News Highlights

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INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 25, 2016

Energy Sector

Whitecap Resources Inc. announced that, in response to the severe decline in crude oil prices in the past few weeks, is implementing multiple initiatives to adapt to the lower prices. The company priority in the current commodity price environment is to protect its balance sheet and to re-calibrate its business plan to ensure long-term sustainability while being positioned for an eventual commodity price recovery. Whitecap's Board of Directors have agreed to a 53% reduction to the company's 2016 capital program to $70 million from its previous December guidance of $150 million. The deterioration in crude oil prices has dramatically affected the industry's project economics. Whitecap's revised 2016 capital program of 23 (22.3 net) wells includes 15 (14.8 net) Viking light oil wells in west central Saskatchewan, 5 (4.9 net) Cardium light oil wells in West Pembina and Ferrier, 2 (2.0 net) light oil horizontal wells in the Deep Basin and 1.0 (0.6 net) well in Boundary Lake. The company's corporate focus on waterfloods across its asset base creates a low base production decline rate of 20% and provides a stable base level of production and funds flow which requires lower sustaining capital requirements. The revised capital program allows Whitecap to generate sufficient funds flow to maintain a total payout ratio of less than 100% at current strip pricing. As a result of crude oil prices below US$30/barrel (bbl) West Texas Intermediate (WTI) and the company's focus on our balance sheet and long-term sustainability, Whitecap has reduced its monthly dividend by 40% to $0.0375 per share ($0.45 per share annually) from the current dividend level of $0.0625 per share ($0.75 per share annually) commencing with the February dividend paid on March 15, 2016. This will reduce Whitecap's cash requirements by approximately $91 million annually and at the same time continue to provide its shareholders with a meaningful dividend that is sustainable longer term. The company remains focused on ensuring the dividend is fully funded through internally generated funds flow without the use of a dividend reinvestment program or bank debt.

US horizontal oil land rigs decreased by 1 to 402, led by the Williston (-2), Eagle Ford (-1), and Mississippian (-1), partially offset by gains in "Other" (+2) and Woodford (+1). In the Permian horizontal oil rigs were flat week/week and vertical oil rigs were down 3.

Canadian rig count was up 21 rigs coming out of breakup season but remains 42% off the level this time last year.

US offshore rig count increased by 3 to 29 and is down 46% over the last 18 months.

Financial Sector

Barclays plc - CEO Jes Staley has started a fresh round of cuts at the investment bank, affecting staff in New York, London and Asia, as he seeks to shrink the securities unit further and the bonus pool for the investment bank may be cut by at least 10%. Barclays is closing investment banking units in Australia and Russia, as well as Asian countries such as Indonesia and Thailand, as part of a review of global operations. Barclays has confirmed the closure of its cash equities and convertible bond trading business in Asia and entities in Taiwan and Korea and around 230 employees are affected. In context, at the end of 2014, Barclays had 20,500 employees in the Investment Bank. The lender is also cutting its onshore markets coverage in Brazil and cash equities sales and execution businesses in Central Europe, the Middle East and North Africa as part of some of the deepest cuts by any bank in recent times. Barclays hasn't made a final decision on compensation and plans to announce bonuses early March, later than the usual mid-February timing. (source Reuters). Barclays says in statement that it expects to report "broadly flat" revenue at the investment bank for 2015 from the previous year. Barclays will report fiscal year results on March 1st. Also, CEO Jes Staley says the bank will continue to focus on the UK and the US, while closing offices in 9 countries across Asia, the Americas and Europe, Middle East and Africa (EMEA). Measures will accelerate the investment bank strategy outlined in 2014, "focusing on its core strengths and running the business for returns." "We continue to build on the business's dual home markets in the UK and US and remain committed to a strong presence in Asia and EMEA".

