News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. July 16, 2018

Owner Operated Companies

BlackRock, Inc, the world's biggest asset manager, reported smaller demand for its funds as investors fled risk, overshadowing a better-than-expected quarterly profit. The company wrestled with difficult market trends during the quarter, including an industrywide slowdown in the demand for its hottest product, exchange-traded funds (ETFs). BlackRock's iShares-branded ETFs took in $17.8 billion during the quarter, down from $34.6 billion in the first quarter. The company also cut fees on some ETFs to increase its market share. Revenue rose more than 10% to $2.9 billion. Net income attributable to the company rose to $1.07 billion in the second quarter, up more than 25%, as weaker, yet still positive, demand for index funds helped support margins and the company benefited from a lower tax rate. Operating income rose 16.4% to $1.4 billion in the quarter from the same period in 2017. BlackRock earned $6.62 per share, compared with $5.20 a year earlier. Excluding items, it earned $6.66 per share, which compares favourably with the consensus expectations at $6.55.

Brookfield Asset Management Inc./ Brookfield Business Partners L.P. – Reportedly, Brookfield Asset Management Inc., a Canada-based alternative asset management firm, is in talks to acquire Altico Capital India Limited, an Indian non-bank financing company, from Värde Partners, Inc. a U.S.-based alternative investment firm. The transaction will allow Altico Capital to expand its operations to non-real estate deals, including structured credit transactions.

Energy Sector

Source Energy Services reported Q2 2018 sales volumes of 814,000 tonnes, which surpassed our 645,000 tonne expectation and represented a 27% increase from Q1 2018 volumes. Management reports approximately 15% of these sales were at the mine gate (versus a 10% expectation), which suggests the company's Western Canadian Sedimentary Basin (WCSB) (in-basin) sales were up approximately 18% on a sequential basis in Q2 2018 despite the spring break-up. We also believe these volumes reflected improving customer demand driven by increasing WCSB frac intensity. While Source will not be reporting its Q2 2018 financial results until July 31, these sales volumes suggest to us the company experienced more normalized rail operations and solid underlying demand growth in the second quarter.

Financial Sector

A record $1.45 trillion of U.S. syndicated lending to companies for acquisitions, leveraged buyouts, dividends and refinancing in the first half of the year has propelled bank fees from arranging the loans to all-time highs. The $8.1 billion earned in the first half of this year slightly topped the prior record $8 billion taken in during the second half of last year, setting a new peak, according to Freeman Consulting Services. The lending pace escalated in the second quarter and is seen staying heated through year-end, encouraged by lower U.S. corporate tax rates and a federal judge's June endorsement of the long-pursued mega-merger between AT&T, Inc. and Time Warner Inc. Bankers eagerly awaited the outcome of the AT&T/Time Warner ruling, long after the deal was first announced in October 2016, and now expect the decision to keep the chute wide open for similar mergers and acquisitions in coming months. For lower-rated borrowers, there is less onerous enforcement under this administration of leveraged lending guidelines put in place five years ago to rein in high-risk practices. (Source: Reuters).

Bank of America Corporation: reported Q2 2018 EPS of $0.63, consensus was $0.57. Relative to consensus, a lower than expected loan loss provision and better than anticipated fee income (trading, Investment Bank fees above guidance) was able to more than combat sluggish net interest income/margin performance. Operating revenues increased 4% year/year and were little changed with prior quarter at $23.1 billion (consensus $22.6 billion). Tangible book increased 1.4% to $17.07 (trading at 1.7x). It posted a 10.75% ROE and 15.15% ROTE. Its CET 1 ratio was 11.4% (unchanged). Average diluted shares declined by 1.6% amid share repurchase. Net interest income increased $0.6 billion (had talked to +$0.5 billion), or 5%, year/year to $11.8 billion, reflecting the benefits from higher interest rates and loan and deposit growth, partially offset by a decline resulting from the sale of the non-U.S. consumer credit card business in Q2 2017 and higher funding costs in Global Markets. Its reported net interest margin declined by 1bp to 2.38%. Excluding Global Markets, its Net Interest Margin increased 2bps to 2.95%. Its yield on average earnings assets expanded 13bps to 3.34% with its loan yield up 14bps and its securities yield up 6bps. Core fee income declined 1% linked quarter (+2% year/year), as increases in card (+$85 million), investment banking (+$69 million) and service charges (+$33 million) were more than offset by declines in trading (-$384 million) and investments & brokerage (-$206 million). Its Non-Performing Asset ratio improved 6bps to 0.66%. Its loan loss provision declined by $7 million to $827 million.

