News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. July 4, 2016

Energy Sector

U.S. land rig count increased by 11 rigs to 408 and is up approximately 9% since the end of May. This week's increase was led by horizontal oil (+8), vertical oil (+5), vertical gas (+2), partially offset by directional oil (-2), horizontal gas (-1), and directional gas (-1). Total horizontal land rig count is 76% down since the peak in November 2014.

U.S. horizontal oil land rigs increased by 8 rigs week/week to 272, as gains in Permian (+5), DJ-Niobrara (+2), Woodford (+2), were slightly offset by losses in Eagle Ford (-1), while Williston, Granite Wash, Mississippian, and "Other" remained flat week/week. Vertical oil land rigs increased by 5 rigs week/week led by "Other" (+3), Eagle Ford (+1), and Barnett (+1).

U.S. offshore rig count was down 2 rigs week/week to 18, and is down 67% since June 2014.

Canadian rig count was down 1 rig week/week as we come out of breakup season and is 45% off the level this time last year.

BP plc has announced the final investment decision to build a third train at its Tangguh Liquefied Natural Gas (LNG) facility in Indonesia expanding capacity by 50% to 11.4 million tons per annum (mtpa) and due online in 2020. The country's energy regulator has indicated an associated investment of $8 billion that is in line with expectations and importantly is within BP's existing capex budget. The project is one of the lowest-cost expansions in the LNG sector, will be an important source of future cash flow growth and backs up our view that BP can grow organically without the need for a big acquisition. 75% of the Train 3 annual production to be sold domestically to Indonesian electricity company PT Pertamina (Persero), with remaining volumes under contract to Kansai Electric Power Co. Inc. in Japan. The project will provide 10,000 new jobs and support local economic growth.

Financial Sector

Berkshire Hathaway Inc. is seeking permission from the Federal Reserve to increase its ownership stake in **Wells Fargo & Company**, after reaching the 10% level that could prompt increased regulatory scrutiny. According to papers obtained by Reuters on Friday, Berkshire said it learned in mid-March that its Wells Fargo stake, including 2.01 million shares held by Buffett, had reached 10.01% because of buybacks by the San Francisco-based bank, which decreased the number of shares outstanding. The Federal Reserve exerts special oversight when investors take large bank stakes. Berkshire said it had no dollar value in mind for purchases, had no plans to make significant changes to Wells Fargo's strategy or corporate structure, and was not contemplating changes to the bank's management or board. (Source: Reuters)

Canadian Imperial Bank of Commerce (CIBC) announced that it has entered into a definitive agreement to acquire PrivateBancorp, Inc. for US$3.8 billion (C$4.9 billion). The transaction is expected to close in calendar Q1 2017. To finance the deal, CIBC will issue 29.5 million common shares and utilize US$1.5 billion in cash. CIBC expects to maintain a common equity tier 1 (Core Equity Tier 1) ratio at closing of at least 10%. The acquisition is expected to be dilutive to cash Earnings Per Share (EPS) by $0.12 per share in year 1 and to be accretive by year 3. CIBC appears to have purchased a good franchise with a good track record, solid credit quality, a seasoned well respected management team and CIBC expects double digit growth. The acquisition is consistent with management's previously messaged plan, provides earnings diversification, some interest rate sensitivity and cross sell of product is probably understated. Nevertheless, the deal is dilutive (not EPS accretive for 3 years), a low return on invested capital (less than 6%) and may see CIBC carry slightly more capital for a period of time than "necessary".

U.K. Banks - As expected, Moody's Investors Service has changed the outlooks on the ratings of 12 U.K. banks and building societies. Simultaneously, the rating agency has changed the outlook on the U.K. banking system to negative from stable. Moody's changed the outlooks on the ratings of eight banks and building societies to negative from stable (Barclays, HSBC Bank, Santander UK, Coventry Building Society, Leeds Building Society, Nationwide Building Society, Nottingham Building Society and TSB Bank), and the outlooks on the ratings of two issuers to stable from positive (Lloyds Bank and Principality Building Society). The agency also changed the outlook on the U.K. government guaranteed senior unsecured debt instruments to negative from stable of the aforementioned issuers, Lloyds and Barclays, as well as Bradford & Bingley and NRAM (No1) Ltd. The ratings of these twelve firms, along with the ratings of four U.K. banks and building societies whose outlooks were maintained (The Royal Bank of Scotland, Skipton Building Society, West Bromwich Building Society and Yorkshire Building Society), were affirmed.

