News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. September 6, 2016

Energy Sector

U.S. land rig count increased by 14 rigs week/week (w/w) to 482, marking the 11th weekly gain over the last 14 weeks, and is trending up 15% quarter/quarter (q/q). The rig count increase was driven by gains in Horizontal Oil (+12) Horizontal Gas (+4), Directional Gas (+2), and Vertical Gas (+1), partially offset by declines in Directional Oil (-3) and Vertical Oil (-2). Total horizontal land rig count is 71% down since the peak in November 2014. The Permian currently makes up ~51% of oil rigs.

U.S. horizontal oil land rigs increased by 12 rigs w/w to 328, and is up 100 rigs since the end of May bottom, led by gains in "Other" (+10, driven by +5 rigs in Oklahoma and +4 rigs in Wyoming), Permian (+4), and Williston (+1), partially offset by declines in DJ-Niobrara (-1), Granite Wash (-1), and Mississippian (-1), while Eagle Ford and Woodford remained flat.

U.S. horizontal gas land rigs increased by 4 rigs w/w to 67, which is the largest weekly gain since late April 2015.

U.S. offshore rig count decreased by 7 rigs w/w to 10, which is the largest weekly decline since late March 2015 and we assume is due to Hurricane Hermine and is down 81% since June 2014.

Canadian rig count decreased by 8 rigs w/w, as we come out of breakup season but is still 26% off the level this time last year.

Royal Dutch Shell Group Plc (Shell) announced last week an agreement to sell 100% of its interest in the US Gulf of Mexico Green Canyon blocks (114, 158, 202 and 248) to EnVen Energy Ventures, LLC. These are old 1990's discoveries. This divestment includes $425 million in cash plus royalties helping towards the 3 year (2016-2018) $30 billion divestment target as this takes the divestment proceeds to $2 billion in 2016 so far. We expect more announcements through the remainder of the year. With the deal closing in October, Shells' gearing at 28.1% (end June) will benefit to the tune of 20bps.

Financial Sector

Bank of Nova Scotia, Canada's third-biggest lender, has pulled back on mortgage lending in its domestic market, potentially insulating itself if house prices fall in Vancouver and Toronto. Canada's banks face heightened scrutiny of their mortgage underwriting practices as authorities try to tackle the potential threat of a housing bubble in the two cities, where prices have soared. "We've ceded some market share. That is very much a choice," James O'Sullivan, group head for Canadian Banking, told investors after the bank reported third-quarter earnings that beat analyst estimates. "I think we're being prudent, I think we're being vigilant in this market but we're not overly concerned. We believe we've constructed a very solid mortgage book here," he said. O'Sullivan said Scotiabank was turning down more mortgage applications than it had done in the past. "We have been taking progressive actions across a number of portfolios. Those would include tightening exceptions, tightening of originations and reduced pre-approvals," he said. Canada's third-biggest lender earned $1.55 per share in the quarter, up from $1.46 a year earlier. Analysts had on average expected earnings of $1.48 per share, according to Thomson Reuters. The bank benefited from a decline in funds set aside to cover bad loans to energy companies, with a partial recovery in the price of oil helping borrowers pay back credit. Like other Canadian and U.S. lenders, Scotiabank had seen a rise in delinquent loans to energy firms due to weakness in the price of oil, which was at a 13-year low of $25 a barrel in January. But a 30% recovery in the price of oil during the latest quarter has alleviated some of those pressures. Scotiabank's provision for credit losses fell to $571 million, a $181 million decline from the last quarter. The bank's total net income rose to $1.96 billion from $1.85 billion previously. Its Canadian business grew its earnings by 8% to $930 million during the quarter, benefiting from a 13-basis-point margin improvement. Its international business saw earnings increase by 9% to $527 million, driven by growth in Mexico, Peru, Chile and Columbia. The bank announced a quarterly dividend increase of 2 cents per share to 74 cents.

Barclays Plc named JPMorgan Chase & Co.'s Tim Throsby to run the corporate and international division, including oversight of the investment bank, as Chief Executive Officer Jes Staley filled the final vacancy on his top management team. Throsby, 50, will take on the role in January, subject to regulatory approvals, Barclays said in a statement Monday, a day after Bloomberg News reported the bank's plans to hire the executive. Throsby joined JPMorgan in 2010 and was named global head of equities two years later, running the business from London. Before joining Barclays in December, Staley spent more than three decades at JPMorgan and has recruited extensively from the U.S. firm as he reshaped his senior management team. (Source: Bloomberg)

Citi / Morgan Stanley - Banco Santander SA hired Morgan Stanley as an adviser to help it buy Citigroup Inc.'s retail assets in Brazil for $350-$450 million. Santander, whose Brazil unit generates about 19% of the Madrid-based company's revenue, also is understood to be working with Credit Suisse Group AG. According to press reports, Santander didn't make a bid for Citigroup's Colombia unit but are working on a proposal to buy Citigroup's assets in Argentina.

