Credit Income Opportunities Fund

Q3 2018 Commentary

Investment Team

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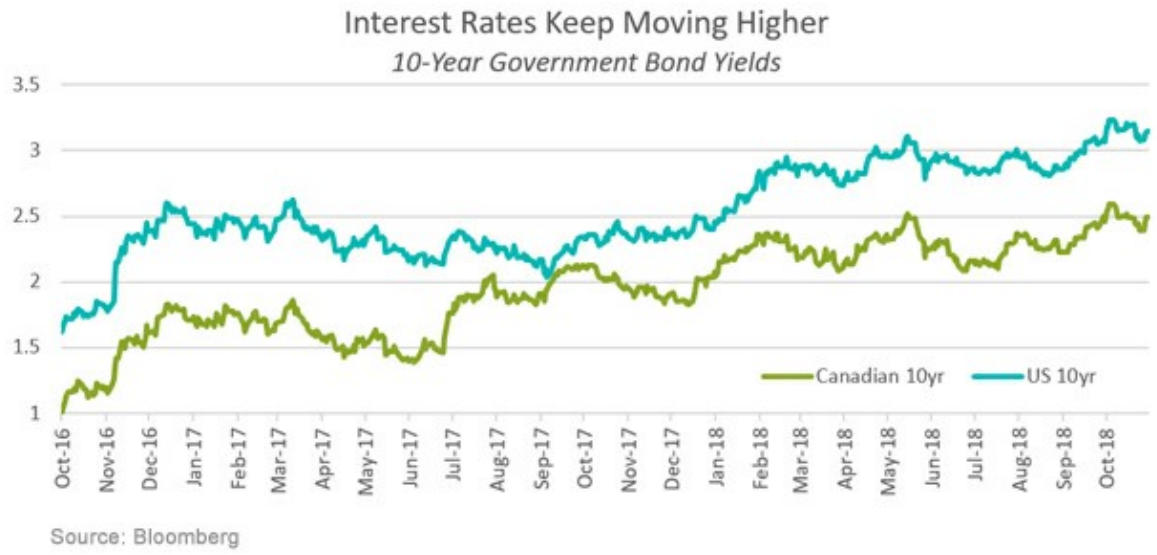
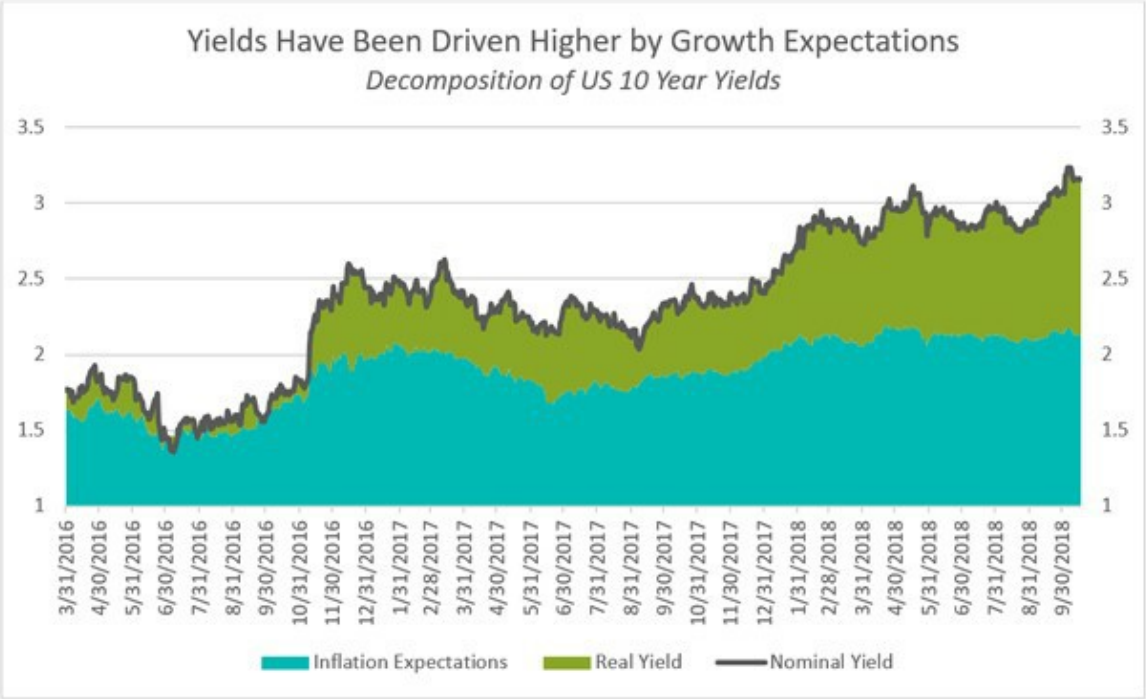
With the interest rate on ten-year bonds approaching 3.25% in the US and 2.75% in Canada, their highest level in 7 years, the markets have become obsessed with the effect higher borrowing costs will have on the economy and financial assets. For years market prognosticators have insisted that unconventional monetary policy was making financial assets expensive, forcing investors to take on more and more risk. Now, as major central banks respond to record low unemployment, inflation and higher economic growth by raising interest rates – pushing up the cost of money – they are apparently responsible for the recent volatility in financial markets and the decline in housing activity. It's difficult to pin-point the main reason for this escalation in volatility, but it can't be solely related to the increase in interest rates. Anxiety over corporate earnings, the US mid-term elections, US tariffs, a slowdown in China, the debt crisis in Italy, BREXIT and the decline in emerging markets all need to be factored into that equation. The Bank of Canada and the Federal Reserve are carefully weighing the number of rates increases required in 2019 to counter inflation and cool growth, without derailing their respective economies. Riskier securities like equities, preferred shares, high yield and investment grade credit are starting to show some weakness. Could we be approaching that turning point in the business cycle where growth has plateaued and all the good news has been fully priced into financial assets? If this new higher interest rate environment is validated with better economic growth, then financial assets could rebound and stabilize; if not, we're probably in for more downward price pressure and volatility. Given all this, it's not surprising that the markets are displaying some degree of uncertainty.



