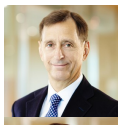
Credit Income Opportunities Fund

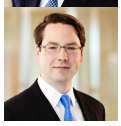
Q4 2017 Commentary

The Sprott Credit Income Opportunities Fund (Series A) was up 2.08% in Q4 2017, +5.29% for the year.

Investment Team



Mark Wisniewski,
Partner, Senior Portfolio Manager



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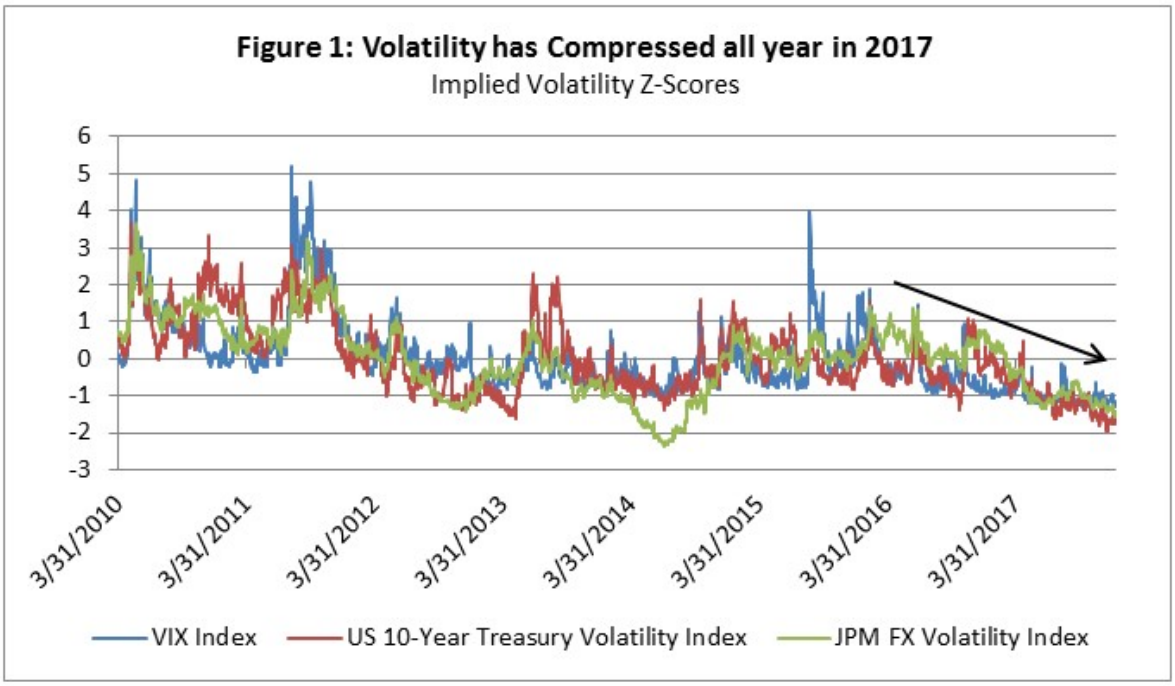
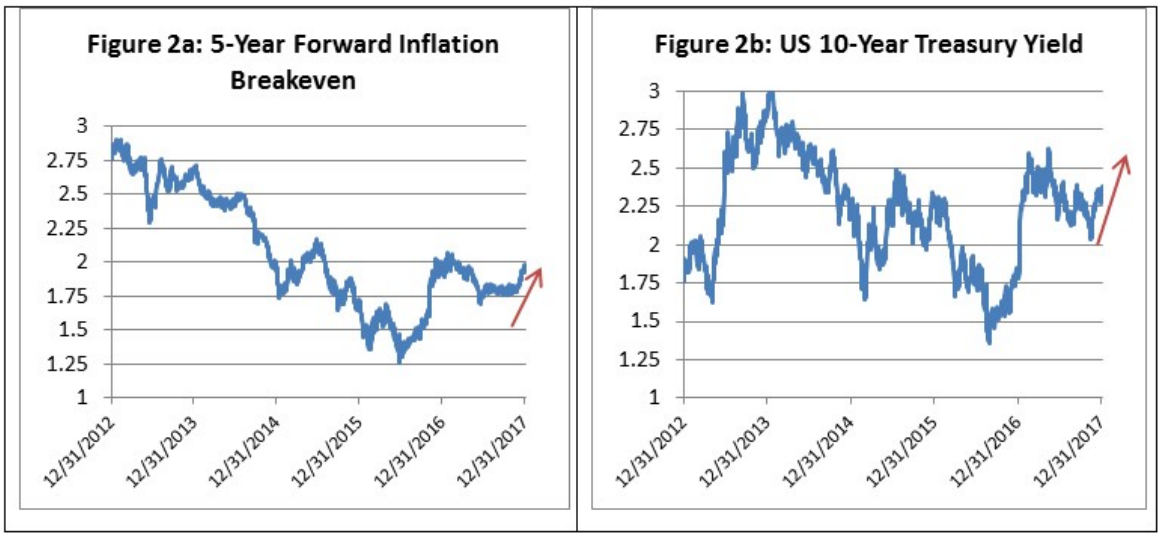
The market's 2017 worry list, was extensive and the uncertainty about the unexpected was sure to escalate volatility. First there was the risk of significant political instability through the elections in France, the UK, Germany, Catalonia and the Netherlands. Britain was in the early stages of negotiating a tricky exit from the EU. Then North Korea continued to threaten the US and its allies. Major central banks throughout the world raised rates and - or signaled a preference for removing easy monetary policy. The newly elected Trump administration faced political opposition on almost every campaign promise, with a late year overhaul of the tax system, their only success. Despite starting 2017 at lofty levels, absolutely nothing jarred the markets move higher. Equities set new records, high yield bonds appreciated and corporate bond spreads compressed. Unlike prior years, it appears that the fear of the unexpected wasn't the source of fear for the market anymore. Considering the lofty valuation of almost every asset class and the price appreciation of Bitcoin or other crypto currencies, it's starting to feel like we're smack in the middle of late cycle silliness.



