News Highlights

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Our views on economic and other events and their expected impact on investments. February 5, 2016

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Energy Sector

Baytex Energy Corporation – Earlier this week we met with Baytex's management and had a chance to review the company's capital program for 2016, operational updates and the company's balance sheet status. Baytex announced in December that it had earmarked $325 million to $400 million (Canadian dollars) for its 2016 capital program. However, in the light of the continued crude oil price weakening and in-line with recent announcements from companies across the spectrum, from junior exploration and production companies to supermajors, its capital expenditures are likely to be further slashed. Marathon Oil Corporation, Baytex's senior partner and operator in Eagle Ford, is due to announce its 2015 results and capital intentions on February 17. Marathon has reduced the number of drilling rigs in Eagle Ford to 7 from 23 the year before. All 7 rigs are drilling in Baytex's acreage, a testament of the superior economics of the area. Of the $325 million at the lower end of the previous guidance, only $25 million was slated for Canada, with only one well planned, at West Pembina. The $25 million could be cut to a minimum of $10 million. Given the above, the company's production is likely to diminish over the course of 2016 from 2015's exit of about 80,000 barrels of oil per day (boed) to roughly 71,000 boed and an average of about 76,000 boed with the company's Canadian operations responsible for the production drop. Baytex has reduced its drilling costs by 27% in Eagle Ford and 20% in Canada, while at the same time slashing operating costs by 15% and general and administrative expenses by 18% relative to its budget. A conservative (though highly likely, given recent capital program announcements in the industry) 2016 capital program could see Baytex spend only $250 million this year. Over the past couple of weeks a couple of transactions meaningful to Baytex's acreage in Eagle Ford have surfaced. Empyrean Energy plc and AWE Limited sold a 3% working interest (WI) and a 10% WI, respectively, in the Eagle Ford Sugarloaf project, in which Baytex also holds 28%. Baytex holds more acreage in the broader Sugarkane area, which incorporates Sugarloaf. The transactions imply a price of US$36,000 per boed of gross production or US$48,500 per boed on a net of royalties basis; applying the same metrics to Baytex's Eagle Ford interest results in an approximate value of $2 billion for the company's US assets. Baytex has $1.6 billion outstanding in senior unsecured notes, with the earliest significant maturity in 2021. Baytex has drawn roughly $300 million from its unsecured syndicated bank loan facility, which currently consists of $750 million and US$200 million (i.e. just over CAD $1 billion). Should the current crude oil price weakness continue, the company is exploring the possibility of securitizing its bank loan facility, in order to gain covenant relief. Given the quality of its oil plays and its continued drive to lower costs, Baytex continues to boast some of the best capital efficiencies, both at well level and corporate level, and, as a result, provides great exposure to a recovery in crude oil prices, though the timing of such recovery is becoming more critical given the company's relatively high debt levels.

Royal Dutch Shell plc - Europe's largest oil company reported its lowest annual income in over a decade and said it would take further steps to cut costs to cope with weak oil prices if needed. Shell said 2015 income fell 87% to $1.94 billion, in line with analysts' estimates, as its oil and gas production unit took a big hit from slumping oil prices. Shell's earnings are the latest demonstration of how badly oil producers are suffering from a 75% fall in oil prices since mid-2014. The world's largest oil company, ExxonMobil Corp., this week reported its smallest quarterly profit in more than a decade, while BP Group's 2015 loss was its biggest ever. Norway's Statoil ASA said on Thursday it would cut 2016 capital expenditure (capex) by $1.7 billion year on year, while U.S. producer ConocoPhilips Company reduced its quarterly dividend. "Shell will take further impactful decisions to manage through the oil price downturn, should conditions warrant that," Chief Executive Ben van Beurden said in a statement. Shell maintained its annual dividend payment of $1.88 per share. Shell is reducing investment, cutting nearly 10,000 jobs and selling assets to cope with the downturn. The CEO told reporters he believed oil prices had reached, or were near, the bottom of the cycle, pointing to growing demand. In order to lower spending, Shell has scrapped multi-billion pound projects over the past year, including a controversial exploration project in the Alaskan Arctic Sea, the Bab sour gas field in Abu Dhabi and Carmon Creek oil sands project in Canada. The company approved only four new projects last year and investment decisions are expected to remain scarce in 2016. Shell maintained its $33 billion combined Shell-BG capital expenditure budget for 2016. Capital spending fell to $28.9 billion in 2015, down $8.4 billion year on year. Shell sold $5.5 billion worth of assets in 2015.