U.S. Banks - 2016 stress test results generally as expected: The U.S. Comprehensive Capital Analysis and Review (CCAR) results were generally in line with expectations. More specifically, the Federal Reserve approved the capital plans of 31 of the 33 participating bank holding companies (BHCs) with none of the U.S. large-cap banks seeing its capital plan rejected by the Federal Reserve, the subsidiaries of Deutsche Bank AG and Banco Santander SA were once again failed by the Fed. Among 'our' banks, arguably JPMorgan

Chase & Co. looks like the biggest "winner" with a buyback well in excess of expectations, with Bank of America Corporation and Citigroup, Inc. largely meeting consensus (and taking an important step in normalizing their capital distributions closer to peer levels), and the super-regionals like Fifth Third Bancorp are mostly in-line as well. According to Citigroup, "Fed does not object to planned capital actions; capital actions include increase of quarterly dividend to $0.16 per share, repurchase program of up to $8.6 billion." (Source: Reuters) Bank of America plans to increase quarterly dividend paid on shares of corporation's common stock to $0.075 per share. The board has authorized repurchase of $5 billion of corporation's common stock from July 1, 2016 through June 30, 2017. Common stock repurchase authorization replaces board's prior common stock repurchase authorization that expires on June 30, 2016. (Source: Reuters). Even Morgan Stanley, which must shore up internal systems before the Fed issues a final verdict, got conditional permission to boost its dividend 33%. Thinking ahead, the universal banks look like this year's clear winners on Dodd-Frank Stress Testing/CCAR, and the size of their capital cushions combined with a lack of qualitative issues could ease some of the market's concerns about future incorporation of the Global Systemically Important Bank surcharges into the stress test minimums and the trajectory of capital return.

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

Bunzl plc's (non food consumables distribution group): Trading in Q2 is similar to slightly better than the first quarter, while recent acquisition activity has been a bit slower than this time last year. Organic growth in the first half was flat to a small positive but this should we believe start to gently improve in the second half as input price deflation, which has been running at 1-2%, annualized. Overall it leaves the group on target for full year numbers on a constant currency basis and there will then be a 4-5% boost from the recent weakness of the pound. Revenue in the first half was up 6% year/year in constant currency terms, made up of a flat to small positive from organic growth, part from acquisitions and part from currency gains. Bunzl has made two new acquisitions and spent £80 million on five acquisitions year-to-date. This is considerably lower than the £210 million spend on 10 businesses this time last year. Two further acquisitions were announced today, a developer and distributor of bespoke retail packaging (£7 million revenue) for non-food retailers in the U.K. and a distributor of Cleaning and Hygiene supplies (£3 million revenue) based near Brussels. The pipeline is still said to be healthy. The U.K. is 17% of the group with an estimated 70% of these sales being resilient and 30% having some cyclicality. Just over 20% of products are sourced from overseas, so price increases will be necessary as inflation starts to come through in around six months when hedging rolls off. The well established and understood strategy of consolidation continues with £80 million of committed spend for 2016. This level of spending is, however, down significantly from the £210 million committed at this point last year and as a result we would anticipate a smaller year of investment against 2015's record of £327 million. In our view the strategy remains sound, however, and the medium-term pipeline remains robust.

Mondelez International Inc. is in talks with The Hershey Company. CNBC reported the bid price is to be US$107 per share, which is only about 10% above last Thursday's closing price. This feels very low (and helps to explain why the shares are currently trading at US$112). Hershey has periodically been viewed as a bid target ever since a 2002 bid from The William Wrigley Jr. Company was rejected by the controlling foundation. Note: **Nestlé SA** was also reported to have made a bid at this time. While this experience has left investors very mindful of the sensitivities of the controlling foundation, it has not stopped periodic take-out speculation. On the surface an acquisition of Hershey would hold a number of attractions for Nestle: i) it would enable it to scale up meaningfully in one of the few industries (Confectionery) in which it does not have a leading position; ii) it would enable Nestle to gain control of the Kit-Kat brand in the U.S.; and iii) it could drive meaningful synergies. Nevertheless, we believe it is unlikely that Nestle would have interest in acquiring the business. To our mind, the recent announcement of Ulf Mark Schneider as CEO is a clear signal that the Board has finally woken up to the rapid change that the Food industry is experiencing and need to embrace more radical change. To quote Nestlé: "The new team is ideally suited to accelerate Nestle's journey to become the world's preeminent Nutrition, Health & Wellness company." To our mind the last thing that Nestle should do right now is a very mainstream mid-market developed world chocolate acquisition. We suspect/hope it learned its lesson on the opportunist acquisition front with Kraft pizza. Last but not least, the asset that Nestlé really wants (Kit-Kat) would very likely revert to Nestlé anyway in the event of a change of control at Hershey.