JPMorgan Chase has been granted a business license to operate a fully-owned fund management business in China, a Chinese regulatory notice showed, as the world's second-largest economy moves to further open its financial markets to foreigners. The license issued to the U.S. bank, which already has a fund management joint venture in China, will enable it to set up an office in Shanghai free-trade zone, as per the notice on the website of the Shanghai Industry and Commerce Administration. China set up the Shanghai free trade zone in 2013 as a venue to pilot economic reforms, in particular in the financial sector. The Shanghai regulator did not provide details of the proposed China unit of JPMorgan asset management business. (Source: Reuters)

National Bank of Canada cash operating Earnings Per Share (EPS) up 6% year/year (y/y) to $1.33, compared to consensus $1.20. Included in operating earnings was a $41 million or $0.12/share gain on the revaluation of its interest in ABA Bank in its Corporate segment, thus underlying EPS $1.21 is in-line with consensus. Earnings were assisted by lower Provisions for Credit Losses (PCLs), adding $0.03/share, offset by weak equity derivative trading revenue. Earnings were driven by Canadian Banking +5%, Wealth Management +5%, offsetting a 13% decline in Financial Markets. PCLs were $45 million or 15 bps of loans vs. $67 million or 23 bps of loans in Q2 2016 (excluding $250 million in sectoral PCLs) and $56 million or 20 bps of loans a year earlier. There were no new oil & gas PCLs this quarter but National Bank drew down its collective allowance by $37 million with $213 million remaining. Oil & gas impaired loans declined to $149 million from $178 million last quarter. Core Equity Tier 1 capital ratio 9.9%, up from 9.8% in Q2 2016, reflecting internal capital generation (+31 bps) partly offset by -22 bps for the acquisition of ABA Bank. Operating Return on Equity: 19.0%.

Activist Influenced Companies

Restaurant Brands International Inc. (QSR) said it would launch Tim Hortons coffee and doughnut shops in Great Britain as part of its expansion plans. The move into Europe comes after Tim Hortons, which has outlets in Canada, the United States and the Middle East, said last month that it would enter Asia by opening its first outlet in the Philippines. Restaurant Brands, which also owns the Burger King chain of restaurants, said that it formed a master franchise joint venture with an investor, which it did not name, in Great Britain. The joint venture will operate a franchise of Tim Hortons stores in England, Scotland and Wales. The company did not say when it would open its stores in the region or how many stores it planned to open. "Great Britain is an attractive QSR market with a strong and growing coffee culture so it is a natural fit for the brand," Restaurant Brands Chief Executive Daniel Schwartz said. Tim Hortons was founded in 1964 and, as of June 30, had over 4,464 system wide restaurants that serve items such as paninis, sandwiches, baked goods and soups, besides coffee and doughnuts.

Canadian Dividend Payers

Distinct Infrastructure Group Inc. (DIG) posted a solid quarter with 82% y/y revenue growth (77% organic) to $15.5 million and 10% y/y earnings before interest, tax, depreciation and amortization (EBITDA) growth to $1.6 million. In comparison, the FactSet consensus EBITDA estimate stood at $1.2 million. The large y/y increase in revenue was largely driven by strong performance in the telecommunications business, as DIG continues to experience robust demand from one of its largest customers. Additionally, iVac's, a division of DIG, start-up revenue made good progress, improving from a weaker first quarter. Gross margin of 28.8% was 2.74% lower y/y due to lower margin work, unionization of DIG's labour force in Eastern Canada, margin pressure in Western Canada, and costs associated with the hiring and training of 100 employees over H1/2016. **Days Sales Outstanding (DSO)** improved by 27 days sequentially to 100 days **and Days Work In Progress Outstanding (DWO)** are improving by 8 days to 139 days as management works to speed up billings and collections. While the improvement is nice to see, these levels are still higher than they should be and combined with the aforementioned revenue growth caused negative Free Cash Flow generation in the quarter. This quarter (Q3) represents the seasonally strongest of the year as the good weather allows more telecommunication work to be performed. However, the company has only ~$6.5 million in liquidity available and therefore may require additional flexibility whether it be equity or something more creative like the securitization of its receivables.

Global Dividend Payers

Bunzl Plc - The first half results were 3-4% ahead of expectations due to slightly more favourable currency and good performance on margins. Group revenue was 2% ahead of company consensus, Profit Before Tax 3% better and EPS 4% above. North America and Continental Europe were the drivers of the good performance, with operating profit 6% and 5% better than expectations, respectively, while the U.K. was 2% behind and Rest of the World in line. Three further small acquisitions were announced, two in Canada and one in Hungary, although this still leaves spending significantly behind 2015; £101 million has been spent on eight acquisitions so far this year, compared to about £240 million on 14 businesses at the same time last year.

Mondelez International Inc. issued a press release stating that it is "no longer pursuing combination with Hershey (…) Following additional discussions, and taking into account recent shareholder developments at Hershey, we determined that there is no actionable path forward toward an agreement". This news appears to vindicate our initial skeptical view of this transaction. We had always struggled to understand Mondelez's rationale for making the original $107/share "lowball" offer. It now seems like it might have been an opportunistic attempt by Mondelez to test if the Hershey Trust

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Company's vulnerability would make them willing sellers. It didn't work, but it cost Mondelez nothing. We are relieved that Mondelez maintained capital discipline and didn't overpay.

