News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 6, 2020

Owner Operated Companies

Nothing significant to report.

Energy Sector

Tensions in the Middle East have been the hot topic since the U.S. drone strike in Baghdad that killed Iranian Quds Force commander Qassem Soleimani. Since then, talk of possible escalation into an all-out shooting war between the two sides has been all over the media. The market has duly priced in an elevated risk premium, which has sent stocks lower, oil prices higher and pushed the USD/JPY exchange rate below 108. It's important to bear in mind the volume of oil that moves through the Strait of Hormuz. In 2018, its daily oil flow averaged 21 million barrels per day (b/d), or the equivalent of about 21% of global petroleum liquids consumption. One of the key supply risks for 2020 was that Iranian volumes returned to the oil market. That now looks unlikely following the death of Soleimani and the potential for escalation depending upon the Iranian leadership response. The Brent oil price is now trading close to $70 per barrel, well above the $60 per barrel embedded in analysts' forecasts for this year. The questions about what role energy has in portfolios in a lower carbon world are likely to dominate the debate in the sector in the year and decade ahead and yet the impact of macro events and the associated volatility is a reminder that there are other drivers of performance.

Financial Sector

Canadian Banks - Calendar 2019 marked the first time since 2010 that the Canadian bank index underperformed the S&P/TSX Composite index (after outperforming for eight consecutive years). The Canadian bank index had a total return of around 15% in 2019, underperforming the S&P/TSX Composite index by around 820 bps compared with an annual average outperformance of around 350 bps since 2010. Since 1970, the bank index has outperformed the market around 74% of the time by an annual average of around 430 bps. In 2019, **National Bank of Canada** was the best-performing bank stock among the "Big 6" with a total return of around 34%. **The Toronto-Dominion Bank** was the worst with around 12%.

HSBC Holdings plc - Bloomberg reported of some defacement of the "iconic" lion statues outside HSBC's main offices in Hong Kong. The article indicates that this vandalism is representative of how HSBC "has become a target of protesters' ire" in Hong Kong. More broadly, the political tensions in Hong Kong have been a negative for the HSBC investment case in recent months, especially with investors outside of Asia. In Hong Kong, HSBC is trailing today's positive start to the broader Hang Seng Index. An additional focus on HSBC will be how their strategic plan (FY 2019 results due in February 2020) approaches the $280 billion of risk weights, which are making close to zero return.

The Daily Mail wrote briefly last week on HSBC's upcoming restructuring plan, which interim CEO Noel Quinn (who analysts still think is favourite to get the role on a permanent basis) is expected to unveil in February 2020. The article focuses on the potential job cuts - a magnitude of around 10,000 is mentioned - including the French retail banking business likely to be sold (this has been heavily speculated), and also parts of the U.S. franchise (mainly on the West Coast). Looking forward to the plan, with HSBC pledging to re-allocate capital away from low return businesses - cuts are expected to focus on the U.K. non-ring-fenced bank; Continental Europe and the U.S. (particularly in Global Banking & Markets), analysts think that this could lead to significant charges in Q4 2019 results and beyond – however, it is certainly a positive, in analysts' views, overall that management have recognized the need to take action on the number of persistently underperforming businesses in the group and to announce a concrete programme to address them.

Prudential plc has announced a new exclusive bancassurance deal in Vietnam with Southeast Asia Commercial Joint Stock Bank that will last for the next 20 years. The deal is, in analysts' view, strategically consistent for them in terms of distribution channels for Prudential products to be sold in the region.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Nothing significant to report.

Economic Conditions

Despite this being the year 2020, don't expect a significant improvement in your vision when it comes to forecasting the economy and financial markets against renewed geopolitical stress. Nonetheless, geopolitical uncertainty is not a sufficient condition to write off risk assets. 2019 was a case in point. Global equity markets had their best performance in a decade in 2019 with the MSCI ACWI Index returning 26.9%. Markets have been supported by central bank rate cuts, liquidity injections (lower reserve requirements and repo market interventions) and a cheaper USD after it was announced that Beijing and Washington would ratify a phase one trade deal on January 15, 2020.

