Sprott Enhanced Equity Strategy

November 2017 Commentary

Investment Team

John Wilson, MBA
Co-CEO, Managing Partner,
Senior Portfolio Manager

OVERVIEW

As expected, November saw rather quick passage in both the House and Senate of a major tax cut package that will see corporate tax rates fall for many large U.S. domestic companies. Market expectations for better growth, driven by this fiscal stimulus, propelled a market rotation from technology momentum stocks into value factors and those smaller domestically-oriented companies set to benefit most from lower U.S. tax rates.

Our value orientation and positioning specifically in large cap U.S. banks, transports and long call positions on the S&P 500, all benefited from the progress on taxes. Given our belief that the market was pricing in roughly 40% of the upside from tax reform, we concluded that owning call options on the market was a more effective way to participate on its passage while lowering the downside risks if it went off the rails (given our risk in the call position was limited to the premium we had paid). Said more simply, call options had become so cheap that owning them became a much better risk/reward than owning the underlying security outright; more upside if the underlying rose and less downside if it fell. While we took some of this position off on the most recent rally we continue to have exposure to upside optionality into year end.

SIGNIFICANT MOVERS

Union Pacific benefited from tax reform legislation given its high capex spend and high tax rate. While tax reform offered fantastic additional optionality, we already liked the company given it has one of best structural cost out opportunities of any large cap industrial while trading at a discount on a free-cashflow yield basis to rail peers and many high quality large cap industrials. We feel the recent rally has priced in ~2/3rds of the upside of tax reform we saw for the company. We still think street earnings estimates don't reflect a significant enough improvement in rail pricing for 2018 which could occur as truck capacity tightens on ELD (electronic logging device) implementation. The earnings lift next year from better pricing has the potential to be much better than we have modeled however we are balancing that with our expectation for weaker volumes in frac sand and coal. Pricing power historically has been a more predictive driver of UNP's EPS growth vs. volume growth so at this point we are cautiously optimistic on the drivers of the stock and continue to hold the position.

Alimentation Couche-Tard, a significant holding in the funds rallied ~9% during the month on better than expected earnings due to improved gas margins in the quarter. We took down our position late last year on the premise that higher energy prices for consumers would sap some of the strength that Couche-Tard had seen in their convenience store sales leading to negative estimate revisions on weaker than expected organic growth. However, over the past quarter or so we have grown our weight in the stock again given our belief that organic growth for the company is set to accelerate next year as we lap easy comparisons. Forward earnings estimates now look attainable and are mainly driven by accretion and synergies from several recent acquisitions. We also see more conservative organic growth assumptions by the street. With the stock trading at a 16X forward (FWD) PE growing EPS 38% in the quarter and we expect another 15% in 2019, we see the potential for a more significant rerate than has already occurred. The stock is currently trading at its largest FWD PE discount to Casey's (25X FWD), a U.S. convenience store chain, in any period of the last 5 years. Relative to our entire investable large cap universe of consumer staples stocks, ATD/B has among the fastest 3 year forward revenue and EPS CAGR while trading at the lowest quartile of forward P/E multiples. Despite the rally we continue to hold the stock on the potential for a further re-rate in the valuation.