The increase in interest rates has made fixed income investing much more interesting and attractive. We are earning way more on our new purchases of higher quality credit, but unfortunately the move higher in rates also negatively impacts our existing holdings. The question we keep asking ourselves is how much higher can interest rates go? When we decompose the components of the yield on US 10-year treasury bonds (real yield, inflation and term premium) we find the recent run-up in yields has been primarily driven by an increase in growth expectations – the real yield. Based on the current environment, the level of 10-year interest rates looks about right.

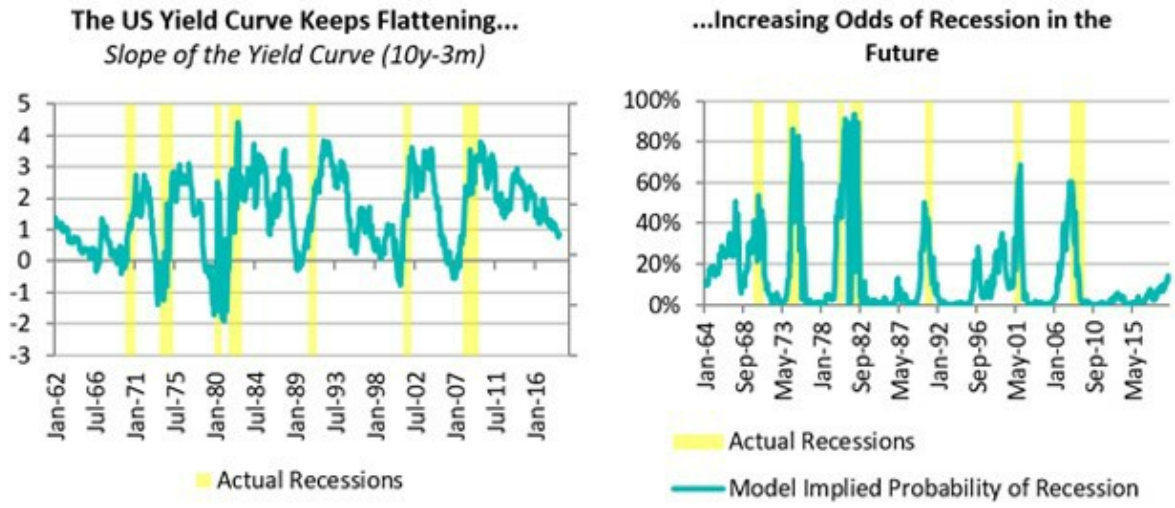
For interest rates to go higher we would need more inflation, an increase in real yields or the term premium. At some point, record low unemployment, the US trade war, and tariffs should increase inflation. With central bank purchasing less of their bonds and governments running bigger deficits that are funding fiscal spending, we should also expect a higher term premium. As recent economic data has started to show some inconsistencies and global PMIs have started to turn down, signally a plateauing in growth, a move higher in real yields isn't so obvious. Putting all of this together, we see some probability of slightly higher long term interest rates for the balance of 2018 and early 2019 – perhaps another 0.25%, but nothing too substantial.