Suncor Energy Inc. reported Q4/2015 results and scaled back 2016 estimated capital expenditure by approximately 10% – while the 2016 operating expense guidance range was unchanged, management reiterated a further $500 million of savings is targeted for 2016, so the downward trend should continue -- present and future capital expenditure appear to be trending positively – Suncor's spend in 2015 hit the low-end of guidance at $6.7 billion ($6.7-$7.3 billion range), and the company reduced 2016 guidance by $700-$800 million. Suncor did mentioned that its stock outperformance has made it willing to undertake other share-based deals – albeit there are no immediate follow-up plans following Canadian Oil Sands.

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BNP Paribas SA: Underlying Profit before Tax (PBT) excluding the Corporate Centre was €2,537 million, in line with consensus of €2,515 million. BNP's diversified model has operated well in our view with a 14.7% beat in its Corporate & Investment Banking (CIB) division, a PBT, 2.6% beat in Asset gathering, offsetting a 2.4% miss in Retail business. BNP reported a €2.31 dividend per share which was in line with consensus and 2016 dividend payout confirmed at 45%. Core Equity Tier 1 ratio is currently 10.8%. Management announced CIB restructuring: gross reduction of risk weighted assets of €20 billion by 2019 [~10% of estimated 2017 risk weighted assets]; net increase of €10 billion due to growth and reinvestment; €1 billion cost savings by 2019 [~8% of estimated 2017 CIB cost base], post tax would be ~8% of 2017 net income. €800 million restructuring charges in 2016-2019; targeting CIB revenues CAGR 4% growth (in line with 3.8% consensus CAGR 2015-17); CIB cost/income reduction of 8% (implies 71% 2015 to 63%); Core Equity Tier 1 target of 12% by 2019 (50bp buffer above the 11.5% requirement) and advises CIB currently has energy exposure of €34.3 billion [total gross commitment on and off Balance /Sheet]; €25.6 billion net exposure; Metal & Mining: €13.7 billion [total gross], €8.4 billion net exposure.

ING Groep NV on Thursday posted a bigger-than-expected rise in fourth-quarter earnings, driven by a robust performance in its retail and wholesale divisions. Underlying pre-tax profit, which excludes special items and divestments, was €1.2 billion ($1.3 billion) for the last three months of 2015, a 54% rise compared with the same period of the previous year. Analysts polled by The Wall Street Journal had predicted an underlying pretax profit of €1 billion. Net profit was €819 million, a 30% drop from the year-earlier period when the results still included income from ING's insurance businesses. (Source: MarketWatch)

Prudential plc shares negatively impacted on press reports (source Bloomberg) Chinese FX regulator (State Administration of Foreign Exchange) would be imposing per transaction limit of $5,000 on insurance products sold through a Chinese Union pay card (would be like a local Visa/Mastercard) effective February 4. This payment method is one type used by Prudential for mainland China new business. For Prudential, the company sells mostly long term recurring premiums business and the average present value size is $4,000/product and annual premiums are approximately $300. This is yet another example of China cracking down on capital outflows. On a primary impact basis, the restriction as reported seems immaterial to Prudential in our view. But the second and third derivative impact may be significant as a combination of China capital controls and ongoing economic weakness could hurt confidence and sales.

