Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Why Have Stocks (Energy in Particular) Been Volatile Recently?

A number of factors, largely unrelated could be pointed as causes of the current market turbulence. To start, a number of large economies, notably China and Germany, previously perceived as growth engines of the global economy are showing signs of weakness, which in turn prompted supra-national organizations, such as IMF to lower their global growth outlook for 2015. These concerns add to the well publicized economic difficulties facing the rest of Europe. Geopolitical turmoil in Ukraine and Middle East impacts global trade, while, at least thus far, failed to impact oil production. Ebola fears put further pressure on sentiment across the globe and is affecting world travel. Bumper harvests in key crops had a crushing effect on grain prices.

Weakness in the energy sector is a function of a supply-demand imbalance, as the global supply growth, driven chiefly by a dramatic increase in the supply of US shale oil, has been outstripping the growth in global demand, affected by the above-mentioned factors. Bold technological innovations have caused the US to become the world's leading liquid petroleum producer, ahead of the Saudi Arabia this year. US crude production reached 8.8 million barrels per day in September (or above 11 million barrels per day when accounting for production of condensate and natural gas liquids) and is expected to keep growing. On the demand side, the US demand is expected to stay largely flat, at 18.9 million barrels per day, as Americans are driving less and using more fuel-efficient cars, while globally demand is only expected to grow modestly. Strength in the US dollar and, increasingly so, speculation, have also been contributing factors to lower oil prices.

However, we expect the imbalance in supply and demand to be relatively short lived as a dramatic drop in prices would have the effect of pricing out of the market the marginal oil producers, in particular in the US shale, which is characterized by an average production cost of $50, and thus re-adjust supply. A number of oil projects have already been placed on hold and more are likely to follow. As oil prices are getting lower, it is likely, as it has been the case in the past, that the demand will be stimulated. We believe that, given the superior economics of the energy companies we hold, in particular Crescent Point Energy and Baytex Energy, such oil and gas producer are in a prime position to participate in the consolidation of the industry caused by the current downturn in prices. Other positive dynamics, such as increased access to markets for Canadian crude provides support to the oil prices realized by Canadian producers. In addition, as history has shown, low oil prices don't tend to last for long, in fact, over the last 20 years, low prices only lasted, in average, for about 12 months.

Energy Sector

Chevron – US-based Chevron and state oil company PDVSA operate the Petroboscan heavy crude joint venture in western Venezuela. Chevron also has a share in the Petropiar oil upgrader in the Orinoco belt. Separately, Statoil Venezuela official Luisa Cipollitti said at a conference in Venezuela that "mega-projects" globally were under threat from the price fall. "Prices ... have fallen and we don't know if in the future there will be enough to cover the cost of these projects," she said. Cipollitti estimated that more than half of the world's biggest 163 oil projects required a $120 price for crude.

Pacific Rubiales Energy Corp - Colombia's largest private oil producer, on Friday said it had signed a three-year deal to analyze potential oil and gas cooperation in Mexico with Pemex, that country's state oil company. The deal will include analysis of exploration, deep-water projects, mature fields and other activities, Pacific Rubiales said in a statement. "We expect Mexico will be a significant driver of future growth for Pacific Rubiales and are committed to further advancing our plans in the country," Ronald Pantin, chief executive officer of Toronto-listed Pacific Rubiales, said in the statement. Mexico's Congress passed a sweeping energy reform late last year that promises to lure billions of dollars in new investment into the country's struggling oil, gas and electricity sectors. Earlier this month, Pemex and Exxon Mobil Corp signed an agreement to jointly explore upstream and downstream business opportunities.

Financial Sector

Bank of America - reported a $0.01 loss in 3Q14. Consensus called for a $0.09 loss. Results include its previously announced pretax charge of $5.3bn for the settlement with the Dept of Justice ($4.9bn in expenses, $0.4bn in provision) which reduced Earnings Per Share by $0.43 (so $0.42 ex. charge). Relative to expectations, lower than expected taxes and loan loss provision drove the upside. Excluding the litigation costs, as well as a $0.04 tax benefit, $9mn in gains in equity investment income, $432mn of debt securities gains, a $298mn provision for U.K. payment protection insurance, net Debt Value Add gains of $205mn, a $407mn loan loss reserve release, and a $80mn increase in provision for reps & warranties (adds $0.08 in aggregate), the Earnings Per Share was closer to $0.34. Core revenues rose 1% y-o-y and declined 2% sequentially to $21.2bn.