While we're on the topic of silliness, the low level of interest rates, globally, is something that comes

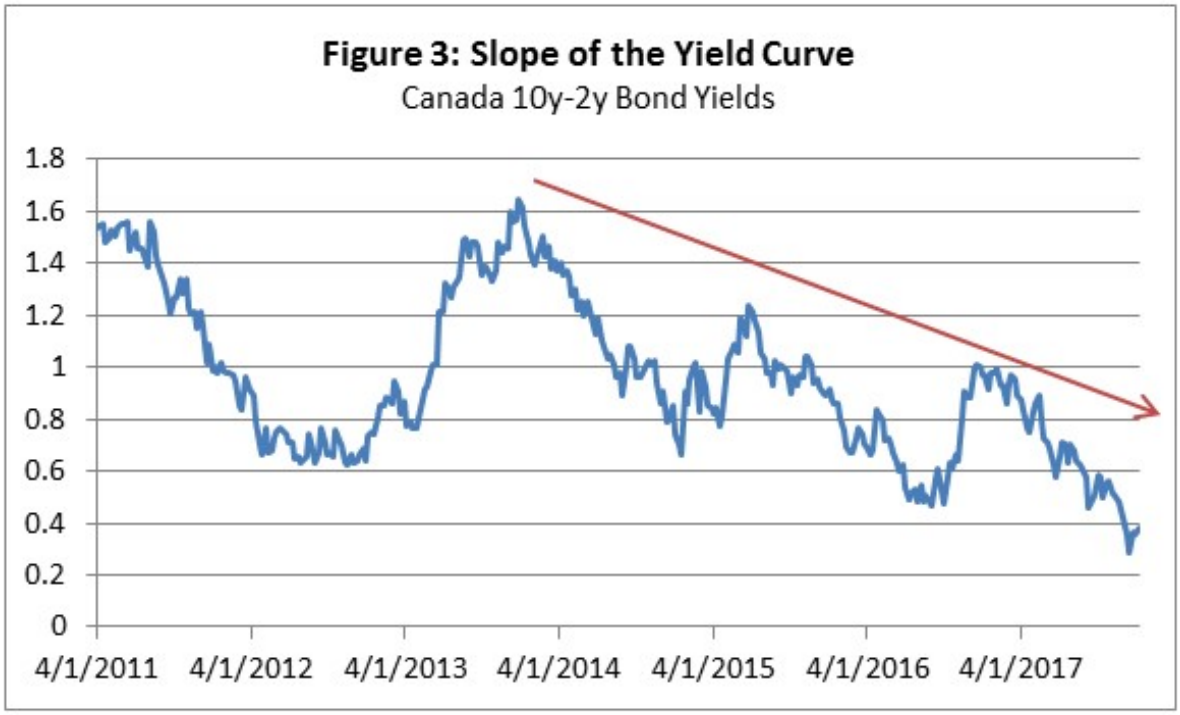
to mind. Despite the continued improvement in the breadth of growth, record low unemployment globally, three rate hikes by the Federal Reserve, two unexpected rate increases by the Bank of Canada, one increase by the Bank of England and a tapering announcement by the European Central Bank, interest rates everywhere remain stubbornly low. It is fair to say that the lack of inflation, bonds greatest enemy, has been a persistent source of encouragement for the bond market. Chair Yellen during the September FOMC press conference, expressed doubts in their committee's ability to understand the low inflation of recent years, coining it the "inflation mystery" Other Central Bankers have insisted that the slack in the labor markets has been responsible for this low inflation phenomenon. They all have a deep rooted belief in the so-called Phillips Curve, which links labor market conditions with inflation. That relationship appears, for now, to be broken. We believe that domestic labor conditions have little bearing on inflation because of globalization. And although globally there was a surplus of capacity, that excess is now shrinking. According to the OECD's November 2017 Economic Outlook, we should expect that over 50% of OECD countries will have closed their output gap in 2018, increasing to 67% in 2019. So while central bankers remain puzzled by low inflation, we believe that more likely than not, it will start showing up in the developed world by mid-2018. Inflation expectations, as illustrated by the Fed's 5-year forward breakeven inflation rate have recently increased by 0.16% to 1.98% (Figure 2a). With the improvement in global economic growth absorbing slack, plus higher oil and commodity prices, inflation will be the big story for 2018. When inflation does accelerate, as we expect, Central Banks will be scrambling to alter the pace of rate increases. With the census of 3 rate increases for Canada and 3 planned for the US, we're hard pressed to see how 10 year Canadian government bonds can't yield 2.75%. When this occurs, it will have a profoundly negative impact on longer dated interest rates, fueling a sell-off in fixed income securities as investors redeem from high duration bond funds and ETF's.



The broad based strength of the Canadian economy this year surprised everyone, including the BoC who responded with 2 completely unexpected rate increases. We are very constructive on growth next year and believe that the Canadian dollar will appreciate post the uncertainty surrounding NAFTA. The negotiation process restarts early in the New Year and should sideline the BoC until March. They will need some clarity on the terms of trade and then access the economic impact. As well, the new mortgage qualifying rules could possibly moderate construction and economic growth, if the demand for housing becomes too tempered. Against that backdrop, the Canadian economy continues to enjoy record low unemployment and growth that has become more diverse

