Our views on economic and other events and their expected impact on investments. April 20, 2020

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Owner Operated Companies

Amazon.com, Inc. is hiring 75,000 more staff adding to the 100,000 recruited in less than a month to handle Coronavirus crisis demand and bucking the trend of mass lay-offs in the economy. The move will bring the group's workforce to nearly 1 million worldwide and the group has advised a temporary increase in the hourly pay of its workers will cost more than $500 million.

Berkshire Hathaway Inc. received its dividends due from its investment in Occidental Petroleum Corporation in shares, not cash as the oil producer tries to shore up its balance sheet. Occidental borrowed US$10 billion last year via preferred shares issued to Berkshire at an 8% coupon in order to part finance its US$55 billion takeover of Anadarko. Regulatory filings show Occidental issued 17.3 million shares to Berkshire in lieu of the dividend due … amounting to 1.9% of the company's equity.

Brookfield Asset Management Inc. – U.S. distressed asset manager Oaktree Capital Management, a unit of Brookfield, is reportedly looking to raise $15 billion for a distressed fund. The new fund comes at a time when disruptions caused by the novel coronavirus outbreak have led to a plunge in company valuations, allowing large distressed debt funds to potentially snap up assets cheaply. Oaktree was co-founded and is co-chaired by veteran distressed debt guru Howard Marks, one of the most renowned debt investors. As of end of last year, Oaktree had $19.41 billion in distressed debt assets under management.

Facebook Inc. – Three Indonesian digital fintech firms are reportedly working with Facebook to apply for regulatory approval to launch mobile payments in the country. The plan, if approved, could be among the first such service under the social media firm's unified payment service Facebook Pay it unveiled in November, through which users across its various platforms including WhatsApp and Instagram can make payments without exiting the app. Facebook is keen to accelerate its expansion in Southeast Asia. Indonesia, home to 260 million people and the region's largest economy, is one of the largest markets globally for Facebook and WhatsApp, with over 100 million users. Elsewhere in Asia, Facebook has held talks to buy a multi billion dollar stake in Indian conglomerate Reliance Industries Ltd.'s telecom unit.

Facebook's planned cryptocurrency Libra will be linked to individual national currencies and overseen by global watchdogs in a scaled-back revamp it hopes will win regulatory approval. The prospect of Facebook's 2.5 billion users adopting Libra has led to intense scrutiny from global regulators, with many worried its launch could erode national control over money. Libra, which had planned to launch by the end of June, now reportedly aims to do so between mid-November and the end of the year.

Energy Sector

The Canada Federal Government announced measures to provide support to Canada's Energy Patch, with a view towards defending liquidity and employment through the extreme challenges of the prevailing COVID-19 environment. The programs will be sponsored by the Government, either directly, or in association with the Business Development Bank of Canada (BDC) and Export Development Canada (EDC), as a means to backstop operations of appropriately positioned commercial interests across the producer, services & mid-stream sectors, and will predominantly target mid/small-capitalization operators in a practical manner. Analysts note that this is explicitly not an industry bailout, with the government assuming limited transfer of risk or creating moral hazard, but is meant to provide a bridge to solid businesses in a foundational industry through the current turmoil. The announced programs are designed to support the short & long-term viability of the industry, summarized as:

EDC RBL Guarantee (Qualified Participants, No Cap Referenced) – Up to $100 million guarantee of reserve-based lending facilities for 12 months (extendable for one year), in conjunction with continued funding from financial institutions, in support of sustaining costs of operations.

- The program will be targeted towards <100 million boed sized producers, with reasonably-positioned pre-crisis liquidity, visibility to viable operations through 2021, no dividend, and compliance with abandonment and climate change directives.
- Further embedded is an EDC Insurance program in support of backstopping letters of credit to facilitate continued operations in association with counterparties (notably, mid-stream & transportation contracts).

BDC Bridge Fund (Qualified Participants, No Cap Referenced) – Commercial second-lien, mezzanine financing on the order of $15-60 million for a term of one year, to fund operational cash flow and ensure a degree of continuity of operations.