Citigroup Inc. reported Q2 2018 EPS of $1.63 and consensus was $1.56. A $45 million gain related to the sale of Visa Inc. Class B shares was partially offset by the impact of previously disclosed items. It added $87 million to its loan loss reserve, compared to $36 million release last quarter. Revenues increased 2% year/year but declined 2% linked quarter to $18.5 billion. Relative to the prior year, it saw growth in all regions and across products in Consumer coupled with broad based loan growth. Specifically, Global Consumer Banking (GCB) increased 2% year/year, while Institutional Clients Group rose 3%. By region, revenues increased 6% year/year in each of EMEA (Europe, Middle East, Africa) Latin America and Asia but declined 1% in North America (NA). On a constant dollar basis, GCB revenues fell 1% linked quarter with NA down 3% and Asia down 1% but Latin America up 7%. By product, retail banking rose 3% but credit card declined 3%. Within Institutional Clients Group, trading revenues declined 1% year/year to $3.9 billion (guided to stability). Equities increased 19% year/year to $864 million, with growth across all products, reflecting the benefit of continued higher market volatility, as well as continued momentum with investor clients. Investment banking fees gained 26% linked quarter with equity underwriting (+55%), advisory (+68%) and debt underwriting (+4%) all advancing. Tangible book increased 0.4% (currency translation weighed) to $61.29 (trading at 1.1x). Its CET 1 ratio was 12.1% (unchanged). Its ROE was 9.2%. It repurchased 33 million shares during the quarter, compared to 30 million last quarter. Average diluted shares declined by 1.2%.

DNB ASA delivered a ROE of 11.8% for Q2 2018, in line with its medium-term target of 12%. Lending growth picked up toward the end of the quarter and ended at 1.9% quarter/quarter. There was a negative effect on Net Interest Income from increasing money market rates. Commission increased quarter/quarter across income lines and Q2 represented another quarter with net reversals. All in all, it all points to a slightly higher net profit for our 2019-2020 estimates. Net gains on financial instruments at fair value (i.e. 'trading income') was hit by a large negative basis swap adjustment and credit spread effects on bonds held by DNB markets, with other mark-to-market adjustments also adding headwinds in the quarter. Importantly, underlying activity increased from Q1.