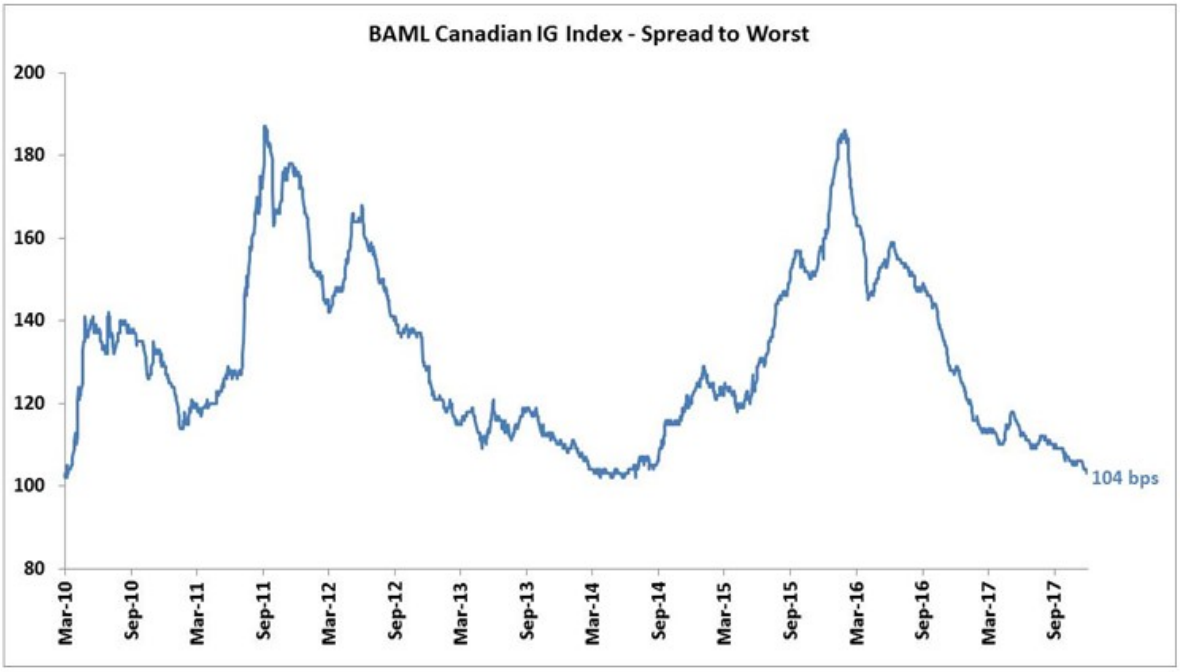
and broad based. The BoC could easily match the Fed with 3 rate increases in 2018. Without any huge surprise in the NAFTA terms or a significant global economic shock, the Canadian dollar could trade through the 1.20 level. Throughout the last quarter we have reduced our US dollar exposure to zero, from a high of 20%.

As we have discussed in prior quarterly reports, the slope of the Canadian yield curve (the differential between 2 and 10 year yields) continues to intrigue us. Although the yield curve has continued to flatten, it is still far from inverted. Regardless, it's a source of unease for us, as it suggests a slow-down in the economy in the near future. The collective wisdom of the bond market equates an inversion of the yield curve to a looming recession, typically within a year. If the yield curve continues to flatten and inverts at some point in 2018, we should expect a recession in late 2019 or early 2020, which would end an unusually extended business cycle. Corporate bonds have had an incredible run since the last sell-off 2 years ago. Credit and economic conditions are currently very favorable, validating the lofty pricing of corporate bonds. As we approach the peak of the cycle, as implied by the yield curve, squeezing out further gains in excess of interest carry, will be a challenge. We could, of course, be a little early on our recession and credit call. Higher economic growth and an increase in inflation in 2018 would temper the rate of flattening or steepen of the curve and with that credit could appreciate modestly or go sideways for another year. Considering this, we're exploring options strategies that allow us to add more credit, but protect the portfolio against an adverse move in credit spreads in the future.