- We assume that these facilities target services & mid-stream entities to support business operations (with the aforementioned being producer targeted), which in conjunction with the EDC Insurance program significantly backstop that subset's continuity of operations and commercial interests.

Orphan Well Clean-Up ($1.7 Billion) – Direct investment towards the accelerated clean-up of orphan wells across the Western Canadian Sedimentary Basin, with material read-through to employment and solvency.

Emission Reductions Fund ($750 Million) – Loan program to incentivize emission reductions and those projects' associated employment.

Occidental Petroleum shareholders will get their first say on the oil company's acquisition of Anadarko Petroleum when they vote on issuing shares and warrants to Berkshire Hathaway for helping finance the $38 billion deal. The Anadarko acquisition closed in August, months before an oil price crash sapped the cash flow Occidental needed to pay the debt taken with the purchase. Critics, including activist shareholder Carl Icahn, have said the financing deal with Berkshire Hathaway's Warren Buffett was too generous. Berkshire Hathaway's $10 billion investment provided it with warrants for 80 million common shares in addition to an 8% dividend on preferred shares received for its support for the Anadarko Petroleum acquisition. Shareholders, who did not get to vote on the Anadarko deal last year, will vote at Occidental's May 29 annual meeting to authorize the warrants and to issue 400 million new shares, some of which could pay the Berkshire dividend. Berkshire's warrants are nearly worthless, because their $62.50 strike price is well above Occidental's $13.63 closing price on Friday. But they give Berkshire more than a decade to exercise the option, and dividends paid in shares could make it a major holder.

Financial Sector

JPMorgan Chase & Co. reported Q1 2020 EPS of $0.78. Consensus was $2.14, though there was a wide range for loan loss provision expectations, which came in higher than expected amid a large loan loss reserve build. Results included a $6.8 billion ($1.66) reserve build, $951million ($0.23) of losses related to funding spread widening on derivatives (within Credit Adjustments & Other in Corporate & Investment Banking) and $896 million ($0.22) of bridge book markdowns. It also had $233 million in securities gains, $197 million legal charge, and $90 million of Mortgage Servicing Rights losses. Positives in the quarter included robust loan and deposit growth and strong trading results. Still, this was overshadowed by a larger than expected loan loss reserve build in lieu of impact of Coronavirus. Revenues declined 3% year/year and were little changed linked quarter at $29.1billion. Tangible book declined 0.4% to $60.71 (1.6x). Its Return on Tangible Common Equity was 5%. Its Core Equity Tier 1 ratio was 12.3% (advanced, -110bps). It repurchased $6.4 billion of shares through March 15, down from $6.9 billion in Q4 2019. Average diluted shares declined by 1.5%.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Johnson & Johnson - Adjusted EPS of $2.30 came in well above Bloomberg consensus estimates of about $2.00. Higher sales, higher margins, a lower tax rate, higher other income all contributed to the EPS beat. J&J reduced guidance to $79.2-$82.2 billion (from $85.4-$86.2 billion). This new guidance range brackets Bloomberg at $79.7 billion. Adjusted operational growth is now expected to be down 3% to up 0.5% versus up 5%-6%. Adjusted EPS: J&J expects EPS to be $7.50-$7.90 versus prior guidance of $8.95-$9.10. This is below the current Bloomberg estimate of $8.16.

Roche Holding AG has announced it has developed COVID-19 serology antibody test, with launch in May 2020 if approved. Analysts' understanding is the antibody test detects those who had the virus, including asymptomatic patients. The test is for hospital/lab blood testing, not home use. High double-digit million monthly capacity is expected by June. Society immunity information could aid faster return to 'normal'.

Economic Conditions

The World Trade Organization (WTO) is predicting a severe decline in international commerce this year. In a new report the WTO forecasts a contraction of between 13% and 32% this year. The wide range of possibilities reflects the uncertainties about the health crisis. It says the impact on trade is likely to exceed the slump caused by the financial crisis just over a decade ago. The more pessimistic case would amount to a decline in global trade similar to what happened in the great depression 90 years ago but in shorter period of time. The WTO's director general Roberto Azevedo described the figures as "ugly".