JPMorgan Chase & Co. reported Q2 2018 EPS of $2.29, a record and consensus was $2.22. This marks the 14th straight quarter JPMorgan exceed consensus EPS expectations. Managed revenues increased 6% year/year and were little changed with Q1 2018 (core revenues looked to have increased closer to 11% year/year and rose 2% sequentially). Relative to a year ago, Consumer & Community Banking (CCB, +10%), Corporate & Investment Bank (CIB, +11%), and Commercial Banking (CB, +11%) all produced double-digit revenue growth, while Asset & Wealth Management (AWM, +4%) also advanced. Its ROE was 14% and its Tangible book increased 2.0% to $55.14 (trading at 1.9x). Its CET 1 ratio (fully phased-in, standardized) was 11.9%. Risk Weighted Assets declined by $4 billion or 0.3%. It had $4.7 billion of net share repurchase, matching the prior quarter. Average diluted shares declined by 1.3%. Net interest income increased 9% year/year driven by the impact of higher rates and loan growth, partially offset by lower Markets net interest income. Linked quarter, Net Interest Income rose 1%. Average earning assets increased 1% from Q1 2018, with loans (+1%), deposits with banks (+1%) and Fed funds sold (+3%) higher, trading assets little changed, and securities lower (-3%). Period-end loans increased 1% linked quarter, with credit card up 3%, wholesale up 2%, and consumer unchanged. Average core loans ex-CIB rose 7% year/year and 2% linked quarter. Fee income rose 4% year/year but declined 2% sequentially. Total trading revenues increased 13% year/year (guided to stability) to $5.4 billion. Fixed income, currency and commodities (FICC) increased 7% on a reported basis (up 12% ex. tax-equivalent adjustments) to $3.5 billion reflecting healthy performance across products with good client flows, and improved Commodities revenue compared to a challenging prior year. Equity Markets revenue jumped 24% year/year to $2.0 billion, driven by strength across products, predominantly in derivatives and Prime. Its Value at Risk declined $43 million from last quarter to $35 million. Investment banking fees increased 26% linked quarter to $2.1 billion with increases in both equity (+65%) and debt (+22%) underwriting, as well as advisory (+9%). Reported expenses increased 8% year/year but declined 1% sequentially. Its managed overhead ratio was 56%, matching Q1 2018. The effective tax rate for the quarter was 21.3%, up from 18.3% last quarter. On a managed basis it was 25.8%. Its reserve/loan ratio declined 3bps to 1.22%.

The Toronto-Dominion Bank (TD) announced the acquisition of Greystone Capital Management for a net purchase price of $792 million. Upon closing (second half of 2018), TD will become the largest money manager in Canada. Greystone has $36 billion in assets under management (AUM) specializing in Alternatives (mainly Real estate), Fixed income, Equities, and Multi-asset solutions. Management targets EPS accretion by year three and adjusted EPS accretion in year one. In particular, we view Greystone's Alternative AUM (55% of total AUM) helps broaden TD's investment offering to Institutional, and enhances their high-net-worth (HNW) clientele product suite. This is TD's first Wealth transaction since purchasing U.S.-based Epoch Investment Partners, Inc. in 2012 (at the time paid 2.8% of AUM at US$668 million for US$24 billion in AUM). TD paid a Price /AUM of 2.2% for Greystone, which is slightly below the 2.4% price The Bank of Nova Scotia paid for Jarislowsky, Fraser Limited ($950 million paid for >$40 billion in AUM) and in line with Institutionally-focused asset managers purchased in Canada. Based on past transactions, we believe TD's purchase price was fair considering the scarcity value associated with increasingly more limited asset managers in Canada that have scale. Founded in 1988 in Regina, Saskatchewan, Greystone has developed into a large, Institutionally-focused manager (e.g. pension funds, insurance providers, trusts and foundations) with a clientele base spread across Canada. According to Benefits Canada, Greystone was ranked #12 in Canada for managing Canadian pension assets (CPA). TD Asset Management was #1 in CPA, and this transaction will strengthen their position at the top. The majority (78%) of Greystone's Alternative assets reside in Real Estate invested in Office, Retail, Industrial, and

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Multi-unit Residential sectors. The balance comes from Mortgages and Infrastructure. Greystone's Alternative products have provided a long-term track record of Fund outperformance relative to industry benchmarks. This acquisition does not have a material effect on TD's overall earnings. Greystone shareholders are set to receive 70% of the purchase price in cash and 30% in TD common shares (with the ability for an additional 20% of consideration). TD's CET 1 ratio will be affected by <10 bps.It is estimated TD's pro forma CET 1 ratio is approximately 11.7%.

