News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 18, 2016

Energy Sector

Canadian oil production – Oil companies reeling from the collapse in global crude prices have slammed the brakes on conventional crude production in Canada, with the Western Canadian active oil rig count halving from last year. Further declines in output are expected to follow, suggesting producer group OPEC (Organization of the Petroleum Export Countries) is winning its battle for global market share in at least one small corner of the Canadian oil patch. Data from RBC Capital Markets, LLC showed there were 228 rigs active in the Western Canadian Sedimentary Basin, home to the world's third largest crude reserves, in the week of January 11 - down 50% from 455 rigs during the same week last year, and 62% below the five-year average of 593 rigs. Winter is typically the busiest time of year for drilling in Western Canada as the frozen ground allows companies to move heavy equipment around easily. This week last year was the high point of activity for the whole of 2015 and the slow start in 2016 will likely heap added strain on companies such as Precision Drilling Corporation and Western Energy Services Corp. Some of these companies were present at a conference we attended last week and revealed a number of measures meant to insure their survivability in a protracted low oil price environment; including high-grading of the active equipment (relative to the rigs being stacked), lowering head-count, focusing on maintenance of the contracted equipment, which now sees heavier usage, and protecting their balance sheet. Conventional crude production in Canada is dwarfed by output from northern Alberta's vast oil sands, where tarry bitumen is mined or steamed out of the ground, but still amounted to around 1.5 million barrels per day ("bpd") in 2015 according to research from Raymond James Ltd. In 2014, it was just under 1.6 million bpd. Oil sands production is set to rise to around 3.1 million bpd by 2020 despite the crude price rout as new projects already under construction start up. Oilfield services companies have been forced to accept rate cuts of up to 30% by oil producers, who have sharply curtailed conventional crude drilling activity even as they plough on with long-term oil sands investments. Canadian Natural Resources Limited's third quarter 2015 conventional production was down 8% versus a year earlier at 265,000 bpd as a result of a 84% decrease in drilling activity and the decision to shut-in 5,700 bpd of uneconomic heavy oil production. Husky Energy Inc. saw overall production decline 2% over the same period to 333,000 bpd, in part because of lower production in Western Canada. It completed five wells in the first nine months of 2015 versus 24 during the same period a year earlier.

As we're writing these notes it has been announced that the Canadian oil and gas producer Suncor Energy Inc. had reached an agreement to buy Canadian Oil Sands Ltd after raising its all-stock offer, valuing the deal at about $4.24 billion excluding debt. The deal came days after Suncor's hostile bid for the company fell short of support from Canadian Oil Sands shareholders. Alberta oil sands producers have been struggling with tumbling global crude oil prices which slid to their lowest level since 2003. Suncor will now offer Canadian Oil Sands shareholders 0.28 of a Suncor share for each Canadian Oil Sands share they hold, more than the initial bid of 0.25 shares offered in October. The raised offer values Canadian Oil Sands at $8.74 per share, which represents a premium of nearly 17% over the closing price on Friday, January 15. Suncor Chief Executive Officer Steve Williams said the company was "pleased to have the support of the COS Board of Directors and shareholders, including Seymour Schulich, and have been advised of their intent to tender their shares." Including Canadian Oil Sands' estimated debt of $2.4 billion, according to the two companies, the new deal is valued at about $6.6 billion. Canadian Oil Sands has a 36.7% stake in Syncrude Canada Ltd, the oil-sands mining consortium in northern Alberta that is Canada's largest single source of crude oil. Suncor currently owns 12% of Syncrude, a stake that would rise to 49% with the takeover.

Financial Sector

Brookfield Asset Management Inc. – The Colombian government sold its 57.6% controlling stake in power generator Isagen SA to Canada's Brookfield Asset Management for $1.99 billion. The stake, sold at the minimum price of 6.49 trillion Colombian pesos, is the largest privatization in the country in nearly a decade. The government plans to use proceeds to fund highways, bridges and tunnels across the country, its so-called 4G infrastructure projects. "We are extremely pleased to grow our business in Colombia, an attractive market with strong long-term growth fundamentals, a highly skilled labor force and continued need for new investment," Sachin Shah, president of Brookfield Renewable Energy Partners LP, said in a statement. The government was advised on the sale by Credit Suisse AG. The sale price was 11.1 times EBITDA and 24.2 times earnings according to Jamie Pedroza of Credicorp Capital Research. The auction has been suspended at least twice because of legal challenges. A last-minute appeal by a left-wing senator was rejected by legal authorities late on Tuesday. Brookfield, which has around $225 billion of assets under management, set up a $400 million fund to invest in Colombian infrastructure assets in 2009. It acquired Transelec Common Inc., the largest electricity transmission system in Chile in 2006. In 2011, it purchased an electrical distribution business in Colombia and in 2012 and 2013, it bought toll road networks in Brazil and Chile.

