Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Energy Sector

Suncor Energy – Canada's largest fuel distributor and retailer, Parkland Fuel Corp, will buy fellow retail fuel marketer Pioneer Energy, which is part-owned by Suncor Energy Inc, for $378 million. Pioneer is jointly owned by The Pioneer Group Inc and Suncor, which is Canada's largest oil and gas company. The Pioneer Group will receive $76 million, or 39% of the total consideration, in cash, and $119 million, or 61% of the total consideration, in common shares of Parkland. Suncor will receive $183 million in cash. Pioneer's holdings include a network of 393 gas stations throughout Ontario and Manitoba. It distributes 5.1% of total retail fuel volumes across Canada.

Total – French oil company Total is to sell more assets and cut costs to generate more cash and is to revamp exploration plans after reducing its oil production target. Total, which has struggled with production outages in Libya, Kazakhstan and Nigeria, on Monday cut its 2017 output goal to 2.8 million barrels of oil equivalent per day from a previous 3 million. Total, like other big oil companies, has been under pressure from shareholders to cut costs and raise dividends as rising costs in the oil industry and weaker oil prices squeeze profitability. It has been selling off businesses, such as its adhesives division Bostik. The company now plans to sell $10 billion worth of assets in 2015-17, having achieved a target of $15-20 billion of sales in 2012-2014. The company's investments would fall to $25 billion in 2017 from a peak of $28 billion in 2013 while operating expenses would fall by $2 billion per year by 2017. On Monday, the group stuck by an earlier target to generate cash of $15 billion in 2017 but cut the target for next year to $7 billion from a previous $10 billion. It had free cash flows of $2.6 billion in 2013.

Financial Sector

Berkshire Hathaway – US Agriculture Secretary Thomas Vilsack met with Warren Buffett last week to urge the billionaire investor to make sure his BNSF railroad is ready for an expected record corn and soy harvest this year. Speaking at a conference sponsored by Growth Energy, a biofuel trade group, Vilsack said BNSF was making "significant" investments. "It's a long-term issue." Backlogs along US rail lines became a major concern for a number of commodities markets this year. In June, for example, US officials ordered BNSF and Canadian Pacific Railway Co to report their plans to clear a backlog of grain cars after months of service delays blamed on harsh winter weather and high freight demand. BNSF is a unit of Berkshire Hathaway. The railroad, which was struggling from the Great Recession when Berkshire bought it for $26 billion in 2010, returned a $3.8 billion profit last year. One major source of profit, oil by rail, has become controversial, with some commodities producers saying railroads, including BNSF, are prioritizing the shipments of crude at the expense of other cargo.

BNP Paribas - France's biggest listed bank has completed the purchase of Bank BGZ, Poland's No.11 lender by assets, from Rabobank for 4.5bn zlotys ($1.39bn) as part of a plan to expand in faster-growing markets. Poland has attractive growth prospects and moderate banking penetration at about 70%, BNP said in its investor presentation last week. The acquisition of BGZ would bring its market share in deposits to around 4%. BNP Paribas should hold between 88.64% and 90% of Bank BGZ, depending on results of the tender offer, it said in a statement on Monday. Rabobank will retain a stake of just below 10%. BNP aims to boost return on equity in Poland to a double-digit percentage by 2017 after acquiring Bank BGZ, said Jean-Paul Sabet, deputy head of international retail banking. In another example of poacher turning gamekeeper BNP has hired the former chief council of the US Office of Foreign Assets Control (OFAC) - the body that implements US sanctions law and that was at the centre of the $9bn fine BNP paid in 2Q. He will become legal counsel of BNP's US sanctions compliance group. The company announced a remediation plan following the sanctions fine that included EUR200m of one off costs associated with the set up of an independent US compliance function based out of New York.

Nordea - has confirmed that it has issued $1.5bn contingent capital with 5.5% coupon for the 5 year and 6.125% for the 10 year instrument. The transaction increases Nordea's T1 capital by 75bps to 17% pro-forma.

TD – The Canadian government should tighten lending rules further to discourage consumers from taking on too much debt in an environment of low interest rates, the outgoing chief executive of Toronto-Dominion Bank said on Tuesday. Ed Clark, who will step down as CEO of Canada's No 2 lender in November, said the central bank's low interest rates were appropriate given the economic outlook, but this meant the federal government should use administrative measures to check a jump in household debt that's come amid a housing boom. "It's just not realistic in a competitive marketplace to say why doesn't one bank lead the way and change the rules. It won't happen. This is a responsibility of the government", Clark said. "I get why they keep worrying about doing it. But I think you have to just keep touching this brake. As long as you run low interest rates, you then should be continuously leaning against asset bubbles." Canada's Conservative government has stepped in four times since 2008 to tighten mortgage lending rules to cool a real estate market that flourished as the financial crisis ebbed. The property rally sent the ratio of Canadian household debt to income to a record high of 164.1% in the third quarter of last year, though it has since eased slightly. Clark announced last year that he would retire. He will be replaced by TD Chief Operating Officer Bharat Masrani.