BNP Paribas SA has chosen banks to prepare a multi-billion dollar stock market listing for its US unit, First Hawaiian Bank. BNP Paribas is understood to be estimating the value of the business at between $4 billion and $5 billion. In December, BNP Paribas said it was looking at "strategic options" for First Hawaiian Bank as part of its plans to improve its finances and to respond to new regulatory requirements. BNP Paribas said at the time that realizing value from First Hawaiian Bank could strengthen the parent bank's Common Equity Tier 1 ratio - a key measure of bank capital stability - by up to approximately 40 basis points (bps). BNP Paribas had a 10.7 Core Equity Tier 1 ratio as of end-September. (Source: Reuters). Also, BNP Paribas sold senior bonds last week at the same premium it paid two years earlier, even though new European Union (EU) rules had in theory just made them riskier. Its German rivals may not be so lucky when they come back to the market. France and Germany are implementing the Bank Recovery and Resolution Directive, which came into force on January 1, 2016. The measure is intended to take taxpayers off the hook and end the protection for some bondholders should a bank fail. But the two countries are doing it differently, part of a patchwork of approaches across the 28-member EU that highlights the latest challenge to investors in bank debt. (Source: Bloomberg).

Brookfield Property Partners LP has made an unsolicited, non-binding proposal to acquire a 67% stake in Rouse Properties, Inc., a US-based real estate investment trust that owns and operates enclosed regional malls, for $17 per share in cash or approximately $657 million. The proposed price represents a premium of 26% to the closing price of Rouse shares on January 15, 2016, and a 19% premium to the 30-day volume-weighted average trading price of Rouse shares. As part of the transaction, Brookfield Property Partners, an affiliate of Brookfield Asset Management, Inc., will retain the 33% stake in Rouse that it currently owns. The bid values Rouse at about $1 billion. New York-based Rouse, which operates 35 malls across the U.S., said it received the offer from the Canadian asset manager and formed a special committee to consider it. The offer comes at a time when the stocks of Rouse and many other US shopping-mall rivals are under pressure amid concerns their earnings are at risk due to overbuilding and the rise of e-commerce. Rouse was created in 2012 from a spinoff of a portfolio of 30 malls by General Growth Properties Inc., of which Brookfield Asset Management owns a 33% stake. It acquired that stake by leading a $30 billion restructuring of the mall owner to help it emerge from bankruptcy protection in 2010. General Growth currently has a market value of about $23.9 billion.

Citigroup Inc. held its quarterly Fixed Income Investor Review conference call last week with CFO John Gerspach and Treasurer James von Moltke. On the call Citi revealed:

- It believes it has moved into the 300 bps G-SIB (global list of systemically important banks) surcharge bucket, down from 350bps.
- It said its 1st half 2016 consumer group cost of credit would be $600 million if oil prices were at $30/bbl (including knock-on impact), down from $641 million in the 4th quarter of 2015, it added that it would expect this figure to fall to $400 million for 2nd half 2016 (so $1 billion for the full-year vs. $0.9 billion in 2015 if at $30; but could double at $25).
- Its energy reserve/loan ratio was 3.8% (note 68% of funded exposure is investment grade; less than half is exploration and production/services).
- It expects to issue $2.5 billion of preferred stock in 2016, compared to $6.25 billion in 2015.
- With respect to Total Loss Absorbing Capital requirements, Citi believes an incremental $10 billion of issuance is needed after the benefit of extending maturities.

Citizens Financial Group, Inc. reported earnings per share (EPS) of $0.42 which met consensus, with better fees (helped by securities gains) offset by higher expenses. Net Interest Income of $870 million was a little above expectations, as loan yields were up 2bp quarter over quarter (Q-Q) and deposit costs were down 1bp Q-Q. Period-end loan growth was solid at +1.5% Q-Q. The 2016 outlook calls for 7%-10% net interest income growth year over year (Y-Y) (assumes two rate hikes). Core fees (ex. securities gains and Mortgage Servicing Rights help) met expectations, but with a better mix, as capital markets revenue missed and service charges beat. The 2016 guide calls for 5%-7% Y-Y fee growth (+2.5%-4.0% with card acct. change). Expenses were higher-than-expected, as outside services stepped higher, partially offset by better “other” expenses. The 2016 outlook calls for 2.5%-3.5% Y-Y core expense growth (+1.3%-2.3% with the card acct. change) which is higher than consensus. Citizens’ provisioned $91 million against $77 million of Non Conforming Obligations (NCOs), with NCOs low but provision higher-than-expected, reflecting management’s intention to start building reserves for loan growth. The 2016 outlook calls for $375 million to $425 million of provision, about in line with expectations.

