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. March 23, 2020

Owner Operated Companies

Nothing significant to report.

Energy Sector

Nothing significant to report.

Financial Sector

HSBC Holdings PLC has appointed Noel Quinn as chief executive officer, handing the insider and interim boss the reins of Europe's biggest bank and ending months of speculation that an external candidate could get the role. Quinn, who joined HSBC in 1987, took interim charge of HSBC last August after the shock ousting of John Flint and has been auditioning for the permanent job since, despite media reports that chairman Mark Tucker preferred an external candidate.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Compass Group PLC - Organic revenue growth for the five months ending February 29, 2020 was 6% as measures to contain Coronavirus in its Asia Pacific region did not materially impact business. Its operating margin during that five-month period increased by around 10 bps with the benefits from the restructuring programme in Europe coming through strongly. However, the acceleration of containment measures adopted by governments and clients in Continental Europe and North America have affected expectations for the Half Year. The vast majority of Compass Sports & Leisure and Education business in these regions have been closed, and its Business & Industry volumes are being severely impacted. Its current expectations are that Half Year 2020 organic revenue growth should be between 0-2%. Compass is implementing significant mitigation plans to manage its costs, and at this stage expects the drop-through impact of the lost revenue to be between 25%-30% across the business. As a result, its operating profit for Half Year 2020 will be £125 million - £225 million lower than expected. The group has significant headroom against a 4x net debt/EBITDA covenant in its U.S. Private Placement Agreements and has substantial liquidity with a £2 billion committed Revolving Credit Facility maturing in 2024. Stable outlooks have recently been reconfirmed via its A/A3 credit ratings.

GEA Group AG 2019 results and 2020 outlook. The company pre-released fiscal 2019 headline results on Jan. 27, 2020. Relative to the pre-release, the key incremental points in last week's release are: 2019 order intake of €4.93 billion and sales of €4.88 billion, in line with pre-release; 2019 adjusted EBITDA of €479 million versus pre-release guidance of €470-480 million, including €41 million charged "above the line", i.e. included in adj. EBITDA, in line with expectations; and GEA took €105 million of restructuring charges in 2019 versus expected €55 million, as the company brought forward restructuring expenses associated with the reduction of approximately 800 jobs, of which approx. 400 had left by end of 2019. Net working capital at the end of 2019 was €682 million or 14.0% of last twelve months sales (Q4 2018: €747 million or 15.5%). Dividend per share of €0.85. 2020 guidance (guidance reflects developments as of March 12, 2020): Acknowledging limited visibility, GEA now expects revenue to decline slightly in 2020 with adj. EBITDA of €430-480 million, and ROCE of 9-11%. In the conference call, management reiterated: all GEA's facilities are operational both in China and Europe and services, which accounted for 32% of revenue in 2019, are so far seen as a primary moving part determining whether EBITDA will be in the lower or upper end of €430 million - €480 million guidance range. EA's service employees have faced challenges in getting access to customers' sites due to COVID-19. Nonetheless ,GEA has seen a strong start of the year and expect a "good Q1"; Net Working Capital is expected to be further improved in 2020 and no reduction of announced dividend is considered.

Economic Conditions

Canada - Reuters highlighted Canada's federal government would provide $27 billion in direct support to families and businesses struggling because of the coronavirus outbreak, and stands ready to do more. Further, the government will also provide $55 billion in additional aid to businesses and households through tax deferrals. The combined measures will put more than 3% of the country's annual output into circulation, officials said. Among the measures announced, the government will provide up to $900 every two weeks to workers who must stay home but do not qualify for unemployment benefits, and a one-time special payment for low- and modest-income households, among other measures. Canada's Finance Minister Bill Morneau stated that the government is in talks with airlines and the oil-and-gas sector about specific aid to them. Further, Ottawa will soon announce a significant investment in Alberta - the heart of the country's struggling energy sector. Bank of Canada Governor Stephen Poloz, who spoke alongside Mr. Morneau, left the door open to further interest rate cuts and to quantitative easing, an emergency stimulus measure that could include the purchase of government bonds.

U.S. Industrial Production - American factories eked out a gain in February on the back of autos and computers, but that was before the Coronavirus 'storm' hit. Manufacturing production rose 0.1% after a downwardly-revised 0.2% decline in January. Production of automobiles and computers/electronics ramped up, but machinery pulled back for a second straight month, reflecting weakness in business investment that in part was likely due to supply-chain issues. **Overall industrial production** jumped 0.6%, but only because a return to more seasonal temperatures juiced heating demand. Mining sank 1.5%, as oil production decelerated from record highs due to less demand from China. The capacity utilization rate crept up to 77.0%, but it's heading much lower in coming months as America's factories and other producers deal with the economic dislocations caused by the coronavirus.

Financial Conditions

U.S. Federal Reserve announced another round of emergency measures to support U.S. credit markets and the economy. The Fed said "the coronavirus pandemic is causing **tremendous hardship** across the United States and around the world", and that "while great uncertainty remains, it has become clear that our economy will face severe disruptions. Aggressive efforts must be taken across the public and private sectors to limit the losses to jobs and incomes and to promote a swift recovery once the disruptions abate."

First, they modified some of the measures announced last week. Large-scale asset purchases or quantitative easing (QE) was set at $500 billion for Treasuries and $200 billion for mortgage-backed securities ("MBS"). These limits have now been lifted; the Fed will buy "the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy." The mortgage buying has also been extended to commercial MBS. And, the list of securities permitted in the Money Market Mutual Fund Liquidity Facility (MMLF) and Commercial Paper Funding Facility (CPFF) was expanded.

The latter facility was set up as a special purpose vehicle with capital provided by the U.S. Treasury, a concept replicated to establish three new facilities that together will purchase up to $300 billion of new investment-grade corporate bonds and loans (Primary Market Corporate Credit Facility or PMCCF), existing corporate bonds (Secondary Market Corporate Credit Facility or SMCCF), along with select asset-backed securities (Term Asset-Backed Securities Loan Facility or TALF). And the Fed promised to do even more, particularly to support lending to small- and medium-sized businesses.

The Fed's traditional role as "lender of last resort" to the banking system is fast becoming one of **lender of last resort to the economy**. The Fed wants to make sure that the expected economic contraction in March and Q3 is not made worse because the credit creation process and credit markets became dysfunctional, and also to ensure that a robust recovery is likely once the COVID-19 crisis subsides.

The Bank of England unanimously decided to cut rates 15 bps to a record-low 0.10%, the lowest official interest rates have been since the Bank was founded in 1694. And, **the Asset Purchase Facility would be raised by £200 billion to £645 billion** (before, the stock of corporate bonds was at £10 billion, and Gilts were at £435 billion ... most of the new funds would be in the latter bucket).

The U.S. 2-year/10-year treasury spread is now 0.48% and the U.K.'s 2-year/10-year treasury spread is 0.42% - 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 3.65% (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 3.1 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 63.80 (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.

And finally ....

"It's not what happens to you, but how you react to it that matters"
Epictetus

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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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