LOOKING AHEAD

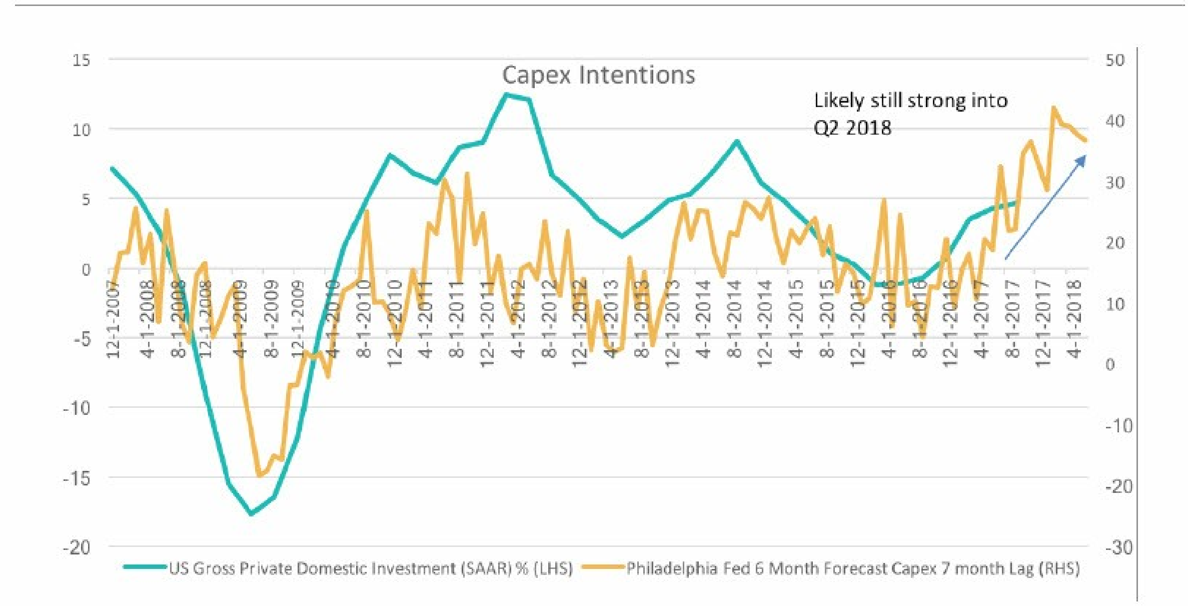
We continue to believe oil related energy stocks are underpriced relative to current crude oil prices and we believe WTI crude prices should be able to rise further to $60 or above near-term. We increased our energy weighting back in September based on our view that inventories are rebalancing and an extension of the OPEC cuts will tighten the market, driving WTI to $60. Energy stocks are pricing in WTI below $50 offering tremendous value in our opinion. Many larger E&P's are generating significantly more free-cashflow than the past due to improved capital discipline. Equities have faded the entire rally in crude with Canadian E&P's trading ~2 turns cheaper on a EV/DACF basis since mid-June. We are also long risk reversal spreads on the XEG and XLE energy ETF's. In these options positions, we expect to incur ~50% of the downside of a typical plain long position on a 10 % sell off in the ETF, while offering equivalent upside on a 15%+ move in each respective index into Q1 2018. We think the options position is an attractive addition to our core equity portfolio in the sector.

With tax reform now in place we believe it's likely that capital spending improves next year as the uncertainty over policy recedes and companies take advantage of the full deprecation of capex. While capacity utilization isn't extremely tight there is likely catch-up investment to be had in 2018. Revenue for S&P 500 companies has grown >5% in the past 12 months, meanwhile capital spending has been flat. While divergences between capex and revenue growth have persisted sometimes for years, that's typically occurred only after large over-investment cycles, the tech bubble of 2000 being a prime example of this. In our current environment, after almost 10 years of working off overinvestment in the housing market (the last bubble) and with manufacturing capital stock the oldest it's been in almost 50 years, we think that argument of continued sustained divergence due to over investment holds little merit.

Chart 1 shows how macroeconomic indices such as Philadelphia Capex Forecast typically lead private investment by several quarters, suggesting the recent acceleration in spending is likely to continue into 2018. While fixed capital investment is not nearly as significant a component of GDP as consumer spending, the volatility in the factor can drive the delta in GDP growth. Furthermore, it's an important barometer of economic health for equity markets. Aggregate fixed capital investment spending correlates well with the ISM manufacturing survey which is a survey that is an important driver of investor sentiment on its own. As discussed in some of our past monthlies we would be much more skeptical of outsized markets returns on the basis that this data is peaking if it wasn't for recent policy catalysts.

One area of possible risk that may impair the current supportive backdrop for markets is a potentially more aggressive federal reserve in 2018. We think it's likely the fed moves at least 3, and possibly 4 times in 2018 which could disrupt the easy credit conditions that fixed income markets have been enjoying. Furthermore, nascent signs of tight labor markets in many major western economies could start to concern the long end of the bond market. While we are not calling for a 3% 10-year bond, even slight movements (40bps) in yields on long duration assets could upset a more fragile fixed income ecosystem. Our fixed income team recently highlighted in their monthly commentary the substantial decline in general credit metrics of many of the investment grade indices this cycle vs. the past. BBB Credits now make up almost half the fixed income universe today vs. <1/3rd in past cycles. Credit spreads are extremely compressed in North America and nonexistent in Europe. Furthermore, liquidity in corporate bond markets is challenged by regulatory structures and ETF flows that augment any shortage. In our commentary next month, we will discuss with more detail what this could look like and how we plan to manage that risk for our clients.

CHART 1: CAPEX INTENTIONS



Source: Ninepoint Partners, Bloomberg Data

[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 November 30, 2017; 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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