Wells Fargo & Company reported Q2 2018 EPS of $0.98 which included a number of unusual items which netted out becomes an EPS of $1.11 and consensus was $1.12. Operating revenues fell 3% year/year and increased 2% linked quarter. Tangible book increased 1.0% to $31.47 (1.8x). Its CET 1 ratio was 12.0% (unchanged). It repurchased 35.8 million shares of its stock, down from 50.6 million shares in Q1 2018. Average diluted shares declined by 0.6%. Net interest income increased 2%. Average interest bearing deposits declined 3%. Period-end loans fell 0.3%. Its net interest margin increased 9bps to 2.93%, driven by a reduction in the proportion of lower yielding assets, as well as a less negative impact from hedge ineffectiveness accounting and the net benefit of rate and spread movements. Average deposits declined by 2.0%. Core fee income rose 2% but Core expenses rose 4% year/year and increased 2% linked quarter. Of note, results included operating losses of $619 million (views $150 million as normalized), which included typical operating losses, as well as non-litigation expense for previously disclosed matters, including policies, practices and procedures in our foreign exchange business; fee calculations within certain fiduciary and custody accounts in its wealth management business; practices in its auto lending business, including related insurance products; and mortgage interest rate lock extensions. Its reported cost / income efficiency ratio was 64.9%.

Activist Influenced Companies

Pershing Square Holdings, Ltd. (PSH) announced that the company has been advised by Pershing Square Capital Management, L.P. (PSCM) that CEO Bill Ackman, PSH Board Member Nick Botta, all members of the Pershing Square investment team, other PSCM employees and members of the PSCM advisory board have purchased a total of 20,659,629 PSH public shares since they began acquiring shares subsequent to the May 10, 2018 closure of the $300 million company tender offer. Since May 29, 2018, Mr. Ackman has purchased a total of 19,650,471 public shares at an average price of $14.87 per share for a total additional investment in PSH shares of $292 million, and Mr. Botta has purchased a total of 850,000 public shares at an average price of $14.88 per share for a total additional investment in PSH shares of $12.6 million. In total, assuming all PSH management shares are converted to public shares, the PSCM affiliates would currently own 29,742,154 public shares of the Company, or approximately 13.4% of the company on a fully diluted basis. The PSCM Affiliates have increased their investment in PSH because they believe that PSH is substantially undervalued. As a result of the Company Tender Offer and the recent purchases by the PSCM Affiliates over the last three months, the Company's free float has been effectively reduced by 42,931,343 public shares, or 18.3%.

Dividend Payers

AT&T, Inc. – The U.S. Justice Department has only a remote chance of overturning AT&T's takeover of Time Warner, in the opinion of AT&T Chief Executive Randall Stephenson. The merger, first announced in October 2016, was opposed by U.S. President Donald Trump. AT&T was sued by the Justice Department on antitrust grounds but Judge Richard Leon concluded the government failed to show that prices would go up and allowed the deal to go forward. Approval of the Time Warner deal last month triggered further moves in a bidding war between Comcast Corporation and The Walt Disney Company over the bulk of Twenty-First Century Fox, Inc.'s film and T.V. assets. Disney has received U.S. antitrust approval for the purchase.

Novartis AG - A favorable resolution of the dosage regimen patent litigation may enable a longer period of U.S. market exclusivity for Gilenya. There are two main patents protecting U.S. Gilenya sales: a) compound patent (expires August 2019) and b) dosing regimen patent (expires December 25, 2027). a) is generally strong. Several generic manufacturer wanted to overturn b) and on July 11, the validity of the dosage regimen patent was upheld by the Patent Trial and Appeal Board. Novartis will now file dosage regimen patent infringement litigation against Abbreviated New Drug Application filers. This does not prevent the generics company from launching after August 2019, but exposes them at risk of having to pay triple-damages to Novartis - which could be very significant in our view.