Fifth Third Bancorp (FITB) reported 4th quarter 2015 EPS of $0.79. As expected, results included several moving pieces: The core EPS was $0.41, whereas consensus was $0.40. Its core EPS excludes: $331 million gain on the sale of Vantiv, Inc. (VNTV) shares, $89 million gain on VNTV warrant actions, $49 million payment received from VNTV to terminate a portion of its tax receivable agreement, $21 million positive valuation adjustment on the remaining warrant FITB holds in VNTV, $10 million charge related to the valuation of the Visa total return swap, and a $10 million contribution to the FITB Foundation. Results also included $2 million of severance expenses and an $11 million loan loss reserve build. Operating revenues rose 1% Y-Y and increased 2% sequentially. Tangible book increased 1.4% to $15.39. Its Common Equity Tier 1 ratio was 9.7%, compared to 9.3% in the 3rd quarter 2015. Aided by multiple accelerated share repurchase programs during the quarter, its share count fell 10 million. Its average diluted share count declined 1.3%. Net interest income declined 0.2% from 3rd quarter 2015, primarily driven by the full quarter impact of $2.4 billion of wholesale debt issuances in 3rd quarter 2015, the $750 million auto securitization completed in November, and commercial loan yield compression, partially offset by mortgage growth. Average earning assets rose 1.1% with loans up 0.2% and securities up 2.5%. Other short-term investments average balances increased $0.5 billion to $2.3 billion reflecting higher cash balances held at the Fed. Period-end loans declined 1.1%. Commercial line usage decreased 77bps from 3rd quarter 2015. Its net interest margin declined 4bps to 2.85%, driven by the debt issuances and auto securitization, slower prepayments reducing net discount accretion on the securities book,

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and an increased short-term cash position. Average core deposits increased 1%. The effective tax rate was 30.7%, compared with 26.0% in 3rd quarter 2015. The increase was primarily driven by the impact of VNTV-related transactions during the quarter. Its Non-Performing Assets (NPAs) ratio increased 5bps to 0.70%. Dollar NPAs rose 8% or $51 million. Its loan loss provision was $91 million, down from $156 million in 3rd quarter 2015. Excluding, the impact from the student loan backed commercial credit, its provision would have declined $30 million sequentially. Its reserve/loan ratio increased 2bps to 1.37%. Its energy loan portfolio was $1.7 billion (2% of total loans), of which 45% is reserved based lending and 18% is oil field services. Commodity trader exposure was $0.3 billion (0.3% of loans).

Goldman Sachs Group Inc. reported earnings of $1.27; however, after excluding the $1.8 billion legal provision for Retail Mortgage Backed Securities Working Group (RMBS) settlement, earnings came in at $4.68, which compares favorably to consensus estimates at $3.54. The majority of the beat came from revenues (+$0.21) while the remainder came from expenses. The compensation ratio was 28% versus estimates of around 33%. Operating revenues (excluding debt valuation adjustment) declined 3% Y-Y and increased 10% sequentially to $7.3 billion. Excluding Legal expenses, expenses declined 2% Y-Y and fell 3% sequentially to $4.3 billion. Non-compensation expenses fell 7% Y-Y and increased 7% from 3rd quarter 2015 (+1% ex. charitable contribution). Excluding the RMBS settlement, its Return on Equity was 11.1% (11.2% for full-year). During 4th quarter 2015, Goldman repurchased 8.9 million shares for $1.65 billion. This is up from 3rd quarter 2015 when it repurchased 5.4 million shares for $1.05 billion, which was up from 2nd quarter 2015 (1.2 million shares for $245 million). The strongest revenue category was Advisory, which totalled $879 million and is almost near FICC (fixed income, currency and commodities) results of $1.2 billion. Volatility in the market and slowing global growth typically puts stress on Goldman's business model. That said, the stock is now trading at 95% of Tangible Book Value and the company has consistently reported double-digit core Returns on tangible capital.

UBS AG - Chief Executive Officer Sergio Ermotti, undaunted by China's economic slowdown and stock market turmoil, told Bloomberg Television last Monday that he plans to add about 600 people in China over the next five years, across businesses ranging from wealth management to investment banking. UBS and Goldman Sachs are the only foreign firms that can offer a full range of services in China through their securities joint ventures, a key advantage over rivals. With long-dominant local firms like CITIC Securities Company Limited under pressure from a government crackdown on financial-industry misconduct, Ermotti is eyeing a rare opportunity to take market share. Separately, US Supreme Court rejects appeal from former UBS employees Peter Ghavami, Gary Heinz and Michael Welty, leaves intact convictions for taking part in scheme to rig municipal bond investment deals.