Global geopolitics - While the assassination of Qassem Suleimani, the Iranian Quds Force commander and one of the most powerful figures in Iran, has taken tensions between the United States and Iran to new highs, there is still reason to hope that both sides will take steps to avoid an all-out conflict for the time being. From Iran's perspective, it is already struggling with an economy that has shrunk by almost 10% in 2019, inflation levels in the 30% range and a currency that has declined in value by about 50% since the U.S. pulled out of the nuclear deal. This has left the government vulnerable to accusations that it is using funds to advance geopolitical objectives in places such as Syria, as opposed to using this capital for domestic needs. The recent mass protests over the government's decision to raise gasoline prices, which reportedly left several hundred people dead and thousands imprisoned, is a case in point. Iran is also worried that a severe retaliation could be met by a more devastating American response. The fact it misjudged Trump's willingness to act has only added to Iran's uncertainty. Iran must walk a fine line between striking the U.S. strong enough to save face without provoking a direct attack on Iranian territory. As for the United States, the conflicts in Iran and Afghanistan have left the American public strongly opposed to further wars in the Middle East. Trump also ran on avoiding further wars in 2016. A direct conflict with Iran would not only destabilize oil markets, it would damage Trump's 2020 election prospects. Even more importantly, getting mired in yet another Middle East war would ease China's path to becoming the world's next dominant geopolitical power. Nonetheless, the events of the past few days have shown that the risk of miscalculation is very high. For instance, a missile attack causing multiple U.S. casualties could provoke a counterattack on Iranian territory. Complicating matters further, in response to the killing of Soleimani, Iraqi members of parliament have passed a non-binding resolution calling for the removal of foreign military troops in the country. Deteriorating relations with Iraq could play to Iran's favour, and potentially undermine U.S. efforts to prevent the re-emergence of ISIS in the region. An even more serious tension point could be looming several months down the road due to Iran's decision to stop abiding by any of the nuclear deal's commitments. This could significantly narrow the estimated one-year breakout time currently needed for Iran to gather enough material to build a nuclear weapon should it choose to go down this route.

Canadian economy unexpectedly shrank in October 2019 as General Motors strike weighed on auto industry - The Globe & Mail reported on December 23, 2019 that Canada's economy unexpectedly shrank by 0.1% in October, the first monthly decline since February, partly because of a U.S. auto strike that hit manufacturing, Statistics Canada data indicated. Goods-producing industries posted a 0.5% loss while service sectors were essentially unchanged. October's growth figures were the latest in a string of disappointing data that analysts say could put pressure on the Bank of Canada to mull a rate cut. The central bank has held its key rate unchanged since October 2018 even as several of its counterparts, including the U.S. Federal Reserve, have eased. In October it forecast fourth quarter annualized Canadian growth would be 1.3% but analysts now say that is likely to be too optimistic. The manufacturing sector contracted by 1.4%, the fourth decline in five months. Durable manufacturing dropped by 2.3% as a strike by the United Auto Workers prompted some Canadian plants and parts producers to scale back production. The Bank of Canada's next fixed rate announcement date is Jan 22, 2020 and market expectations, as reflected in the overnight index swaps markets, show operators expect it to stay put. Statistics Canada said retail trade in October 2019 fell by 1.1%, the largest decline since March 2016, on broad-based weakness. Transportation and warehousing rose by 0.6% on strength in the aviation sector, both in passengers and cargo.

The U.S. ISM manufacturing index was 47.2 in December 2019, coming in under the 50 mark for the fifth consecutive month. This matches the streak during the 2015-16 collapse in oil prices as the most persistent factory contraction since the Great Recession. However, the current downturn is more broad-based than the oil shock. Indeed, the December reading alone was the worst single month since June 2009, pulled down particularly by the production component in the index. Manufacturers are facing the brunt of the trade wars (specifically exports and capital expenditures) amid ebbing global and domestic economic performance. Although global trade policy prospects are brightening to begin 2020 (phase one U.S./China trade deal scheduled to be signed January 15, Congress closer to ratifying the USMCA), Boeing's suspension of 737 Max production casts another dark cloud over early-year factory prospects. Meanwhile, construction spending increased 0.6% in November, and October was revised up to +0.1% (it was -0.8% previously). The advance in residential activity (7.4% in the past five months alone) has more than offset flat non-residential activity (just 0.2% in the past five months). Housing was slow to pick up on improving affordability, and it should now provide some economic offset to factories' woes.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.24% and the U.K.'s 2 year/10 year treasury spread is 0.17% - 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. Also, the narrowing gap between yields on the 2 year and 10 year Treasuries is of concern given its historical track record that when shorter term rates exceed longer dated ones, such inversion is usually an early warning of an economic slowdown.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.72% (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 3.9 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 14.47 (compares to a post-recession low of 18.00 achieved in early November) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 bodes well for quality equities.

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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, 'GDP' gross domestic product, 'netback' is a measure of oil and gas sales revenues net of royalties, production and transportation expenses and is used to compare performance in the oil and gas industry, 'ROE' return on equity, 'ROTE' return on tangible equity, 'ROTCE' return on tangible common equity.

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PIC20-003-E(01/20)