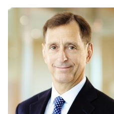
Credit Income Opportunities Fund

Q2 2018 Commentary

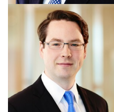
The Ninepoint Credit Income Opportunities Fund (Series A) was up 0.76% in Q2 2018, +0.91% YTD.

After an extraordinary 35 year run, the bull market in bonds might be coming to an end. Central banks globally are tightening monetary conditions and winding down quantitative easing programs. Newly elected governments are embracing fiscal stimulus, boosting their spending and running larger deficits that will inevitably be financed by more borrowing. Record low unemployment is elevating wage gains, commodities prices are rising and inflation has moved well over 2%. In such an environment, one would expect much higher interest rates across the term structure and a steeper yield curve. Although that was the case earlier in the year, fixed income markets have reversed course, becoming fixated on the Trump tariffs and the potential of a global trade war that would slow global economic growth. According to a research note by J.P. Morgan, the recently announced tariffs are going to equate to a 0.5% reduction in global growth. Although that's not a huge hit to growth, it appears to be the tip of the iceberg, as the US recently announced tariffs on another $200 billion in Chinese goods, in addition to earlier rounds of tariffs. The risk of an all-out global trade war will eventually push volatility higher and stress financial markets. So far, global bonds are on track for return of -3.5% this year (Merrill Lynch BofA research), the worst performance for bonds since the early 90's. The direction of interest rates and credit spreads from here will be mainly a function of the US administration's tough stance on trade and a compromise or counter-tariffs by other countries. We maintain that interest rates will be heading higher from here, but likely end the year at a level below the recent highs.