Source: Bloomberg

Major central banks are raising short term rates and along with this the term structure of interest rates (2-year to 30-year rates) is also increasing – but at a slower pace – which creates curve flattening. Our yield curve model, which we use as a recession indicator, has the probability of recession in the next 12 months at around 15%. We're at that transition point where the bond market is weighing the final number of rate increases required to slow economic growth and inflation. The expectation is that the Bank of Canada will raise rates three more times in 2019, bringing the overnight rate to 2.5%, the lower end of their (2.5% to 3.5%) neutral range. In the US, the Federal Reserve is expected to raise rates one more time this year and three times in 2019, bringing the overnight rate to 3.25%, at the higher end of their neutral range (2.5 to 3.5%). If both

the BoC and the FED execute on their planned increases and we don't get a spike in economic growth or inflation, we would expect the yield curve to be inverted by mid-year 2019. When in the future does recession actually arrive? Perhaps in a year or two. The yield curve is a great indicator of recession, but its ability to predict the exact timing isn't great.



Source: Bloomberg

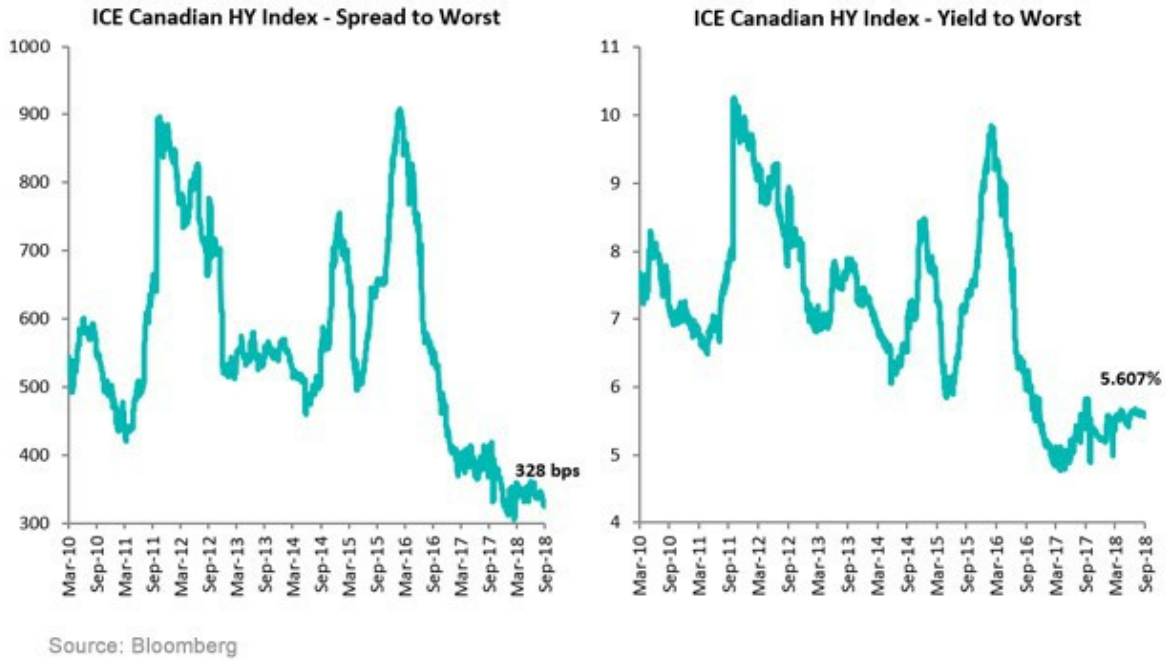
The continued depreciation of the Canadian dollar to the 1.31 level has been a complete mystery to us. The Bank of Canada has made good on three rate increases this year and they haven't really changed the tone of their market dialog to suggest a dovish bias. Canadian GDP has been fine, trade is improving, job growth has been stable, and inflation is higher. We were really convinced that post NAFTA , the CAD would have improved closer to 1.27 and perhaps even 1.25 by year-end. Given, our constructive view on the CAD we've been running the portfolio with no foreign currency exposure and will continue to do so, by hedging the currency when we purchase foreign securities. Having said that, we haven't purchased many USD securities as it costs us close to 0.80% annually to hedge the dollar exposure. We've added some global diversification to our security mix by buying Maples, which are bonds issued by foreign companies in our market in CAD.

