News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. February 1, 2016

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Energy Sector

Royal Dutch Shell plc shareholders - the final hurdle for the completion of the Royal Dutch Shell deal has now been passed with the BG Group plc shareholders voting 99.5% in favor of approving the deal. Earlier, Shell shareholders voted 83.1% in favour of approving the deal. Although widely anticipated to pass, it is always reassuring when confirmation comes. There remain some legal proceedings to finish but the deal is set to close as planned on February 15th. In our view, 2016 is set to be a milestone year for Shell. The acquisition of BG should enhance Shell's free cash flow profile in almost any oil price environment and the additional further scale in both LNG and deepwater Brazil should critically give the management far more portfolio options – and lower-cost ones – than would otherwise have been the case. Based on current assumptions on synergies and capex, the deal is net present value break-even in the 'low $60s' according to the management team, and with room for further operational synergies and capex cuts post the closing of the deal, we expect to see this break-even price move down over time. Recent actions make it clear that Shell has been resetting the business not only in preparation for a lower oil price environment with less competitive options being stopped, but also for the incorporation of the BG assets with the announcement of a new upstream organisation. Shell is clearly not exempt from the squeeze in earnings and cash flow faced by the industry but with the acquired assets it is likely to have more levers than most to pull through the downturn.

Whitecap Resources Inc. – Last week, we had the opportunity to discuss the recently announced capital program for 2016 with the company's CEO, Grant Fagerheim. The company had announced that, in response to the severe decline in crude oil prices in the past few weeks, it is implementing multiple initiatives to adapt to the lower prices. 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 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 (i.e. assuming an average $37.50/barrels of oil equivalent per day (boed) for 2016). The company had planned to finish drilling its 23 wells for the 2016 drilling program by the end of January and lay-off the 6 drilling rigs it had utilized. The company's 2015 exit production was around 41,000 boed and with the January drilling production should increase to 43,500 boed. With no further drilling throughout 2016, the company expects to exit 2016 with a 33,500 boed production for a roughly 37,000 boed average production over 2016. The company financed its $70 million 2016 capital program by selling some mid-stream assets for which it maintained a re-purchase option (for a total cost of 12% annualized). The company maintains the flexibility to ramp-up its drilling program, should crude oil prices improve significantly later in 2016. It has licensed 88 wells through the third quarter of 2016. We appreciated the Whitecap's management conservative approach to capital spending in 2016, summarized by the CEO's views that one 'can always accelerate in the future, but can't decelerate what's already spent'.

Financial Sector

Barclays plc's retreat from Asia is set to gather pace after it hired Lazard Ltd. to advise on the planned sale of its wealth management operation in the region that is likely to be valued at more than $500 million. The move comes only days after Barclays told staff that it plans to cut up to 1,200 jobs in its investment bank, many of them in Asia, and to close seven offices in the Asia-Pacific region, including in South Korea, Taiwan and Australia. (Source: Financial Times). Financial Times also reports that Barclays CEO poaches risk officer from JPMorgan Chase and Co. Says C.S. Venkatakrishnan has been recruited from JPMorgan to replace Barclays' current chief risk officer, Robert Le Blanc, who now becomes vice chair of risk and strategy, an advisory role that also reports to the chief executive.

JPMorgan Chase & Co. - $2.5bn settlement: The bank finally settled two of its biggest legal headaches left over from the financial crisis. The bank will pay insurer Ambac Financial Group, Inc. almost $1 billion, and another $1.42 billion to end most of its remaining disputes with the estate of the defunct Lehman Brothers. The latter resolves most of a lawsuit accusing it of draining Lehman Brothers Holdings Inc. of critical liquidity in the final days before that investment bank's September 2008 collapse. The settlement was made public last Monday, and requires approval by US Bankruptcy Judge Shelley Chapman in Manhattan. It resolves the bulk of an $8.6 billion lawsuit accusing JPMorgan of exploiting its leverage as Lehman's main "clearing" bank to siphon billions of dollars of collateral just before Lehman went bankrupt on Sept. 15, 2008, triggering a global financial crisis. (Source: Reuters).

JPMorgan has begun a trial project using blockchain as it seeks to lead banking-industry efforts to cut the cost and hassle of trading. Per the Financial Times, JPMorgan is collaborating with Digital

Asset Holdings, the New York-based start-up run by Blythe Master, the bank's former head of commodities. The pair are looking at several applications for the technology, including addressing liquidity mismatches in JPMorgan's loan funds, which normally let investors take out their money at short notice even though the underlying assets can require much more time to sell. "To sell a loan is a very cumbersome, time-consuming process; settlement can take weeks," said Daniel Pinto, head of JPMorgan's investment bank. Exploring alternatives through blockchain "makes all the sense in the world; it's easier and faster operationally, and you get fewer mistakes".