UBS AG's prized wealth management division and its 'new' investment bank suffered big earnings falls in the fourth quarter. The Swiss bank has been Europe's star performer since its 2012 decision to dramatically cut its investment bank and put wealth management, at the centre of the group. But a tough end to 2015 casts UBS's decisions in a different light. Adjusted pre-tax earnings at wealth management fell 27% on year to CHF 505 million ($494 million) and it had net new money outflows of CHF 3.4 billion as low interest rates, volatile markets and sluggish Asian growth conspired against the bank. Adjusted pre-tax earnings at the investment bank fell 19% in what UBS described as "treacherous" market conditions. Shares fell almost 8% in Zurich last Tuesday to CHF15.36 as investors reflected on those trends, and warnings from chief executive Sergio Ermotti about the "very challenging" start to 2016. (Source: Financial Times)

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

BCE Inc. reported a drop in fourth-quarter profit as it paid more to win wireless business and for workers' severance, but raised its dividend and pointed to moderate growth in 2016. Bell, as the company is known to customers, said that wireless revenue grew 5.9% as it added 91,000 postpaid wireless customers, who typically spend more than those who prepay. Wireless market leader Rogers Communications Inc. said last week it added 31,000 such customers. In the fourth quarter, Bell's wireless customers, on average, spent $63.67 a month, although it paid more to court and retain them amid aggressive holiday promotions, versus $59.16 for Rogers. The Montreal-based company also added 74,000 Fiber TV customers and 39,000 high-speed Internet connections. Fixed-line revenue declined 1.5%, but margins improved on cost-cutting. Its media unit reported a 3.4% gain in revenue, but margins were squeezed by rising content costs. The company expanded its control of HBO content in Canada in November. Bell said the "significant cost restructuring" in its media unit will bring labor savings that should offset further content cost increases and the impact of new broadcast rules that will bring more consumer choice. Net income attributable to shareholders fell to $496 million, or 58 cents a share, from $542 million, or 64 cents, a year earlier. Bell raised its dividend by 5%, in contrast to Rogers, which surprised investors by holding its payout steady. BCE Chairman Thomas O'Neill will retire in April. BCE plans to nominate Gord Nixon, the former chief executive officer of Royal Bank of Canada, to replace him, the company said.

Brookfield Property Partners LP (BPY) Related - General Growth Properties Inc. (GGP) reported Q4/15 funds from operations per share of $0.43 in-line with consensus of $0.42 (range = $0.41-$0.43), and GGP guidance of $0.41-$0. PBY owns ~34% of GGP and its estimated GGP represents ~33% of BPY's net asset value

per unit. Operationally, Q4 was a good end to the year for GGP, with recurring (i.e. ex termination fees) same-property net operating income +6.5% year over year (YoY) (vs. +4.6% in Q3/15 and +4.2% for the full year 2015). Same-property occupancy was -20bps YoY to 96.5%, while average tenant sales were +3% YoY to $588/square foot on a trailing twelve month basis (+3.9% YoY in Q3/15). Turning to capital allocation, GGP repurchased 271,000 shares in Q4 at a total cost of ~$6.8 million or ~$25/sh (~11% below current price) and extended the maturity on its $1.5 billion corporate credit facility to October 2020; GGP repurchased a total of 4.32 billion shares in 2015 for ~$109.5mm at a weighted average price of $25.34/sh – in Q1/16, GGP sold its interest in 4 retail properties for gross proceeds of $302 million ($250 million net). GGP's quarterly dividend is unchanged at $0.19/sh ($0.76/sh annualized) for a dividend yield of 2.7%. GGP increased the dividend by ~5.6% in November – the $0.76/share equates to a forecast payout ratio of 61% on previous consensus estimates.