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Berkshire Hathaway Inc. – Warren Buffett is expanding his bet on the oil industry, slowly adding to his already large stake in oil refiner Phillips 66 even as crude oil prices have sunk to a 12-year low. From January 4 to January 11, Berkshire, which Buffett has run since 1965, paid about $390 million for an additional 5.1 million shares of Phillips 66, according to filings with the U.S. Securities and Exchange Commission. The purchases boosted Berkshire's investment in Phillips 66 to 65.68 million shares, or about 12.3% of shares outstanding, worth around $5.2 billion as of January 11. Berkshire began quietly rebuilding its stake in Houston-based Phillips 66 early last year, after having in February 2014 swapped $1.35 billion of shares for a chemicals business that it folded into its Lubrizol unit. Phillips 66 shares have held up better than many others in the oil sector. Its shares began trading in 2012 after a spinoff by ConocoPhillips, which Berkshire also owned. Two years later, Berkshire shed its remaining ConocoPhillips stake, as well as a large investment in Exxon Mobil Corporation.

Activist Influenced Companies

Zoetis Inc. – commented on European commission decision regarding Belgium tax rulings. It also provided a preliminary update of financial guidance for 2016 and 2017. The company said it does not expect the European commission's decision to have an impact on the company's 2015 results; it does, however, expect, to record a one-time, net tax charge in the first quarter of 2016, which is expected to be approximately $35 million to $45 million. Zoetis expects the ruling to lead to a reduction to its adjusted diluted EPS guidance by $0.13 for 2016. The consensus analyst expectations, as per Thomson Reuters I/B/E/S, is currently $1.93 earnings per share for the company's 2016 fiscal year. Zoetis also said it expects its guidance for 2017 to reflect the benefit of certain actions that could mitigate this impact on future results.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

Nothing new to report.

Economic Conditions

US retail sales retreated 0.1% in December, against expectations for a flat reading, with weakness fairly broadly based, including in sales of groceries, clothing, electronics and general merchandise. Some strength was recorded in the month in sales of furniture and building materials. Core retails sales, which excludes sales of motor vehicles and parts, were down 0.1% as well in the month. A preliminary reading of consumer sentiment for January, performed by the University of Michigan, indicates a modest recovery, to 93.30 index points, from December's 91.80 reading, broadly in line with the expectations.

Insofar as the US business activity is concerned, the industrial production in the month of December surprised on the downside, lower by 0.4% compared to a 0.2% expected retreat and adding to November's already weak showing of – 0.90%. The performance was dragged lower by mining (including oil and gas), not surprisingly, but also by manufacturing and utilities (given the much warmer than seasonably weather). Capacity utilization was down to 76.5% in the month, from 76.9% in November. This was the fourth month in a row of negative or flat growth and, together with the weak consumer showing, should cause the US Fed to re-examine their plans for four interest rate raises this year.

Canada – Existing home sales pulled-back 0.6% in December, though they were higher by 10% in year on year terms. The still hot markets of Toronto and Vancouver were balanced out by much weaker markets around Calgary, Edmonton and Regina. New home prices, meanwhile, managed to eke out a 0.2% gain in November, in line with the expectations and building on October's 0.3% advance.

Financial Conditions

The following information is as of the morning of January 18, 2016.

The US 2 year/10 year treasury spread (the difference between yields on differing debt instruments) is now approximately 1.18% and the UK's 2 year/10 year treasury spread is approximately 1.23% - 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 their costs of capital.

Influenced by the withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to approximately 3.92% (it was 3.31% at the end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing US housing inventory is at 5.1 months supply of existing houses. So the combined effects of low mortgage rates, near record high affordability, a more promising 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 approximately 27.02 (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 bodes 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 Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

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