Prudential plc Investor Day Feedback - At its investor day last week, management pointed to its Asian sales being far less sensitive to equity market and GDP levels than its recent share price weakness would seem to imply, specifically as recurring premium focus rather speaks to long-term savings trends and taps into the approximately 60% cash typically found in Asian consumers asset allocations. It cited agent growth, back office capacity and irrational pricing by some regional players (not AIA Group Limited) as key factors. It did not, however, provide updated statistics on agent growth numbers. In our view, reassuring comments on the good growth outlook in a number of key Asia markets were made, but it did not provide any trading update. The key exception for top-line growth is Indonesia, where weak GDP is hurting, though it did point to a stabilization in consumer confidence statistics. Positively, Prudential can increase current debt levels of £4.2 billion by another £7 billion before it hits Solvency II constraints, compared to a current surplus of £9.2 billion. We see the balance sheet as well positioned to take any cyclical shocks and weather current volatile markets. The 2017 estimated dividend yield is 4.4% versus peers at 5.4%.

Royal Bank of Scotland plc (RBS) tried to put its troubled past behind it last Wednesday by making a £3.6 billion ($5.1 billion) provision to top up its pension fund and make amends for British and US mis-selling. Chief Executive Ross McEwan has been trying to clean up RBS so that the UK can shed the 73% stake it holds following the bank's £46 billion rescue during the financial crisis. The news wipes out any expectation of a profit for the year at RBS, which has not made a profit for seven years. In a 'buy' note published last Monday, analysts at UBS had estimated pre-tax profits of just £354 million for 2015 as a whole. (Source: Reuters).

State Street Corporation reported Q4 operating basis earnings per share (EPS) of $1.21, versus consensus of $1.18. Revenues were slightly below consensus and operating basis expense was approximately 5% below consensus. The effective tax rate was lower than indicated by management guidance and this could have added 2-3 cents to earnings per share. Despite a slight revenue decline quarter/quarter, the firm achieved positive operating leverage, largely driven by a reduction in compensation expense. FX translation reduced both revenues and expenses, but even on a constant currency basis, the expense decline modestly exceeded the revenue decline. State Street said it is targeting positive fee operating leverage in 2016. State Street expects its new expense program to produce about $550 million in annualized savings by the end of 2020. The expense savings seem to be back-end loaded as the firm is only expecting approximately $75 million in annual pre-tax net run-rate expense savings in 2016 and approximately $125 million additional savings in 2017. State Street guided to 2016 net income of $2,025-$2,125 million in a static rate environment and $2,100-$2,200 million in a rising rate environment (assuming a Fed rate hike in both March and June and a UK central bank rate hike in both May and August). This compares with consensus of $2,143 million. The firm also said it expects to generate positive fee operating leverage year over year.

UK Banks - Sky News reported last week that the UK banks will provision a further £5 billion for PPI (principal protected loss insurance) through the fourth quarter 2015 results with a potential £2.5 billion at Lloyds Banking Group plc. According to the article, the provisions would include an estimate of future claims resulting from the publicity campaign ahead of the Regulator's (FCA) proposed 2018 deadline. This appears to be an attempt to draw a line under an issue which has cost the major banks approximately £29 billion to date. For Barclays, whilst not large of itself (<0.2% of Risk Weighted Assets), incremental provisions would be clearly unwelcome given the need to build capital towards its end-state requirements, and of even less impact on HSBC Holdings plc whereas likely, in our view, to be more an initial burden on Royal Bank of Scotland.

Activist Influenced Companies

Johnson & Johnson – Artisan Partners, a major shareholder in Johnson & Johnson, has urged several activists to pressure the consumer products giant to consider major changes that include a potential split. Artisan has asked Johnson & Johnson's management to consider separating its three divisions – consumer products, pharmaceuticals and medical devices – into standalone companies in hopes of unlocking up to $90 billion in enterprise value. Johnson & Johnson posted fourth-quarter earnings forecasts, but gave a 2016 revenue outlook that was below analysts' estimates. The firm also said earlier in January that it was slashing 3,000 jobs in its struggling medical device division. In 2006, rival pharmaceutical giant Pfizer sold its consumer products division to Johnson & Johnson for $17 billion, becoming a focused play on drugs. Pfizer is now considering separating its patented drugs from its generics division.

Pershing Square Holdings Ltd. – Two government probes into the conduct of longtime enemies Pershing Square Holdings and Herbalife have failed to find sufficient evidence of criminal wrongdoing by either party, according to the Wall Street Journal. The probes included an investigation of claims that Herbalife, a nutrition and weight loss company, has a fraudulent business model, and an inquiry into allegations that investment firm Pershing Square manipulated Herbalife's stock. The queries mark yet another point of tension in the feud between the two parties. Pershing Square's Bill Ackman, has bet $1 billion of his firm's $15 billion in assets under management against Herbalife and has been one of the company's most vocal critics, comparing its business model to a pyramid scheme.