The Procter & Gamble Company (P&G) said that it has commenced an exchange offer for the separation of its global fine fragrances, salon professional, cosmetics and retail hair color businesses along with select hair styling brands (collectively known as P&G Specialty Beauty Brands) pursuant to its previously announced to sell the business to Coty, Inc. Under the proposed split-off, P&G will transfer the assets and liabilities of P&G Specialty Beauty Brand to Galleria Co., a wholly owned subsidiary of P&G created to facilitate the transaction. Galleria will then be merged with a wholly owned subsidiary of Coty. The exchange offer provides P&G shareholders with the ability to exchange their shares of P&G common stock for shares of Galleria Co. common stock, which will eventually convert into shares of Coty class A common stock. Shareholders are expected to receive approximately $1.075 of Galleria common stock for every $1.00 of P&G common stock tendered and accepted in the exchange offer.

Economic Conditions

U.S. nonfarm payrolls rose 151,000 in August. The softer gain marks a moderation in job growth following increases just north of 270,000 in each of the previous two months. Importantly, a burst of government hiring has padded the headline figures of late. Private-sector payrolls rose just 126,000 in August, slowing from the 160,000 pace so far this year and the healthy 221,000 pace in 2015. Declines in manufacturing and construction weighed. Household survey jobs were also soft, up just 97,000. While this followed a 420,000 spurt in July, the prior three months were similarly weak. The **unemployment rate stayed at 4.9%**. Also confirming the softness in the jobs report was a 0.2% decline in aggregate work hours. The two-month tally is up just 0.9% annualized from Q2, so it would require a burst of productivity (which we haven't seen in over five years) to support a Q3 GDP growth estimate of about 3%. But the expenditure data does support a GDP growth in that range so we'll have to wait and see.

U.S. trade deficit shrank more than expected in July, by a chunky $5 billion to $39.5 billion. Real goods exports jumped 2.9% after consecutive declines, while imports surprisingly fell after a string of healthy gains. Trade could support GDP growth in Q3.

Canada – The Canadian GDP retreated 1.6% (annualized rate) in the second quarter of 2016, a bit worse than the consensus expectations, which were calling for a 1.5% pull-back. The pull-back was chiefly driven by the slowdown in oil and gas activity due to Alberta fires. The Canadian balance of trade for the month of July resulted in a lower deficit than expected, at $2.49 billion relative to $3.25 billion. Exports advanced 3.4% with resource and manufacturing industries leading the way. Imports, meanwhile, retreated by 0.1%, a potential lead indicator of weak consumer activity.

Purchasing Manufacturers' Indices (PMI): Several PMIs in Asia registered an improvement in August. In China, the official manufacturing PMI increased to 50.4 from 49.9 in July, the highest since November 2014 but the positive tone was dampened slightly by a decline in the Caixin manufacturing PMI which mainly surveyed the Small and Medium Enterprises as the reading dipped to 50.0 from 50.6 in July. Overall, both the China's official and Caixin manufacturing PMI were higher than their 12-month average reading, suggesting some stabilization in the sector. In addition to China, Indonesia, Taiwan and Singapore also recorded PMI readings in August which were above their 12-month average. This was in contrast to the developed economies where there appeared to be some moderation in momentum in the manufacturing sector as the PMI for Eurozone, Japan and U.S. slipped below their 12-month average. We believe further recovery in developed economies' demand is crucial for the stabilization in Asia's manufacturing sector.

Hong Kong July retail sales dropped 7.7% –Year over Year - In July, the retail sales amounted to HK$34.6 billion, -7.7% y/y. Excluding the impact of price change, the sales declined by 8.5% y/y. Sales of jewelry, watches and clocks, and valuable gifts decreased 26.2% y/y, sales of commodities in department stores decreased 6.9% y/y, sales of electrical goods and photographic equipment declined 21.8% y/y, sales of miscellaneous consumer durable goods dropped 34.4% y/y. In contrast, sales of commodities in supermarkets increased 1.9%, sales of apparel advanced 1.8% y/y and sales of medicines and cosmetics rose 9% y/y.

Financial Conditions

Banks have intensified their battle against a planned toughening of global capital rules, urging regulators to scale back reforms that they warn would force them to curtail lending. In a joint letter to the Basel Committee on Banking Supervision, associations representing banks in Europe, Japan and Canada say that the proposals as they stand would "significantly increase capital requirements", in turn limiting banks' ability to lend. The letter, dated August 31 and signed by the European Banking Federation, the Japanese Bankers Association and the Canadian Bankers Association, is part of a push by the industry to limit what they see as a backdoor attempt by regulators to increase capital requirements by rewriting parts of the rule book for how banks should calculate risk. (Source: Financial Times)

The U.S. 2 year/10 year treasury spread is now .81% and the UK's 2 year/10 year treasury spread is .56% - 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 3.46% (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 4.3 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 12.41 (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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