Nestlé announced last Monday that the Board will propose that current CEO Paul Bulcke succeeds Peter Brabeck as Chairman at next year's AGM in April and that Bulcke will be succeeded by Mark Schneider, previously CEO of Fresenius. Schneider will join Nestlé September 1st and after a 3 month hand-over period will become CEO on January 1, 2017. Bulcke becoming Chairman is not a huge surprise, but the decision to appoint a relatively young (50yr old) 'outsider' with no Fast Moving Consumer Goods experience, currently CEO of a company just over a 10th the size of Nestlé (as opposed to an internal appointment) is a big surprise, in our view. The Board reconfirmed the long-term orientation for Nestlé as a Nutrition,

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Health and Wellness company and expressed the intention of fully integrating both Nestlé Health Science and Nestlé Skin Health into the Nestlé organization reporting directly to the CEO of Nestlé from January 1, 2017. The concept of "Nutrition, Health and Wellness" was mentioned 5 times in the press release.

Economic Conditions

U.S. personal spending rose 0.4% in May after an upwardly-revised 1.1% jump in April. Volumes were similarly strong, rising 0.3% and 0.8% after dipping in March. This sets consumer spending up for a 4% or better gain (annualized) in the second quarter - the fastest since late 2014. Spending on durable and non-durable goods led the way, with notable strength in discretionary items. Real spending on recreational goods and vehicles jumped the most in two years, and more Americans went to restaurants. While real disposable income growth slowed to 0.1% in the month (due to the combination of softer job growth and higher gasoline prices), it's still up a solid 3.2% in the past year. As well, the personal savings rate, though dipping, held above 5% and its two-decade average, suggesting some wiggle room to keep spending in the face of somewhat slower income growth. Underlying inflation held steady, with core prices up 0.2% in the month and the yearly rate staying at 1.6% for a third straight month. The better-than-expected spending report suggests an upside to expectations of estimates of 2.6% GDP growth in Q2 2016.

U.K. Standard & Poor's Global Ratings stripped the U.K. of its pristine triple-A credit rating last Monday, following through on its warning that last week's vote to leave the European Union threatens the country's constitutional and economic integrity. The firm, which cut the country's ratings by two notches to double-A, also said the vote for "remain" in Scotland and Northern Ireland creates wider constitutional issues for the country as a whole. S&P's ratings outlook is negative. S&P was the last of the so-called Big Three rating firms to remove the U.K.'s triple-A rating.

EU: European Central Bank President Mario Draghi said on Tuesday that he expects the U.K.'s decision to exit the European Union to reduce economic growth in the eurozone by up to 0.5% over three years, people familiar with the matter said. At a summit meeting in Brussels, Mr. Draghi told EU leaders that the effects of Britain's historic vote are difficult to predict, but that it would likely curb growth in the currency union by between 0.3% and 0.5% in total from its baseline scenario over the next three years.

The inconclusive Australian election over the weekend is another source of global political uncertainty. The country's AAA rating is now at risk with the lack of a firm result from the election. Of the 150 Lower House seats, PM Turnbull's centre-right Liberals-National coalition have 67 (will need help/support from another party), while the opposition Labor Party has 71. Smaller parties gained headway during the vote and these are the parties that the ruling coalition and the Labor Party will need to make a deal with. Otherwise, there will be a hung parliament. Meantime, the vote counting continues, covering those by post and pre-votes. The uncertainty will make the Reserve Bank of Australia's decision more challenging this week. However, no changes are expected to be made tomorrow to the cash rate, which is currently at a record low 1.75%.

Financial Conditions

U.K. It seems likely that the Bank of England will cut rates this summer (they have been locked at a 0.5% overnight rate since early 2009, the longest stretch of rate inactivity by any major central bank), to try and stem the U.K.'s slide into recession. With a serious economic slowdown in Britain all but inevitable due to the intense uncertainty, Governor Carney pointed squarely at more stimulus this summer, be it rate cuts and/or Quantitative Easing, in a Thursday speech. That said, the double-digit slide in the pound will pump up inflation, if temporarily, and there's the small matter of the U.K.'s massive current account deficit of nearly 7% of GDP to fund (more than twice the size of any other major economy). The U.K.'s credit rating was unceremoniously clipped two notches by S&P this week to AA, a harsh reminder of the country's unfriendly external situation. True, U.K. policy has typically done what it needs to do on the rate front, and let the pound absorb the volatility; but with the pound already down more than 11% and threatening to possibly spill lower, this time is by no means "typical".

The U.S. 2 year/10 year treasury spread is now .85% and the U.K.'s 2 year/10 year treasury spread is .69% - 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.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.48% (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 4.7 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 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 14.77 (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 Investment Counsel Inc. currently offers 7 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

Private/Alternative Products

Portland also currently offers private/alternative products:

- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund
- Portland Global Aristocrats Plus Fund

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