Investment Team



Mark Wisniewski,
Partner, Senior Portfolio Manager



Etienne Bordeleau-Labrecque, MBA, CFA
Vice President, Portfolio Manager

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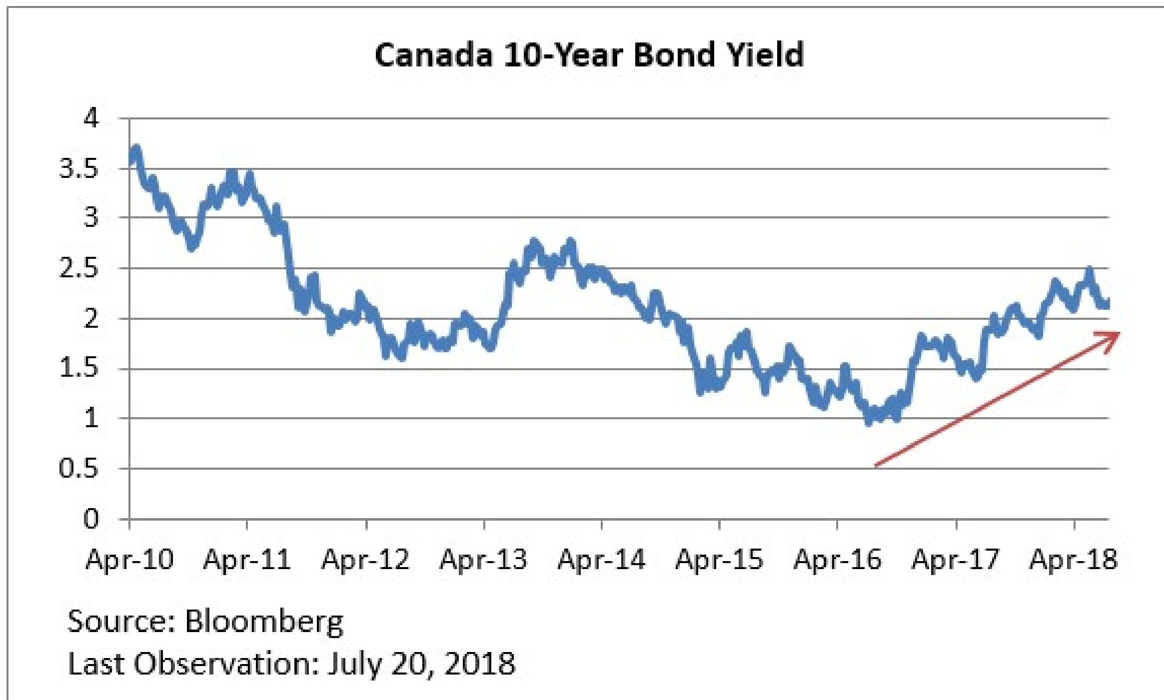
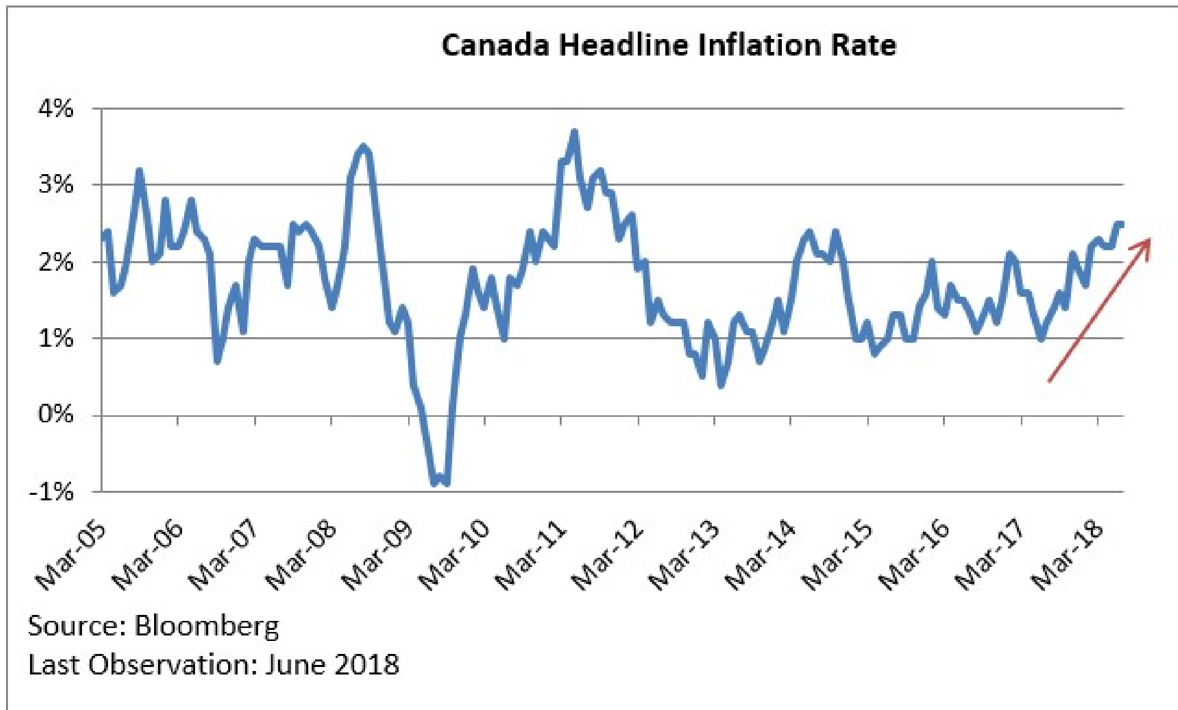
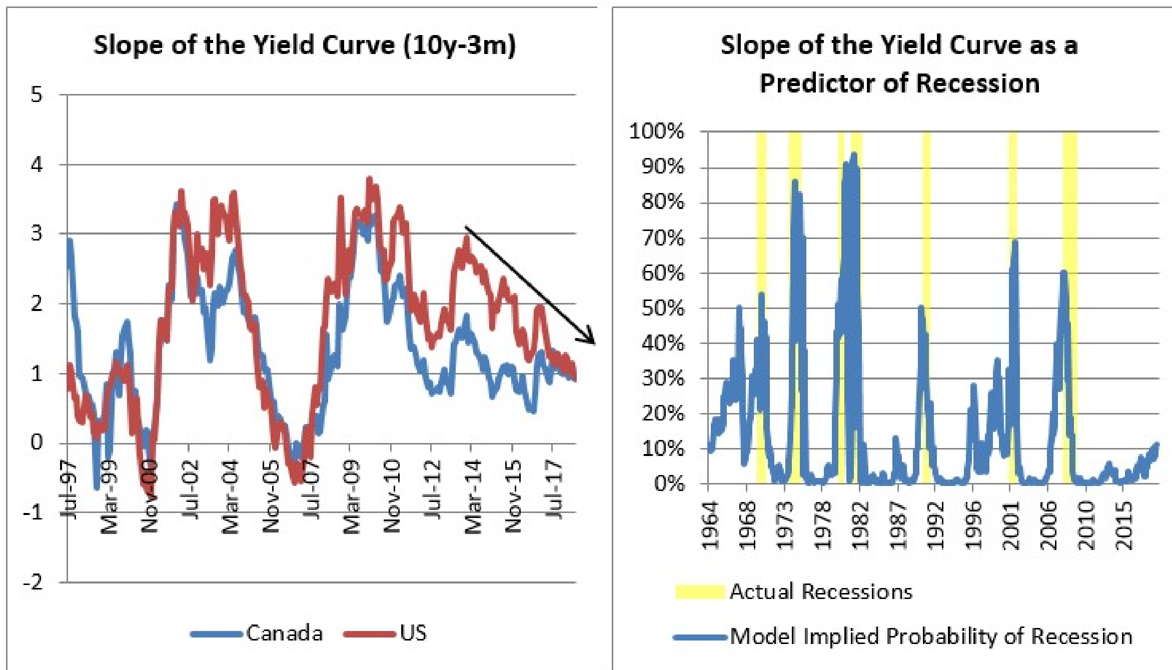