Consensus was $21.3bn. Tangible book declined 1% to $14.13. Its Common Equity Tier 1 Ratio Under Basel 3 (Standardized Approach, Fully Phased-in) was 9.6% in 3Q14 (+10bps), while Advanced Approaches was also 9.6% (-30bps; additions to Operational Risk Weighted Assets). Its Firm Supplementary Liquidity Ratio was 5.5% and Banks was 6.8%.

Reported net interest income rose 2%, while core NII (ex. market-related adjustments) increased 1%. Average earning assets declined 1.5% with loans down 1.5% and securities up 1.9%. Its reported net interest margin rose 7bps to 2.29%. Its core NIM gained 4bps to 2.30%. Excluding litigation, expenses declined 8% y-o-y and improved 3% from 2Q14 to $14.1bn. Core expense improved 2% from 2Q14 reflecting lower revenue-related compensation costs in Global Markets. It reached its target of $2.0bn quarterly New BAC cost savings during 3Q14. Headcount declined 7% y-o-y (-2% from 2Q). The effective tax rate was driven by the non-deductible portion of the Dept of Justice Settlement charge. Its Non Performing Assets ratio improved 9bps to 1.61%. It sold $2.5bn in nonperforming and delinquent loans during 3Q14. Its Non Conforming Obligations ratio improved 2bps to 0.46%. The loan loss provision increased $225mn to $636mn, driven by $400mn in incremental costs associated with the consumer relief portion of the DoJ Settlement. Including the incremental credit costs associated with the DoJ Settlement, the reserve release was $407mn in 3Q14. It released $662mn in 2Q14. Its reserve/loan ratio declined 4bps to 1.71%.

Goldman Sachs results - overall 3Q earnings per share of $4.57 was well ahead of expectations (Consensus: $3.21), largely thanks to disciplined expense management–-compensation was accrued at 33% vs. 43% consensus and is reflective of solid expense discipline and embeds the operating leverage at Goldman Sachs. While overall top-line trends were generally in line to better than forecast, trading revenues did benefit from one-time debt extinguishment gains thus on a core basis were a bit weaker than expectations. Total revenues of $8.4 billion were about in line with our forecast (+21% yr/yr, -11% qtr/qtr). Investment Management revenues (+20% yr/yr, +1% qtr/qtr) and Investment Banking (+26% yr/yr, -18% qtr/qtr) were in line. Total expenses of $5.1 billion were below expectations and drove most of the earnings upside this quarter. Basic share count was down 1% qtr/qtr thanks to continued proactive share repurchase activity (GS bought back 7.1 mil shares during 3Q for $1.25 billion)—we believe this bodes well for GS forward-looking earnings/return profile, particularly in the more vibrant revenue backdrop. Return on equity was an impressive 11.8% in 3Q and 11.2% year-to-date.

ING – Management is in the final stages of restructuring the capital of the group to make it accessible to shareholders. It is estimated that €3.3bn of capital could be returned to shareholders as of 2Q 2015, and €11bn in 2015/16. Adjusted for 26% of its market capitalization in excess capital, the shares trade today on 7.2x 2016e, a 7% discount to the European banks, yet we believe the core business can generate a Return on Net Assets of ~13% and a high dividend pay-out (~50% post 2016). Currently ING trades at about 90% of tangible book. Looking ahead, we expect it will look to recapture some of market share ceded over past 5 years due to EU restrictions with resumption of dividends likely in 2016. ING also looks to be one of the larger beneficiaries of the ECB's forthcoming Asset Backed Securities purchasing program. As of Q2, ING's securities portfolio consisted of €19bn covered bonds, 4.3bn non-US ABS, and 2.2bn other ABS. As of 2013 year-end, ING also held €3.2bn Retail Mortgage Backed Securities (2.2bn Spain, 0.5bn Italy, 0.4bn Portugal, 0.1bn Ireland).