Brookfield Property Partners LP (BPY) has posted strong cash flow growth which we expect to continue for the next few years. For Q4/2015, BPY reported funds from operations (FFO) per unit of $0.34, up 27% from $0.27 in the year-ago period, ahead of consensus of $0.32. For the full year 2015, FFO per unit increased from $1.11 in 2014 to $1.18. The increase was from a combination of same-property growth across the office and retail portfolio as well as new acquisitions somewhat offset by asset sales. BPY announced a 5.7% increase in its quarterly distribution to $0.28 per unit or $1.12 per unit on an annualized basis. FFO from the office platform increased to $194 million in Q4/15 from $150 million in Q4/14 mainly due to the increased ownership interest in Canary Wharf and positive same-property net operating income growth at its properties in Lower Manhattan, and higher fee income.

Global Dividend Payers

BHP Billiton plc has announced that S&P has downgraded its credit rating from A+ to A and kept the company on negative watch ahead of the half-year results. The rating downgrade was no surprise.

Johnson & Johnson – Europe's drug regulator said on Friday the defective blood clotting test device used in a key trial for the approval of Bayer's top-selling anti-clotting drug Xarelto did not distort the study's main findings. The study known as ROCKET compared Xarelto with older drug warfarin for preventing strokes in patients with a type of irregular heartbeat common among the elderly. That is by far the biggest market for the drug, which Bayer jointly developed with Johnson & Johnson, and which competes with Bristol Myers-Squibb and Pfizer's Eliquis. A so-called INR device by Alere, which measures how quickly blood starts clotting and which was used in the trial, was recalled in December 2014 after giving falsely low test results. Bayer said at the end of October that Xarelto has a 34% market share globally. Bayer chalked up €1.68 billion in revenue from Xarelto in 2014 and €1.60 billion in the first nine months of 2015, up 38% from a year earlier, making it Bayer's best-selling drug.

Liberty Global plc – Vodafone Group plc has confirmed a Bloomberg story that they are in talks with Liberty Global regarding a joint venture in the Netherlands "that would incorporate both companies' local operating businesses". The Bloomberg story reports that Liberty "may make an offer for Deutsche Telekom AG's local mobile unit if the negotiations with Vodafone don't lead to an agreement", citing a person with knowledge of the matter. Netherlands is only 3% of Vodafone revenues and 4% of Vodafone earnings before interest, taxes, depreciation and amortization (EBITDA), so the outcome isn't particularly material to Vodafone's valuation per se. But obviously the news is more significant in terms of the prospect for a bigger deal between Vodafone-Liberty that would strengthen Vodafone in Germany and the UK. The Netherlands is currently in our view Liberty's biggest operating challenge in Europe, and by helping Liberty fix it, Vodafone might reduce the willingness of Liberty to consider a wider deal in time. Based on the Bloomberg story, Liberty is weighing a Vodafone joint venture against buying T-Mobile Netherlands (currently owned by Deutsche Telecom) so may have some negotiating leverage with Vodafone on deal terms.

LVMH Moët Hennessy Louis Vuitton SE demonstrated a robust Q4 2015 despite the very difficult economic conditions. Fashion & Leather Goods is the main focus, which was up 3%, ahead of Bloomberg consensus at 1%. Louis Vuitton brand saw a positive performance with margins stable. This should come as a relief given the concerns post the Paris attack and weak US and Asian trading in the sector in our view. Wines & Spirits came in below expectations but the only real disappointment was jewellery, which slowed materially.

Revenue came in at €35,664 million, (Bloomberg consensus €35.5 billion) but EBIT came in line at €6,605 million (Bloomberg consensus €6.5 billion). FY 2015 organic growth amounted to 6% (Bloomberg 5%) with Q4 organic growth at +5% vs. Bloomberg consensus +3.9%. This was in line with 9M +6%, which is a good result in our view given the difficult market. Watches & Jewellery were weak at +3% (consensus +8%). Q4 15 showed Europe weaker at +6% following the Paris terrorist attacks (9 million +12%). The US also slowed down after 9M +11% to +5% in Q4 on the back of the strong dollar. Japan continued to be strong with +12% (9million +13%) and the rest of Asia fell -2% (9million -6%).