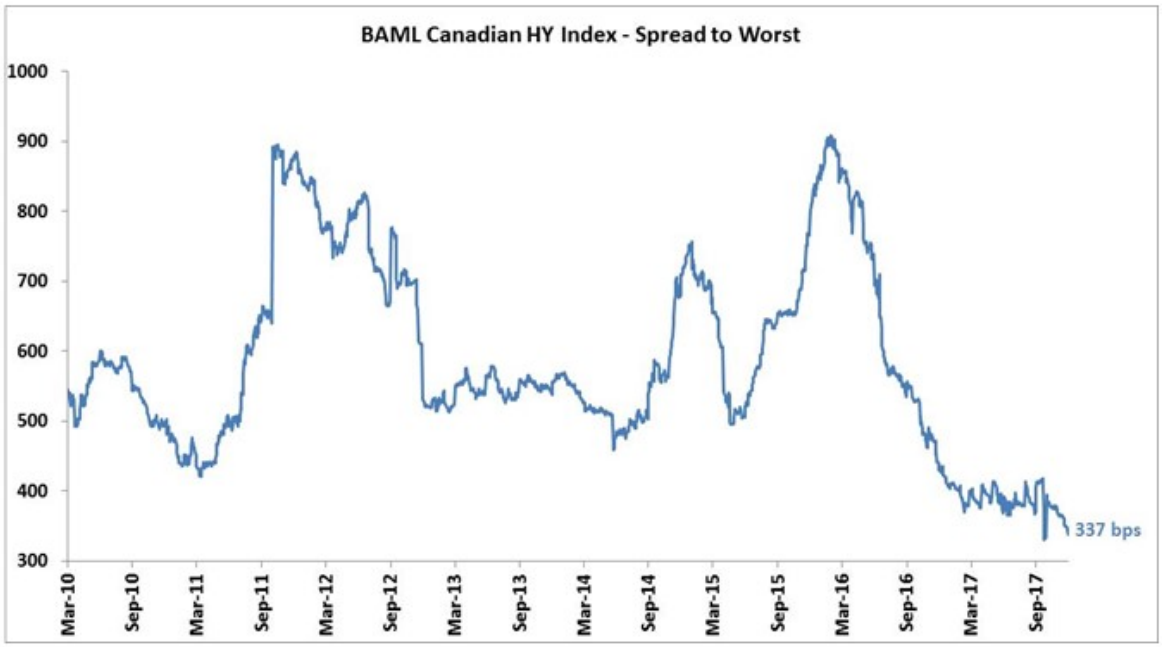


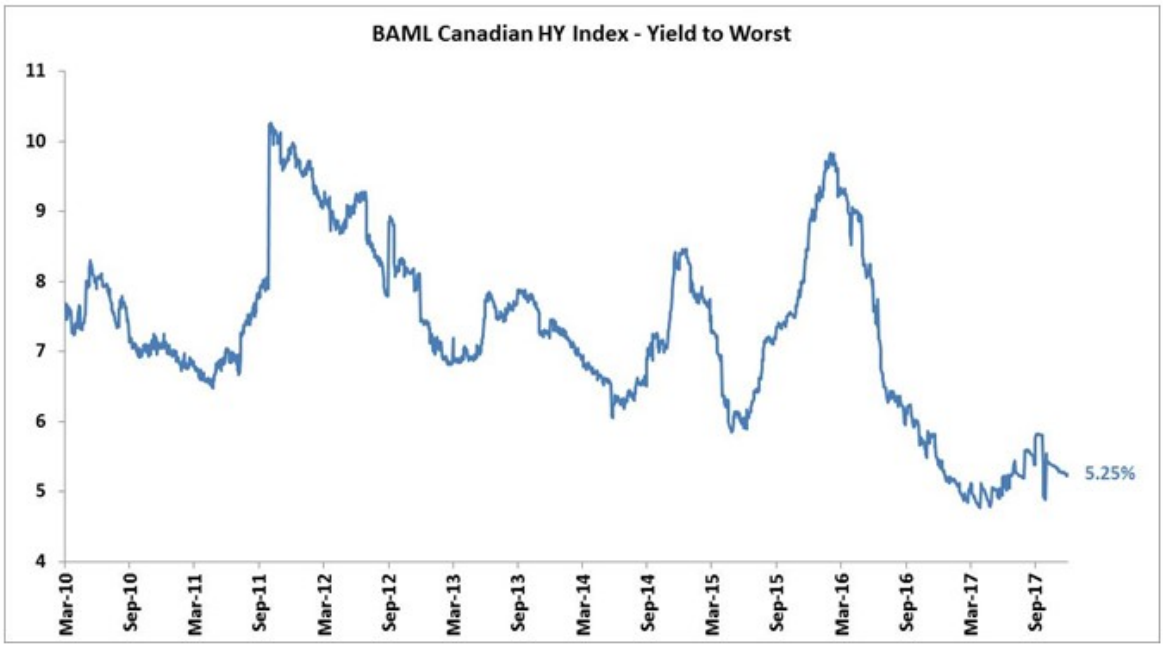
During the quarter IG credit continued to tighten, although modestly. The spread on the Merrill Lynch Canadian Investment Grade Index moved in 6bp to 104bps, tighter by 25bps this year. With the yield on the 5 year Canadian government bond rising by 0.65% this year, the all-in yield on shorter dated corporate bonds still looks very attractive, regardless of the spread compression. Corporate BBB 5 year bonds generate a yield in the range of 3.25% to 4%. With credit spreads approaching historic lows, it is much less compelling and more risky to use leverage to generate yield. Consequently we see short to intermediate term credit, unleveraged, as the best place to