Morgan Stanley - reported EPS of $0.84. Excluding a net discrete tax benefit of $237mn ($0.12) and a Debt Value Adjusted (DVA) benefit of $215mn ($0.07), EPS was $0.65. Consensus was $0.54. Better than expected trading results fueled the upside. Results also included gains related to the sale of TransMontaigne and a retail property space. Excluding DVA, revenues rose 7% y-o-y and increased 2% from 2Q14 to $8.7bn. Consensuses was $8.2bn. Relative to 2Q14, Institutional Securities (+3%) and Wealth Management (+2%) revenues increased, while Investment Management declined (-5%). Expenses increased 1% from 2Q14. Compensation was stable, and so the comp ratio declined from 49% to 47%. While the bank posted an Return On Equity of 10.0%, excluding DVA and the tax benefit, it was closer to 8.0%. Tangible book rose 3% to $29.25 (1.1x). Its Common Equity Tier 1 capital ratio was 14.3%, up 40bps. During the quarter, it repurchased $195mn or 5.9mn shares. In 2Q14 it repurchased a higher $284mn or 9.3mn shares. To date it has repurchased 48% of its $1bn CCAR 2014 ask. Still, average diluted share count was little changed for the 2nd straight quarter.

The Bank of England has launched a full-blooded counter-attack on the EU cap on banker bonuses, calling it the "wrong policy" just one day after European regulators tried to stop banks from dodging the rule. In a sign of mounting tension between EU countries over pay, Andrew Bailey, the chief of the BoE's Prudential Regulation Authority, said the debate over bonuses was "misguided" and that variable pay should play a significant role in banker remuneration. The UK is expected to ignore the year-end deadline set in the EBA opinion, which does not carry legal force, instead waiting for more detailed guidelines on pay from the EBA in 2015. The BoE is bringing into force its own regime requiring bonuses to be deferred for years and allowing them to be clawed back in the case of wrongdoing – even if the employee has already spent the money. (Source:Financial Times)

Global Dividend Payers

ABB – a move we deem good for the likes of ABB is that more than 1,000 miles of subsea power lines connecting Great Britain to France, Norway, Denmark, Belgium and Ireland could be constructed by 2020, under plans set out by UK energy regulator Ofgem which said that seven new interconnector projects had now been deemed viable for potential construction by 2020. They would entail more than £6bn in investment and could provide up to 7.5 gigawatts of electricity - enough to power 22m homes in Britain, the regulator said (Source : The Telegraph)

BHP Billiton - confirmed that it will pursue a Standard listing on the UK Listing Authority's Official List and admission to trading on the London Stock Exchange for the new company it plans to create via demerger. This is in addition to the proposed primary listing on the Australian Securities Exchange and secondary inward listing on the Johannesburg Stock Exchange. As previously announced, BHP Billiton plans to create an independent global metals and mining company based on a selection of its high-quality aluminium, coal, manganese, nickel and silver assets. Separating these businesses has the potential to unlock shareholder value by significantly simplifying the BHP Billiton Group and creating two portfolios of complementary assets. BHP Billiton Chief Executive Officer, Andrew Mackenzie, said: "We are pleased to offer an additional listing in London in response to the interest investors have shown in the new company. We continue to work towards completion of the demerger in the first half of the 2015 calendar year, subject to receipt of the necessary approvals."A final Board decision on the demerger will only be made once the necessary Government, taxation, regulatory and other third party approvals are secured on satisfactory terms.

Bunzl - issue a short, and in-line Q3 Interim Management Statement which detailed that sales growth during Q3 was 6% (3% organic) in-line with consensus assumptions for 2nd Half and Full Year 2014. A very small (€3m of sales) acquisition of De Ridder, a Netherlands based specialist distributor of consumables for Prisons, was announced, which is in-line with Bunzl's bolt on strategy.

Nestle – toned down expectations for full-year sales after slower third quarter growth showed the impact of softening demand in Asia and falling prices in Europe on the world's largest food company.The sales figure was below forecasts and Nestle executives made it clear they expected 2014 growth closer to 4.5% than the company's formal 5% target. Nestle has started selling underperforming units to focus on products offering higher returns. These include its Nespresso coffee pods, health foods and skincare products that it hopes will drive future growth. Underlying organic sales growth, stripping out the effects of currency swings and acquisitions, was 4.5% in the first nine months of the year

Roche - reported Q3 group revenues of CHF11.8bn v consensus CHF11.6bn. Both divisions were ahead of expectations with Pharma delivering CHF9.1bn in revenues v consensus CHF9bn and Diagnostics delivering CHF2.7bn v consensus CHF2.6bn. The growth at 5% in Q3 is below trend due to a rebate reversal (beneficial) in Q3 2013 that removed c1% from growth this quarter. The HER2 breast cancer franchise (Herceptin, Perjeta, Kadcyla) delivered 23% growth in Q3 and came in 4% ahead of expectations. This franchise is the main growth driver for Roche and its expect this franchise to roughly double by 2020. Guidance is unchanged at low to mid single digit top-line growth and Core EPS growth ahead of that. Roche has closed the Intermune acquisition and raised $5.75bn in debt at 2.3%. The deal will be neutral to 2015 Core EPS and accretive thereafter. Also, the FDA approved key product Esbriet for the treatment in idiopathic pulmonary fibrosis early but also approved Boehringer Ingelheim's Ofev.