Statistics Canada's preliminary estimate of Q1 GDP growth came in at -10% annualized (or 2.6% non-annualized). This is the worst quarterly print on record going all the way back to 1961. March GDP was deemed to have shrunk 9% non-annualized, the largest one-month decline ever recorded. This first GDP growth estimate by Canada's statistical agency is based on incomplete data and, consequently, will be revised in the coming weeks and months.

In Canada, seasonally adjusted home sales fell 14.3% from February to March. The decline was broad based, with decreases reported in all 26 of the major markets surveyed, except Regina.

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U.S. employment - Another 5.2 million Americans registered for unemployment benefits last week as businesses remain shut amid the coronavirus lockdown. The new Department of Labor filings bring the number of jobless claims over the last four weeks to more than 20 million. That amounts to roughly as many jobs as employers had added over the previous decade. The economic crisis comes as the number of U.S. virus cases exceeds 629,000. The surging joblessness is a stark reversal for the world's biggest economy where the unemployment rate had been hovering around 3.5%.

U.S. Industrial Production - The economic impact of the coronavirus in the U.S. has become abundantly clear in the past couple of weeks. The 5.4% decline in U.S. industrial production was larger than expected, with no sectors/industries spared. Here is how the big three industry groupings fared: Manufacturing, which accounts for 75% of total output, fell a record 6.3%, which was 2x what was expected. This component includes machinery, computers, autos, planes, food, paper and plastics. Mining output, which accounts for 15% of output, fell for the second month in a row, down 2.0%, also worse than expected. Utilities was down for the third time in the past four months. The component accounts for just over 10% of overall production, and it fell 3.9% in March. With quieter factories, the capacity utilization rate dropped a record 4.3 points to a decade-low 72.7%. Only production of semiconductors and printed circuit boards were a rare bright spot, up 0.6%, and communications equipment (+0.2%). Both are likely related to the abrupt move to working from home.

U.S. housing starts fell more than expected in March, down 22.3% to a one-year low of 1.216 million units annualized. That's the largest decline since March 1984 and was spread between both singles (-17.5%) and multis (-31.7%), and across all four regions of the country. (The Northeast was particularly weak, down 41% as half a dozen states were in lockdown mode.) And, there were downward revisions to the prior two months. Building permits, an indicator of future starts, were also down but the decline was not as steep as expected. Permits fell 6.8% to a 9-month low of 1.353 million units annualized, suggesting that there is activity waiting in the shadows once activity resumes. But April won't be any better, as the lockdown/ social - physical distancing continued in various parts of the country.

China's Q1 GDP fell sharply by 6.8% year/year, marking the weakest print since at least 1992. However, there was little surprise in this outcome. March indicators were weak, but mixed relative to expectations. Weaker than expected retail sales highlight significant consumer caution even as the economy opens up. Less weak than feared industrial production and unemployment reveals some success on the supply side. Officials are talking up the prospects for recovery, but many risks lie ahead in analysts' view, especially on the demand side given weakness in global activity. The data is unlikely to lessen the pressure for more stimulus, with a 20 bps cut in the 1 year rates likely next week and more special bond issuance in the pipeline in analysts' view.

Financial Conditions

The Bank of Canada (BoC) kept its policy interest rate at 0.25%, which amounts to the lower effective bound for a BoC that would prefer to avoid zero/negative interest rates. (That rate had been 1.75% prior to the onset of the COVID-19 crisis, but was cut three times in March by 50 bps apiece, with the last two moves being unscheduled.) Importantly, the BoC unveiled significant new measures to support the financial system, including more aggressive Government of Canada T-bill/bond purchases and new facilities to buy provincial and corporate bonds, plus lengthier term repos.

The U.S. 2 year/10 year treasury spread is now 0.42% and the U.K.'s 2 year/10 year treasury spread is 0.23% - 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 3.31% (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 40.51 (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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