invest. At $116 billion of Canadian IG new issues this past year, a record, the appetite for credit continued to be extremely robust. Despite the magnitude of issuance, Canadian banks were less active, down 19%. However, we did see much more activity from international issuers, $9.85 billion from new companies like Apple, Disney and McDonalds. As well, there was a record $3.15 billion in hybrids issued by TransCanada and Enbridge. This was an important development as issuers have traditionally preferred to access the US market for hybrids because of better pricing and larger transaction sizes. The interest in this product has escalated, so we expect more hybrid issuance in 2018. Net new additions to our investment grade portfolio were BNS, BMO, Toromont Industries Ltd., Sun life Financial Inc., Fairfax Financial, Metro Inc. and MCAP Commercial.



The Merrill Lynch Canadian High Yield Master Index closed out the quarter with at a spread of 337bps, tighter by 33bps with an all-in yield of 5.25%, tighter by 92bps from the start of the year. We view high yield as expensive, regardless of the improvement in energy prices and projected default rates. And the coupon one receives continues to decline, despite the deterioration in credit metrics (leverage, interest rate coverage). With HY spreads as tight as they are, it will be difficult to generate carry in excess of 5%. If the market corrects and HY sells-off, as we expect, the return could be zero. Consequently we prefer shorter dated investment grade credit that yields as much as 4%, preferred shares that yield 5% and secured loans that yield in excess of 10%. We recently added a loan position in Lilis Energy that has a yield of 10%. That's almost twice as much as what we'd earn from high yield and that loan is senior secured. Net new high yield additions to our portfolio in the 4Q17 were Enbridge Energy Partners, Enbridge Inc. and Tidewater Midstream.





Throughout the last quarter, we maintained a conservative positioning bias. Our core portfolio has 31.5% cash, 21% investment grade, 25% high yield, 7.5% secured loans, and 15% equities – we added positions in RBC and BCE preferred. The average credit quality of the portfolio is BBB-, leverage is low at 0.7 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 has been reduced to 0%. With the addition of a recent portfolio options positions we have lowered our aggregate duration to effectively zero, yet the fund still yields 4.9%, with lots of cash. If the market continues along without any significant changes in credit spreads we would expect to earn our carry of 4.9%. If we do get a sell-off in credit, we've got lots of levers to pull to add higher yielding positions by deploying cash, increasing leverage and adjusting our security mix.

The markets worry list is again building for 2018. Theirs is still the BREXIT negotiations, a looming election in the UK, Angela Merkel's party's political future and Germany's relationship with the EU, US mid-term elections and the fate of the Republicans, a Trump trade war, China's economic growth rate, North Korea, Canadian real estate prices, the price of oil, the BOJ's positions on tightening monetary policy, the unwinding of easy money by global central banks, interest rates, inflation and of course the price of Bitcoin. We are entering 2018 on a much stronger economic footing and although the yearly worry list isn't shrinking, maybe like last year, the market won't worry about it and volatility will remain low. Who knows.

Certainly not me, I like to worry!

Happy New Year,

Mark, Etienne & 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 December 29, 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.

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