Canadian Dividend Payers

Canfor Corporation entered into an agreement to purchase the assets of Wynndel Box and Lumber Ltd. (Wynndel), located in Creston Valley, B.C., for an undisclosed amount. Wynndel is a one-sawmill operation that produces premium boards and customized specialty wood products sold under the brand name WynnWood – the sawmill asset has nameplate annual production capacity of 65 millimeters per board foot (mm/bd.ft.) – the acquisition also includes harvesting rights for 65,000 cubic metres (approximately 27.6 mm/bd.ft.) in the Kootenay Lake Timber Supply Area – while the Wynndel acquisition is relatively immaterial against Canfor's total production capacity of approximately 5 billion/bd.ft., it has access to a high-quality fibre basket and enhances Canfor's ability to produce a broader mix of higher-value specialty products.

Global Dividend Payers

AT&T Inc., the No. 2 US wireless carrier, said fourth-quarter revenue grew less than expected as it added fewer mainstream wireless customers than a year ago due to stiffer competition from rivals. AT&T had 526,000 net new postpaid customers, down 38.4% from 854,000 a year earlier. For its prepaid service, the company had 469,000 net new customers. Total operating revenue rose 22.3% to $42.12 billion. Earnings of 63 cents, excluding certain items, were in line with analysts' forecasts. Average revenue per postpaid wireless customer fell 2% in the fourth quarter ended Dec. 31. AT&T has been seeking new revenue streams and is betting on its 2015 acquisition of the DirecTV satellite TV business to help beef up its bundles of cellular, broadband, TV and fixed-line phone services. It has expanded in Mexico after the recent purchase of the third- and fourth-largest wireless carriers in that country. Net income attributable to AT&T was $4.01 billion, or 65 cents per share, compared with a loss of about $4 billion, or 77 cents per share. In 2016, the company expects capital expenditures around the $22 billion range. It forecast double-digit consolidated revenue growth and adjusted earnings in the mid-single digit range.

Mexico will launch a long-delayed tender for one of the largest infrastructure projects under President Enrique Pena Nieto, a wholesale telecoms network that will cover most of the country. The project, which was meant to be launched by 2014, is part of a sweeping telecoms reform aimed at curbing the dominance of Carlos Slim's America Movil and improving Mexico´s low levels of cell phone penetration and network coverage.

Diageo plc - reported 1st half 2016, with 1.8% organic rev growth (estimated 3% underlying) and operating profit up 2.4% organic (estimated 1.5% underlying). Headline organic net sales growth was 1.8%; adjusting for the US shipment phasing, its estimated approximately 3% underlying. On a positive note, India is picking up some momentum, US spirits depletions are decent with Bulleit, Don Julio and Buchanan's maintaining momentum (and the gap between depletions and shipments should be much better in second half of the year), East Africa is growing strongly after the reversal of the tax hike on Senator keg, the comparisons get much easier in South East Asia and we see a broad-based improvement in trends in Western Europe. On a more cautious note, US growth is still heavily dependent on flavour innovation and it is uncertain if Cîroc Apple can pick up the slack from Crown Royal Regal Apple (we suspect not), Brazil will have much tougher comparison in the second half of the year, and the Nigerian macro is likely to deteriorate. FX headwinds from weak Emerging Markets should turn to a net positive in second half and 1st half 2017 due to the weakness of the british pound.

Procter & Gamble Company's (P&G) new chief executive is off to a good start as the company's core sales returned to growth in the second quarter, helped by price hikes and as it shed underperforming brands. Organic sales - core sales that exclude the impact of currency, divestitures and acquisitions - rose 2% in the quarter. P&G also posted a better-than-expected profit by cutting costs. David Taylor became the CEO of P&G in November, in the middle of P&G's turnaround plan. P&G is selling unprofitable brands and focusing on core brands such as Gillette, Pampers and Tide to revive sluggish growth, which analysts have blamed on the company's slow reaction to trends in top markets such as China. P&G now expects to reduce non-manufacturing costs by 25%-30% percent by 2016, a year ahead of schedule. The company, which gets nearly two-thirds of sales from outside North America, also said it would reduce its focus on unprofitable brands in India in favor of higher-margin products. P&G said the strong dollar reduced second-quarter sales by 9% and in 2016 expects it to reduce sales by 7% points. P&G's second-quarter sales fell 8.5% to $16.92 billion, slightly below analysts' average estimate. Excluding items, it earned $1.04 per share.