So far this year, the Bank of Canada and the Federal Reserve have both increased rates two times, irrespective of the uncertainty related to trade. The expectation for the balance of the year is one more by the BoC and two more for the FED – pushing the base rates up to 1.75% and 2.5% respectively. With central banks raising rates and core inflation likely in the range of 2.25% to 2.75%, it's hard for us to accept that 10 year yields can remain close to 2.15% in Canada and below 3% in the US. If inflation persistently exceeds markets' expectations, which we believe is a risk, we could see interest rates head to new highs. We've been in an extremely low interest rate environment for 10 years and as this normalizes, it will have some serious implications for the economy and financial markets. There's been an extraordinary thirst for yield that has forced investors to take on significantly more risk. That behavior has, in turn, provided cheap funding for many risky (and zombie) companies and ventures. We are now at a point in the cycle where the unwinding of excessive monetary stimulus will increase term premiums and policy rates globally. As interest rates normalize, the cracks in the financial foundations will begin to show, eventually stressing corporations and investors. When this eventually happens is anyone's guess, but we are entering a point in the cycle where it's prudent to be mindful of these risks. We don't currently hold any governments bond and we're maintaining a short duration bias as we navigate through this transition higher in interest rates.



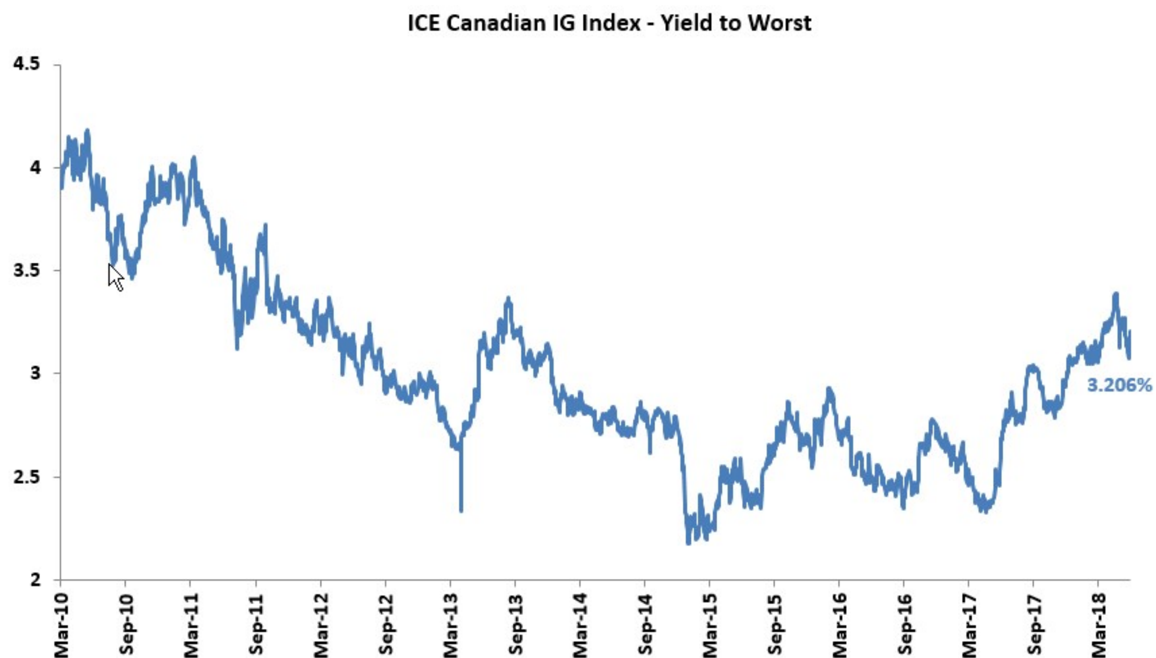
Throughout the last quarter, the yield curve, both here and in the US, has continued to flatten. Although there is still more compression required before the curve goes inverse, the flattening trend has not abated, suggesting there is a lack of confidence in the economy by the bond market. The yield curve inversion – timing of recession deliberation – has become topical with economic strategists and central bankers, but there isn't a clear consensus on when an economic slow-down actually happens. Looking back at history, there have been times when the yield curve was extremely flat for years, like the pre-recession 90's. Yet in 2008 the inversion led to a recession within a year. Others argue that deficit funding requirements and the reversal of quantitative easing by major central banks is pressuring the front-end of the curve and contributing to the curve flattening. If the curve stays flat for a considerable time, which is a risk, it will dry up the incentive for financial institutions to lend and that will, in turn, push the economy towards recession. Bottom line, the timing of recession is hard to predict, but it's increasingly probable and on the horizon.