Wells Fargo - is easing lending requirements for people buying certain types of homes, the latest in a series of moves by the bank to ramp up new mortgage lending. "We're tweaking our condo [condominium] approvals to make them more consistent with what Fannie [Mae] and Freddie [Mac] allow," Franklin Codel, head of mortgage production at Wells Fargo, said in an interview. Wells required much greater detail from borrowers applying for mortgages with down payments of 25% of the value of the property or less. However, the equivalent level of detail will now be needed from those with a down payment of 10% or less. (source : Financial Times)

Banks in Italy and Spain were among the leading borrowers in the European Central Bank's first targeted-loan programme, taking more than 45% of the €82.6 billion ($106.5 billion) to trim funding costs. UniCredit SpA said it raised €7.8 billion, while Intesa Sanpaolo SpA took €4 billion. Banco Santander SA sought €3.6 billion, a person familiar with the matter said, the most among Spanish banks whose borrowings were disclosed. Overall, Italy's 15 largest banks, whose assets are under scrutiny by the ECB, borrowed €21.1 billion. ICCREA Banca obtained €2.2 billion on behalf of smaller cooperative banks, pushing the take-up to 28% of the total. Spanish lenders took at least €14.8 billion. (Source:Bloomberg)

Canadian Dividend Payers

Brookfield Property Partners – upgraded its guidance for its funds from operations (FFO) growth of 8%-11% per annum, as well as for its distribution growth target to 5%-8% per year, during last week's investor day.

Global Dividend Payers

Bayer – has appointed investment bank Rothschild to advise on the German drugmaker's plan to list its plastics business, in a deal that could value the unit at about £10 billion. Bayer's chief executive Marijn Dekkers said last week that the divestment of the MaterialScience unit, which may be rebranded before a listing, will free up money for investment in Bayer's healthcare, veterinary drugs and crop protection businesses. Rothschild will help to prepare the MaterialScience unit for an initial public offering (IPO) as soon as this time next year or for a spin-off by handing current Bayer shareholders shares in the separate unit. Investors had long speculated that Bayer could split off MaterialScience, which makes transparent plastics for blu-ray discs and panoramic roofs for luxury cars, as well as chemicals for insulation and padding foams.

Tesco - has this morning issued another profit warning, but this time it is accounting driven rather than trading driven. The company discovered on Friday that its previous guidance (provided on 29 August) for 1st Half EBIT of £1.1bn is likely to be c£250m too high. This is due to accelerated income recognition and insufficient booking of costs. Some of this is likely to be intra-year timing, but by no means all – so there is a clear implication in our view that the Full Year guidance of £2.4-2.5bn needs to come down. Tesco makes no comment as to how much – £250m is not necessarily the maximum reduction required. 1st Half results will be delayed from 1 October to 23 October – when hopefully a fuller diagnosis can be provided. Adding an accounting issue to its trading issues is clearly unhelpful for Tesco. Marketing Week reported last week that Tesco is testing a mobile payments system that enables customers pay for their shopping using their smartphones. The PayQwiq service is being trialed by staff members in a number of stores in London and Edinburgh. After registering, customers can use an app to display a QR code which the till scans to pay for their shopping. Marketing Week quoted a Tesco spokesperson as saying that the response so far had been good, but there are as yet no details on a wider roll-out.

Economic Conditions

US: Federal Reserve Open Market Committee made no alterations to its forward guidance, keeping the phrase: "… it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends." The lack of alternation elicited another dissenting voter, with Dallas Fed President Fisher joining Philly's Plosser. Asset purchases were tapered by another $10 billion to $15 billion, and the FOMC statement said: "… it will end its current program of asset purchases at its next meeting" as has been advertised. Apart from these items, there were no other material changes to the Statement.

In the Summary of Economic Projections, the profile for year-end policy rates was lifted. The median for 2015 was 1.38%, up 25 bps, and 2016 was 2.88%, up 38 bps. The inaugural projection for 2017 was 3.75%, the same as the longer-term level but with more dispersion. Note there are now five quarter-point rate hikes penciled in for next year, six for 2016 and three-to-four for 2017.

Among the central tendency economic projections, the only major change (midpoint moving by more than a tenth) was for real GDP growth next year, now 2.6%-to-3.0% vs. 3.0%-to-3.2% before. The inaugural 2017 forecasts had growth slightly above the longer-run level and the jobless rate a bit below.