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Barrick Gold Corporation announced its 2015 production results which were in-line with guidance and estimates. The company expects impairment charges potentially in the order of $3 billion (including $1.8 billion for goodwill and $1.0-1.2 billion for Pueblo Viejo and Pascua Lama). Overall, Barrick closed the year with production fairly in-line with expectations and met its $3 billion debt reduction target (inclusive of approx. $2.4 billion repayments in 4th quarter 2015). While the company highlighted potential impairments, we think the company will not breach its financial covenant (net debt/total capitalization ratio of less than 0.60) which it's estimate will approach 0.5 from the previously reported ratio of 0.42 as of September 30, 2015. 2015 gold production was 6.12 million ounces (Moz) and in-line with guidance of 6.0-6.15 Moz. Copper production came in at 511 million pounds (Mlbs) consistent with guidance of 480-520 Mlbs. 4th quarter 2015 gold production was 1.62 Moz, a bit above expectations as a result of residual production from Pierina (30 koz). Copper production was 138 Mlbs, 2% above expectations as lower production from Zaldivar was more than offset by higher production from Lumwana and the inclusion of initial production from Jabal Sayid. As of September 30, 2015, Barrick estimated that its net debt/total capitalization ratio was 0.42, less than 0.60 required under its new financial covenant. Previously, Barrick was required to maintain a consolidated tangible net worth (CTNW) of at least $3 billion but Barrick estimated its CTNW was $6 billion at September 30, 2015 before it proposed and its lenders agreed to replace this CTNW covenant with the new net debt/total capitalization financial covenant above.

Global Dividend Payers

GEA Group AG reported preliminary 4th quarter 2015 order intake of €1,240 million, compared to consensus of €1,136 million. The order intake of €1,240 million implies organic order growth of +1% in the quarter, reversing the deteriorating trend seen during 2015 as organic order growth went from +5% in Q1 to -9% in Q2 and -13% in Q3. As per usual, the 4th quarter 2015 order release comes without any substantial commentary. The company only notes that the quarter was supported by larger orders from a broad range of customer industries, including dairy, with details to follow when the company publishes its fiscal year 2015 report and fiscal year 2016 guidance on February 4th. In our view, the 4th quarter order intake helps to de-risk the 2016 earnings outlook, notably for GEA's Solutions segment, which is encouraging after the disappointing 3rd quarter 2015 result. We believe some of the order deferrals seen then are likely to have been closed during 4th quarter, but don't expect the base order trend to have seen much of a pick-up in 4th quarter (-5% organically in 3rd quarter).

Johnson & Johnson (J&J) – said it would cut about 3,000 jobs within its medical devices unit over the next two years, or about 4% to 6% of the struggling division's global workforce, to generate annual cost savings of up to $1 billion and focus on more innovative products. The job cuts relate to J&J's orthopedics, surgery and cardiovascular operations, although there are no immediate plans to eliminate specific products. The company's consumer medical devices, vision care and diabetes care will not be affected, J&J said. J&J's medical device sales approached $19 billion in the first nine months of 2015, but fell 10.4%, making the wide array of products its poorest-performing segment. The company expects pretax restructuring charges of $2.0 billion to $2.4 billion in connection with these plans, of which about $600 million will be recorded in the fourth quarter of 2015. The announcement likely means that an acquisition is still in the cards for J&J, given that it had about $37 billion in cash as of the end of the third quarter. J&J also reiterated its full-year 2015 forecast, and said the restructuring in the devices business would not affect the $10 billion share repurchase program. The restructuring is expected to produce annualized pretax cost savings of $800 million to $1 billion, J&J said. Most savings are expected by the end of 2018, including about $200 million in 2016. J&J employs about 60,000 within its devices unit, representing almost half its global workforce of about 127,000.

Pearson - Breaking with tradition, the company released guidance to 2018, effectively lowering marginally its numbers for 2015 and much more sharply expectations for 2016, but balancing bad news with a restructuring plan which – at £320 million of implementation costs - is much larger than anyone anticipated and by stabilizing the dividend at 52 pence for the 2015 and 2016. There are, in our view, many shades to what Pearson's management can do going forward, but the two fundamental choices were (and still are) to either continue pursuing the current global strategy (with some adjustments at the edges) or shrinking the company down to a much smaller core in US and UK education. Effectively, Pearson lowered expectations for revenues in 2016 (the mid-point EPS guidance implies a 5.6% decline in organic revenue growth) and for 2017 (which is now expected to be a year of "stabilization", i.e. little or no organic growth). As a result, Pearson has effectively shifted focus to restructuring and to the related cost savings until 2018. Cutting costs does not preclude maintaining the current strategy, just as it does not preclude changing it over time.