There was $24.7 billion of investment grade credit issued in 3Q18 ($87 billion YTD), which is a little lower than what the market expected for the quarter. We're reading and hearing more from companies that the ongoing uncertainty related to tariffs and global trade tension are factoring into their capital expenditure plans. The reduction in bond supply so far this quarter might be related to this uncertainty. The ICE (formerly the Merrill Lynch) Canadian Investment Grade Index, tightened by 1bp to 111bps in 2Q18. That's wider by 21bps from the tightest level of the year. The move higher in government bond rates has made IG credit much more attractive; consequently, the market is well-bid for IG product. The all-in yield on the ICE IG Index is at 3.45%, 0.25% higher than last quarter – of note, the ICE IG BBB Index now yields about 3.76%. Where we go, spread wise, from here will be entirely a function of recession risk and that doesn't appear to be currently factored into credit spreads or government bond yields. We've been slowly migrating our portfolio to shorter-dated IG,

which will be more defensive when credit becomes negatively impacted by recession risk. Net new additions to the portfolio over the quarter were: AT&T Inc., TELUS Corp., GM, SunLife Capital Trust, Brookfield Infrastructure, Glacier Credit Card Trust.

Source: Bloomberg

Regardless of the volatility in the equity markets, high yield bond prices have been incredibly resilient. During the recent quarter the ICE Canadian High Yield Index tightened in 26bps, to a spread of 328bps and an all-in yield of 5.61%. That's tighter by 9bps over the year and in 31bps from the widest level. The outperformance of high yield bonds can be attributed to technical factors that have limited supply. In Canada, the energy/commodity complex accounts for a high percentage of HY issuance. After oil and commodities prices hit record lows in 2016, the majority of those companies refinanced their debt, when their balance sheets became impaired. In the US, there has been record demand for leveraged loans because of the resurgence of CLO's. Consequently, HY companies in the US and some here, have called or tendered for their bonds and issued loans that have very attractive rates and terms. With equity markets selling off and the yield differential of around 1.85%, between generic high yield and BBB investment grade credit, we feel the risk in junk bonds doesn't justify the measly return potential. The only sectors that are relatively attractive to us are energy E&P, servicers and the commodity complex with yield in the range of 7% to 9%. Although we still have a 25% weight in high yield, half of it is lower duration. During the quarter the only new additions to the portfolio was Vesta Energy Corp.



The fund continues to maintain its conservative positioning. The core portfolio has 63% investment grade (of which 11% are floating rate), 25% high yield, 6% secured loans and 5% preferred equities. We used the move up in rates as an opportunity to invest our large cash position into 1-year-and-under investment grade credit. 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 almost entirely investment grade credit with an average duration of 6.1 years, interest rate-hedged with government bonds. From a currency perspective our USD weight, consistent with our view on the Canadian dollar, is 0%. The aggregate duration of the portfolio has been extended to 1.9 years and the fund yields 5.6%.

It's been a challenging environment for fixed income and we don't see that changing this year. Our bias is to maintain our conservative positioning and add risk when its better priced. Although we think the credit markets are due for a correction, at some point, the exact timing is obviously difficult to predict. Consequently, we're focused on being directionally accurate.

Regards,

Mark, Etienne and Chris

[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 September 30, 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.

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