Syngenta ag agrees to approximately $43.8 billion of China National Chemical Corporation (ChemChina) for an all cash takeover offer at CHF 465/share plus special dividend of CHF 5 and ordinary dividend of CHF 11, scheduled for May, 2016. By comparison Monsanto Company offered CHF 433 per share about half in stock and in November ChemChina had first offered CHF 449 per share in cash. ChemChina's offer is more liquid than Monsanto and there is little business overlap and so less risk of regulators rejecting the combination (Monsanto had proposed divesting the seeds

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business). ChemChina is now seeking to assure US politicians not to be wary of this bid being an overt attempt to shore up China's food security ….to the detriment of others…..albeit this is now the fourth large cross-border deal involving Chinese groups bidding for US and European assets…and does in our view highlight the determination of China to secure quality strategic assets.

Economic Conditions

US – The Institute for Supply Management's non-manufacturing index (the NMI), which gages the health of the country's services sector, surprised on the downside in January, reaching a 53.5 index points level compared to December's 55.8 index points read and the expected 55.1 index points print. This is likely to pour more cold water on the US Fed's plans to tighten the US monetary policy.

Nonfarm payrolls rose 151,000 in January, shy of the consensus call of near 200,000 and the weakest print since September. Still, this followed unusually strong gains in the previous two months (262,000 December and 280,000 November) and a solid 222,000 monthly average last year. The guts of the report were pretty decent, too in our view. Most industries continued to hire, with even the hard-hit manufacturing sector seeing its strongest gain (29,000) in more than a year. Construction hiring slowed, however (18,000), despite a likely boost from unusually mild weather. The (more volatile) household survey reported 615,000 new positions (after 485,000 in December), allowing the **unemployment rate to edge down to 4.9%** for the first time since the early days of the Great Recession. That was despite a further uptick in the participation rate. With qualified workers becoming a scarce commodity, wage growth has turned up modestly. Average hourly wages jumped 0.5% in the month and 2.5% from a year ago, breaking out of its lower range of the past few years. Higher minimum wages in many states added to the upturn.

Aggregate weekly work hours jumped 0.4% in January after a sizeable gain in December. Even assuming a continuation of the weakest productivity trend in three decades, the upturn in work hours (2.6% annualized from Q4) suggests circa 2- 2.3% GDP growth in Q1.

US trade deficit continues to act as the biggest weight on the economy. The deficit widened modestly to $43.4 billion in December. Exports fell for a third straight month, while import volumes rebounded, led by purchases of automobiles and parts (reflecting record-high sales last year). Net exports sliced 0.7% from GDP growth in 2015, and will continue to take a toll this year, unless the US currency extends this week's worst slide (4%) in nearly seven years.

Canada – lost 5,700 jobs in January, missing the expectations for a 5,500 positions gain. Full-time employment and government jobs actually increased in the month, while the private sector, led by the self-employed drove the overall numbers lower. Jobs were lost in manufacturing, transportation and agriculture, offset by job gains in healthcare, culture and recreation. The headline unemployment rate nudged higher, to 7.2%.

Canada's merchandise trade deficit narrowed in December, to $590 million from $1.59 billion, undoubtedly helped by the weaker dollar, as exports exceeded expectations, at $45.35 billion for the month.

Financial Conditions

The Bank of England maintained the official Bank Rate at 0.5% and kept the programme of asset purchases paused at £375 billion. However, February's decision saw regular standout Ian McCafferty back in the pack with a 9-0 vote and so firming the view that the bank rate will remain firmly on hold for the time being.

Reserve Bank of Australia, as was widely expected, left the overnight cash rate steady at 2.00%, for the eighth consecutive month. However, an easing bias was maintained, with the accompanying statement concluding that "continued low inflation may provide scope for easier policy, should that be appropriate to lend support to demand".

The US 2 year/10 year treasury spread is now 1.14% and the UK's 2 year/10 year treasury spread is 1.20% - 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 3.72% (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 record high affordability, 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 23.08 (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.

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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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