark

MONTHLY RETURNS (%) AS AT JUNE 30, 2017[1]

| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEPT | OCT | NOV | DEC | YEAR | FTSE TMX CANADA ALL CORPORATE BOND INDEX |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2017** | -0.12 | 1.42 | 0.29 | 0.67 | 0.08 | -0.25 | | | | | | | 2.10 | 2.87 |
| **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 | 3.73 |
| **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 | 2.70 |
| **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 | 7.58 |
| **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 | 0.86 |

[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 June 1, 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 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 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.**

Ninepoint Credit Income Opportunities Fund is offered on a private placement basis pursuant to an offering memorandum and are only available to investors who meet certain eligibility or minimum purchase amount requirements under applicable securities legislation. The offering memorandum contains important information about the Funds, including their investment objective and strategies, purchase options, applicable management fees, performance fees, other charges and expenses, and should be read carefully before investing in the Funds. Performance data represents past performance of the Fund and is not indicative of future performance. Data based on performance history of less than five years may not give prospective investors enough information to base investment decisions on. Please contact your own personal advisor on your particular circumstance. This communication does not constitute an offer to sell or solicitation to purchase securities of the Fund. The information contained herein does not constitute an offer or solicitation by anyone in the United States or in any other jurisdiction in which such an offer or solicitation is not authorized or to any person to whom it is unlawful to make such an offer or solicitation. Prospective investors who are not resident in Canada should contact their financial advisor to determine whether securities of the Fund may be lawfully sold in their jurisdiction.

The opinions, estimates and projections ("information") contained within this report are solely those of Ninepoint Partners LP and are subject to change without notice. Ninepoint Partners makes every effort to ensure that the information has been derived from sources believed to be reliable and accurate. However, Ninepoint Partners assumes no responsibility for any losses or damages, whether direct or indirect, which arise out of the use of this information. Ninepoint Partners is not under any obligation to update or keep current the information contained herein. The information should not be regarded by recipients as a substitute for the exercise of their own judgment. Please contact your own personal advisor on your particular circumstances. Views expressed regarding a particular company, security, industry or market sector should not be considered an indication of trading intent of any investment funds managed by Ninepoint Partners. Any reference to a particular company is for illustrative purposes only and should not to be considered as investment advice or a recommendation to buy or sell nor should it be considered as an indication of how the portfolio of any investment fund managed by Ninepoint Partners is or will be invested. Ninepoint Partners LP and/or its affiliates may collectively beneficially own/control 1% or more of any class of the equity securities of the issuers mentioned in this report. Ninepoint Partners LP and/or its affiliates may hold short position in any class of the equity securities of the issuers mentioned in this report. During the preceding 12 months, Ninepoint Partners LP and/or its affiliates may have received remuneration other than normal course investment advisory or trade execution services from the issuers

mentioned in this report.

Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: CIBC Mellon GSSC Record Keeping Services: Toll Free: 1.877.358.0540