Economic Conditions

US – US headline inflation rate, as measured by the year on year change in the consumer price index (CPI), was 0.7% for the month of December, slightly below the consensus expectations and a couple of notches above November's reading. Prices were dragged lower by both energy and food prices. The core figure, which excludes the impact of energy and food prices, was up one tenth in the month, to 2.1%, in-line with the expectations. The stats depicting that state of the US housing market were mixed last week. The National Association of Home Builders' (NAHB) Housing Market Index remained flat at 60.00 index points, slightly below expectations, though solidly anchored in the 'optimistic' territory in regards to home builder's outlook. The US housing starts reached a 1.15 million units annualized rate of growth in December, below the expected 1.20 million units reading and the November's 1.18 million units level. The existing home sales, however, were stronger than expected, at 5.46 million units annualized, compared to 5.20 million factored in by the consensus and significantly ahead of November's 4.76 million unit annualized figure.

Canada – Retail sales in Canada surprised vigorously on the upside, growing by 1.7% in November, compared to October's 0.1% muted advance and the expectations for a 0.2% read, driven by strong sales across the board, including autos, sporting goods, building materials, electronics and clothing. Core retail sales, which strip off the effects of auto sales, were also up by 1.1%. Inflation in Canada moved higher in December, despite lower gasoline prices. The headline rate of 1.6% was just below the consensus expectations, with food driving the growth in prices, on account of a weaker Canadian dollar. The core reading, which removes the effect of eight most volatile price series, including food and energy, moved down one notch to 1.9% compared to November's 2.0% reading.

Europe - Mario Draghi, president of the European Central Bank (ECB), at the ECB press conference, stated, "The monetary policy measures that we have adopted since mid-2014 are working. . . . Yet, as we start the new year, downside risks have increased again amid heightened uncertainty about emerging market economies' growth prospects, volatility in financial and commodity markets, and geopolitical risks. In this environment, euro area inflation dynamics also continue to be weaker than expected. It will therefore be necessary to review and possibly reconsider our monetary policy stance at our next meeting in early March, when the new staff macroeconomic projections become available which will also cover the year 2018. In the meantime, work will be carried out to ensure that all the technical conditions are in place to make the full range of policy options available for implementation, if needed." The ECB announced just 7 weeks ago that: (i) The deposit rate would be lowered 10 bps to -0.3%; (ii) The timeframe for the Asset purchasing would be extended by half a year to March 31, 2017, or beyond if necessary; (iii) Principal payments would be reinvested; (iv) Local and regional government debt would be purchased, and (v) Long-term refinancing operations would continue at full allotment…… all in the name of anchoring inflation expectations and having inflation that is below, but close to, 2% in the medium term (i.e. their mandate). Back then, the measures were described as being 'fully appropriate' but those measures reflected circumstances that prevailed then and since then, the circumstances have changed. He cited oil plunging 40% since the cut-off date of the last projection, along with similar moves by commodity markets, financial markets, and the geopolitical situation. These conditions have worsened. “Our credibility would be harmed if we didn’t review the situation.” So at the March 10th meeting, the ECB Governing Council will have fresh economic projections (for growth and inflation, as far out as 2018) and it is then that they’ll review what has happened and reconsider their policy stance. President Draghi was a little vague….he did not want to discuss the specifics of what instruments they would use but he stressed that they have the power, willingness and determination to act, with no limits. When asked if he was concerned about global financial stability and the banking system, President Draghi responded that if heightened volatility in financial markets were to persist longer than the short run, it may well become an unwanted tightening in financial conditions, which is why they will review and reconsider their monetary policy stance in March. And “so far, we haven’t seen signs of potential financial instability like we saw in pre-crisis times.” The Bottom Line: The ECB is opening the door for more action at the March 10th meeting in anticipation of which the Euro may well weaken.

Financial Conditions

The US 2 year/10 year treasury spread is now 1.16% and the UK’s 2 year/10 year treasury spread is 1.27% - 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 3.81% (was 3.31% 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 22.34 (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 Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund

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