Source: Bloomberg

New issue activity in investment grade credit has been very robust. At $67 billion it's up 16% year-to-date. Of note, Canadian financials have accounted for 66% of the new supply, up from 49% in 2017. The Canadian banks have been issuing loads of deposit notes which will be phased out later this year and replaced by new, riskier securities which, in times of financial instability, could be converted directly into equity. With greater new issue bond supply, higher interest rates and trade tensions, credit spreads have continued to drift modestly wider. ICE, formerly the Merrill Lynch Canadian Investment Grade Index, moved out 5bps to 112bps in 2Q18. That's up 22bps from the tightest level of the year. Corporate bonds are on track for their worst performance in years. In Canada, the corporate credit index has so far this year returned 0.6%, the worst year since 2002. In the US, the return on investment grade was -3.3%, which is the second worst first-half return since 1994, according to Morgan Stanley. With higher government bond yields and wider credit spreads, we prefer lower duration investment grade securities and floating rate notes. US credit looks very attractive, but unfortunately FX hedging costs make it less compelling. If and when we get an appreciation in the Canadian dollar, or a decline in those hedging costs, we would look to add more US investment grade credit. Net new additions to the portfolio over the quarter were: TransCanada Pipelines Ltd, CCL Industries, Brookfield, AutoRoute 30, Canadian Tire and Keyera Corp.

Source: ICE



Source: ICE

Given the stability and resilience of the equity markets, high yield bond prices have been fairly stable. They've even outperformed IG credit, which we think is surprising. During the recent quarter the ICE Canadian High Yield Index tightened in 5bps, to a spread of 354bps and an all-in yield of 5.6%. At a spread differential of around 2.15%, between generic high yield and BBB investment grade credit, we feel an investor isn't being adequately compensated for the greater credit risk in junk bonds. Energy E&P and servicers appear to be the exception, with yields in the range of 7% to 8% and these companies have raised equity, in many cases refinanced their debt and trimmed their costs. With oil prices rising and supply tightening these companies should do well over the next few

years. A good barometer of high yield demand has been the flow of money into US high yield funds and, so far this year, they are net negative (-$23.7 billion year to date). This would suggest that the appetite for riskier credit by investors is declining. Although we still have about a 28% weight in high yield, half of it is lower duration and we have some credit hedges to mitigate price declines. During the quarter net new additions to the portfolio were: Gibson Energy Inc., Kruger Products, GFL Waste & Environmental and Millar Western Forest Products.

Source: ICE

Source: ICE

The fund is maintaining its conservative positioning. The core portfolio has 25% cash, 35% investment grade (of which 11% are floating rate), 28% high yield (partially hedged), 6% secured

loans and 6% preferred equities. The average credit quality of the portfolio is BBB and leverage continues to be low at 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 our USD weight, consistent with our view on the Canadian dollar, is 0%. With the addition of the portfolio options positions, we have effectively lowered our aggregate duration to 0.2 years and the fund yields over 5%. As such, the portfolio has lots of liquidity valves to employ when we see new opportunities in credit.

Trade discussions will continue to dominate the direction of the markets this year and there is no way to determine what President Trump will say or do on trade. Until we get a clear picture of the extent of the US tariffs and the retaliation by other countries, it will be hard to assess the economic impact. Given all this uncertainty, we're sticking with a conservative positioning bias in our portfolio until we gain better clarity.

Regards,

Mark, Etienne and Chris

NINEPOINT CREDIT INCOME OPPORTUNITIES FUND - COMPOUNDED RETURNS[1] AS OF MARCH 31, 2022 (SERIES F NPP507) | INCEPTION DATE: JULY 1, 2015

	1M	YTD	3M	6M	1YR	3YR	5YR	INCEPTION
Fund	0.2%	-3.2%	-3.2%	-2.1%	1.1%	6.7%	5.0%	5.1%

[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 29, 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.

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

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