Economic Conditions

U.S.A. vs. China - Following China's tit-for-tat response to U.S. trade tariffs of 25% on USD $34 billion worth of Chinese imports which took effect Friday July 6, U.S. President Trump returned the serve by instructing the U.S. Trade Representative to release a new round of 10% tariffs on new list of Chinese goods valued at USD $200 billion. The new tariffs are not immediate as the public consultation process is set to take place until August 30, 2018. If the latest tariff proposal does take effect, then Trump's administration will have implemented tariffs on nearly half of U.S.' imports from China. But the threats do not end there as President Trump had recently threatened to ultimately impose tariffs on Chinese goods, up to USD $500 billion (i.e. nearly the total amount of U.S.' imports from China). Risk of trade tensions escalating into a "trade war" has definitely increased with the latest U.S.' actions which came quickly after the first round of tariffs just went into effect on July 6, indicating that Trump has not budged on his tough stance on China and his aim at Beijing's 'Made in China 2025' plan. Likely, the Chinese will need to find a measured response but they currently do have enough imports from the U.S. to respond in kind. That leaves the choice of either increasing the percentage of duties or look at alternative measures. In the end, the increased trade tensions will mean slower growth globally and in the U.S. While there still remains hope for some resolution instead of further spiraling trade measures, the outlook has become more uncertain. We view the full impact of the trade actions will likely be felt only in 2019 and will remain watchful of the trade numbers in the coming months to assess the potential impact on 2018 growth.

U.S. retail sales expanded for a fifth month in a row in June, rising 0.5% month/month in June, in line with consensus expectations. The previous month's data was also revised upwards, from 0.8% to 1.3%. In June, sales of motor vehicles and parts climbed 0.9%. Without that category, sales advanced 0.4% (also roughly in line with analysts' anticipations) thanks to gains for health/personal care items (+2.2%, the biggest jump since 2004), non-store retailers (+1.3%), gasoline stations (+1.0%) and furniture (+0.6%). Overall, outlays increased in 8 of the 13 categories surveyed. Core sales, which are used to calculate GDP and exclude food services, auto dealers, building materials and gasoline stations came in flat following a healthy 0.8% progression the prior month.

British Prime Minister Theresa May appointed Jeremy Hunt as foreign minister on Monday after predecessor Boris Johnson resigned in protest at the government's plans for a close trading relationship with the European Union. The appointment of Hunt, the long-serving health minister, sees a close May ally replace the maverick Johnson, and could alter the Brexit balance of May's top ministerial team in our opinion. While Johnson was one of the most high-profile Brexit campaigners, Hunt backed "Remain" during the 2016 referendum campaign. Britain must be free to protect its leading position in the services sector, including finance, after it leaves the European Union, Prime Minister Theresa May said on Monday. May's plan for Brexit, includes a free-trade area for goods but little detail on the approach to services. "We believe it is important to maintain more flexibility in how we're dealing with services," May told parliament. "On services, we want to be free to ensure that we are able to put in place what we believe is necessary to maintain our key position in services, not least on the financial services." (Source: Reuters). Business has given a broad welcome to Theresa May's new Brexit plan, although executives and lobby groups have stressed the importance of the U.K. making rapid progress in its negotiations with the E.U. Industrial companies that stand to benefit from Britain's proposed U.K.-E.U. free trade area for goods expressed satisfaction with the government's plan outlined after the cabinet supported it last week. Executives in the City of London said it was helpful the government had set out its thinking, although some expressed concern that the three-page statement did not give much prominence to the service sector's strategic importance. (Source: Financial Times)

Financial Conditions

The Bank of Canada increased its policy rate by 25bps as fully anticipated by markets and most forecasters. The bias to the overall set of communications was more hawkish than markets expected at the margin and it leaves the door open to considering two more rate hikes before year-end relative to earlier forecasts for one more hike.

The U.S. 2 year/10 year treasury spread is now .25% and the U.K.'s 2 year/10 year treasury spread is .53% - 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 costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.53% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing U.S. housing inventory is at 4.0 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, economic recovery, job creation, and low prices are still supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now at the low end of a more normal range of 4-7 months.

The VIX (volatility index) is 12.61 (compares to a post-recession low of 9.52 achieved in early November) 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 Investment Counsel Inc. currently offers 8 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
- Portland Value Fund
- Portland 15 of 15 Fund

Private/Alternative Products

Portland also currently manages the following private/alternative products:

- Bay & Scollard Development Trust
- Portland Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

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

We want to share our insights with you and welcome your feedback. Our website has the latest, as well as archived videos, company profiles, and press articles. Please visit us at www.portlandic.com.

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Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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