The Fed also released its "Policy Normalization Principles and Plans". The FOMC will set a target range for the fed funds rate going forward, rather than a point target. It will guide the range with the interest rate its pays on excess reserves, and use its other new tools (term deposits and overnight reverse repos) only if needed, particular the repos. Ending reinvestment of principal payments will stop only after rate hikes have begun and there will be no outright sales for the foreseeable future (although they might occur in the longer run).

U.S. housing starts fell considerably more than expected in August, but they didn't completely reverse the prior month's huge jump. Starts buckled by 14.4% in August to 956k units annualized, the largest monthly decline since April 2013. But there were, on net, upward revisions to the prior two months. July is now showing a 22.9% surge to 1,117k units (was +15.7% to 1,093k), while June's soggy 945k is now coming in at 909k. For August, both singles and multi-family construction took a step backward, the latter moreso than the former. And the setback wasn't confined to just one area……all regions of the country saw fewer ground being broken last month. Building permits, which are a good indicator of future starts, also fell more than expected in August, down 5.6% to a 2-month low of 998k units, annualized. Again, fewer permission slips were granted for singles and multis across all four regions of the country.

US industrial production has surprisingly taken a step back in August, down 0.1%, which compares to July's 0.22% advance and the expected 0.30% improvement. The US capacity utilization also felt short of expectations in August, at 78.81%, relative to 79.30% expected. The reading indicates slackening in the economy as July's capacity utilization stood at 79.10%. The mount of slack in the economy could partially be used to explain the tamer than expected inflation numbers for August, with headline consumer price index (CPI) inflation at 1.7%, relative to the expected 1.9% and July's 2.0% rate. The US core inflation rate exhibited similar dynamics, at 1.7% year on year, short of both the expectations and July's figure of 1.90%.

The US leading economic indicators (LEI) were up 0.2% in August, short of the expected 0.4% reading, which seems to indicated that, although the US economy is still expected to improve in the second half of the year, it is unlikely to repeat the first half's performance.

Canada: The headline consumer price index (CPI) inflation was flat in August in Canada, at 2.1%, in line with the consensus expectations. The core reading however, which excludes the effects of eight most volatile price series, including food and energy, unexpectedly jumped to 2.1% from 1.7% in July, significantly ahead of the expected 1.8% rate reading. The increase in consumer prices was driven by household expenses, but other categories, such as clothing, health and personal care and recreation, also contributed to the increase.

Scotland voted to stay in the U.K., with a final tally of 55.3% choosing to stay in the Union…..and so in my view remain patriotic rather than nationalistic.

Financial Conditions

ECB's efforts to stimulate the European economy faltered last week when demand from banks for its cheap 4 year loans fell short of expectations. European banks borrowed Euro 82.6bn through the first of its 'Long-Term Refinancing Operations' (LTROs) out of a possible Euro 400 billion…..meaning that the banks have less available to on-lend to businesses and customers in order to stimulate growth and counter low inflation. The LTROs allow banks to borrow at a rate of just above the refinancing rate of 0.05% until late 2018 so long as they meet targets for lending to businesses – if they miss the targets they must pay the funds back in 2016. However, the Financial Times reports that Eurosystem officials had only modest expectations for the take up and believe the next round in December will be higher with four more planned in 2015 and two more in 2016. It therefore seems unlikely in our view that the ECB will consider more radical measures of quantitative easing until there is further evidence that this stimulus is not as successful as hoped.

US Federal Reserve policymakers remain determined to flatten the yield curve as much as possible, having indicated they expect 'exceptionally low levels of interest through 2014 with the Federal Reserve carefully calibrating the beginning of unwinding quantitative easing and undertaking that the Federal Reserve will keep rates low until mid 2015. The US 2 year/10 year treasury spread is now 2.01% and the UK's 2 year/10 year treasury spread is 1.63% - meaning investment banks remain constrained from profiting from a steep yield curve and instead are seeking operational efficiencies, including job cuts and lower compensation, to maintain acceptable levels of profit, i.e. above their costs of capital. It seems the top tier 6-9 investment banks will continue to command their market and possibly increase their share – as barriers to entry for newcomers have in our view been raised.

Influenced by the withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to 4.23% - (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to give priority to incentivising home ownership. Existing US housing inventory is at 5.5 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months.

The VIX (volatility index) is 13.15 (compares to a post-recession low of 10.7 achieved in early June) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Mutual Funds

- Portland currently offers 6 Mutual Funds:
- Portland Advantage Fund
- Portland Canadian Balanced Fund
- Portland Canadian Focused Fund
- Portland Global Income Fund
- Portland Global Banks Fund
- Portland Global Dividend Fund

Private/Alternative Products

Portland also currently offers 4 private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland GEEREF LP
- Portland Advantage Plus Funds

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

Sources: Thomson Reuters, Bloomberg, Macquarie, Credit-Suisse, KBW, Bank of America, TD, BMO

Source: Thomson Reuters, Bloomberg, Company reports

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