Roche Holding ag reported full year results that operationally were in line with expectations while an unexpected foreign exchange loss booked in net financial income depressed Core earnings per share to CHF 13.49, 3% below expectations. The company's guidance for 2016 (low to mid single digit sales growth and EPS ahead of that) is off an EPS basis without this foreign exchange loss – effectively the company is committing to margin improvement despite ongoing investments (outlook not muted).

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Economic Conditions

US – The rate of growth of the US economy slowed down in the fourth quarter of 2015, to 0.7% from the third quarters reporting of 1.5%, a notch below the economist's consensus estimate of 0.8%. The chief contributor to growth was the consumer spending, which contributed 1.5%, followed by housing at 0.3% and government with 0.1%, offset by a drop in inventories, removing 0.5% from growth, same as net exports. Business investment also subtracted from growth in the quarter. The US Institute for Supply Management's Purchasing Managers Index (PMI), a key manufacturing gage, was mildly ahead of the expectations for the month of January, but, at 48.2 index points, still firmly anchored in contraction mode.

US real personal spending rose at a still solid 2.2% annualized pace in the fourth quarter (and that accounts for 70% of the US economy). But most of that gain was in November as real personal consumption expenditure (PCE) was revised up to +0.4% in November (biggest increase since May) but slowed to just 0.1% in December. In other words, spending momentum slowed as 2015 drew to a close and enters the year on a weaker note. This, even with personal incomes up 0.3% in December, in-line with the average over the past six months and the personal savings rate rose to 5.5% in December, the 2nd highest since 2012.

US new home sales surged 10.8% in December to 544,000 units annualized. That was a lot more than expected, and is the highest level in nearly a year. Plus, with the upward revisions (28 thousand total) to the prior three months, especially to September and October, we believe momentum is evident, particularly as the gains were felt across the country. According to the National Association of House Builders, prospective homebuyer traffic picked up as 2015 came to an end, which may be one reason inventories rose to the highest level in six years (still far from the peak). But with the current sales rate, the months' supply was pulled down to 5.2, the lowest since the summer. Prices surprisingly eased a bit, down 2.7% in the month, or 4.3% year over year. Sales of homes priced under $199,999 and those between $500,000-to-$749,999 saw a pickup in their share of total sales, but homes in the $200,000-to-$299,999 still made up the largest share (35%). We would expect a large gain such as this one be followed by a much smaller move (or some retracement) next month. But with solid job growth and low mortgage rates, there is we believe lots of fundamental support for the housing sector (and we believe there will be more once wage growth picks up a little more).

Canada – The Canadian economy advanced in November, as expected, by 0.3%, driven higher by wholesale and retail trade, manufacturing and utilities and also, for a change, mining and oil and gas. The services sectors, however, suffered in the month with finance, health-care and administration all lower.

Financial Conditions

The Bank of Japan (BOJ) unexpectedly eased in its first Monetary Policy Meeting of 2016 on January 28/29th with an even more surprising announcement to introduce negative interest rate for the first time in its history. We did not expect the easing to come so soon and much less this negative rates surprise. The key easing measure that will come into effect as of February 16, 2016 is: The BOJ will adopt a three-tier interest rate system in which the outstanding balance of each financial institution's current account at the BOJ will be divided into 3 tiers: (1) The Basic Balance will be charged a positive interest rate of +0.1%; (2) The Macro Add-on Balance will be charged an interest rate of 0.0% (includes BOJ's provision of credit through the Loan Support Program and the Funds-Supplying Operation to Support FIs in Disaster Areas affected by the Great East Japan Earthquake); and (3)The Policy-Rate Balance will be charged a negative interest rate of -0.1% on the excess amounts outstanding of (1) and (2) held at BOJ.

No other changes were made to the Quantitative and Qualitative Monetary Easing (QQE) program. We believe the intentions of the BOJ are far more significant than the direct consequences of today's announcement. The BOJ has put in place an operational framework that will allow them to provide material additional support to the economy, should circumstances require it. We believe the BOJ is preparing to change horses to one that has more ability to run further. And if crude oil prices dip further into the year, we should expect more stimuli from BOJ earlier rather than later.

The Reserve Bank of New Zealand left the Official Cash Rate (OCR) at 2.5%— after the surprise "hawkish cut" of December 2015—and left a clear easing bias (i.e. to lower rates further) on the table, as expected. Being a small and open economy, the Bank cited unfavourable global headwinds, including "weaker growth in the developing world and concerns about China and other emerging markets. Prices for a range of commodities, particularly oil, remain weak. Financial market volatility has increased".

The US 2 year/10 year treasury spread is now 1.14% and the UK's 2 year/10 year treasury spread is 1.22% - 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 3.79% (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 5.2 months supply of existing houses. So the combined effects of low mortgage rates, near re\cord 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 20.20 (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

We want to share our insights with you and welcome your feedback. Our website has the latest, as well as archived videos, company profiles, and press articles. Please visit us at www.portlandic.com.

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