Syngenta reported Q3 2014 sales of US$2,975mn, 0.5% below market consensus (US$2,989mn). Full year guidance for 6% revenue growth (constant currency) was maintained but appears weather dependent (requires improved Latin American rainfall). EBITDA margin is now expected to be below 2013 (partially mix and currency impacted, 19% EBITDA margins implies c$2.88bn (vs consensus $2.97bn). Additionally, Free Cash Flow targets (previously US$1.3bn) were not restated - impacted by the late start to the Latin American season (drought impacted) and uncertainty on North American pre orders (considering the recent soft commodity price weakness).

Economic Conditions

US retail sales retreated more than expected in September, lower by 0.3% compared to the consensus forecast for a 0.1% pull-back, as most retail categories suffered in the month. Auto sales were 0.8% lower in September, whilst core retail sales, which exclude sales of auto vehicles and parts, also declined, by 0.2% compared to expectations of a 0.3% advance. The retail situation, however, could redress, as the US consumer sentiment, measured by the University of Michigan, improved in October, to 86.4 index points, from 84.6 in September, as both the 'current conditions' and, in particular, the 'expectations' components of this composite index advanced in the month.

U.S. industrial production jumped 1.0% in September, the 7th gain in the past eight months and doubling expectations. (Note that the unexpected decline in August was revised lower to -0.2% from -0.1%, initially). September's jump was the largest since November 2012 and was broadly based across most industries except, rather surprisingly, autos.

U.S. housing starts rebounded 6.3% in September to 1,017,000 units annualized. The move itself beat consensus, as did the level, and this is coming from an upward revision to August. Instead of that 14.4% weather-related plunge in the month, starts "only" fell 12.8%, but the level was little changed (slight upward revision). July's result were also revised lower, to 1,098k from 1,117k. This is only the 5th reading over one million units over the past six years.

Canada – Inflation data provided no surprises in September, as the core consumer price index (CPI) recorded a 2.0% year on year rate of increase, much as expected, a notch below August's 2.1% reading. The core inflation reading, which strips off the effects of eight most volatile price series, including food and energy, was also in line with the expectations, at 2.1%, and in line with August's 2.1% rate.

UK inflation fell to a five-year low of 1.2% in September from 1.5% the month before, official figures show. The rate – as measured by the Consumer Prices Index – is the lowest since September 2009, when it was 1.1%. Lower energy and food prices helped to cut the rate, while the Office for National Statistics (ONS) also cited cheaper transport costs as a factor. The Retail Prices Index measure of inflation fell to 2.3% from 2.4% in August. (BBC News)

UK house prices grew at the same rate in August as in July, thanks to continued strong demand in London. July's figure was the biggest increase for seven years. The Office for National Statistics reported that prices in the capital rose 19.6% in the 12 months to August, the second biggest monthly jump since the agency began compiling statistics in their current form in 2002. Chris Jenkins, head of housing market indices at the ONS, said the big year-on-year rise in London was partly because of a slower rate of growth in August 2013. "But that still takes nothing away from the fact that prices in London are rocketing," he said. (Source : Financial Times)

Japan government said it will more than double its allocation for domestic stocks. Nikkei rallied. In addition, Japan Prime Minister, Shinzo Abe, hinted that he may delay increasing Japan's consumption tax in an interview with the Financial Times. The tax increase from 8% to 10% would be "meaningless" to the government if it inflicted too much damage to the country's economy. The higher tax was to help cover support the nations pension and health benefits.

Financial Conditions

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 1.82% and the UK's 2 year/10 year treasury spread is 1.49% - 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 3.97% - (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 21.99 (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
Certain statements included in this document constitute forward-looking statements, including those identified by the expressions "anticipate," "believe," "plan," "estimate," "expect," "intend" and similar expressions to the extent they relate to the Fund. The forward-looking statements are not historical facts, but reflect the Portfolio Management team's current expectations regarding future results or events. These forward-looking statements are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations. The Portfolio Management team has no specific intention of updating any forward-looking statements whether as a result of new information, future events or otherwise.

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