News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. June 24, 2016

Energy Sector

Brexit impact on crude oil – Crude oil prices (West Texas Intermediate or WTI) plunged nearly 7% to $46.69 as the Brexit referendum votes were counted last night before recovering to around $48.00 in the early hours of Friday, as markets around the world were dealing with the effects of the unexpected Britain European Union (EU) exit outcome. One of the immediate effects of the news of the 'Leave' camp win was a strong rally in 'safe' assets, in particular the US dollar, with the DXY index moving from 93.3 points to 96.6 points (i.e. 3.5%) in a matter of only a couple of hours, before retreating to a 95.5 points level. A strengthening of the U.S. dollar pressures demand from importers of commodities, including crude oil, which are denominated in the US currency. Such commodities become more expensive for holders of other currencies, such as euro, yen or yuan. Companies with producing assets in the North Sea, such as Royal Dutch Shell plc and Total SA, were particularly affected, as the news of Brexit has raised further prospects of a new Scottish referendum, which could further complicate operations in the area. We believe that some of the concerns are unwarranted, as large oil companies have the experience and wherewithal to deal with uncertainty and protracted economic turbulence as they have operated for decades in economically and politically challenging environments in developing nations. Amid market turmoil/underperformance big oil majors typically outperform. Brexit should have little impact on Big Oil given they are US$ businesses for revenues, costs and reporting. Foreign exchange is also the least material driver of their near term earnings. We are of opinion that the Brexit driven pull-back created a buying opportunity for quality oil & gas companies.

Baytex Energy Corporation said that some of its indirect subsidiary entities have received reassessments from the Canada Revenue Agency that deny non-capital loss deductions relevant to the calculation of income taxes for the years 2011 through 2015. Baytex says it remains confident that the tax filings of the affected entities are correct and will vigorously defend its tax filing position. By way of background, Baytex acquired several privately held commercial trusts in 2010 with accumulated non-capital losses of $591 million. The losses were subsequently used to reduce the taxable income of those trusts by $591 million. The reassessments disallow the deduction of the losses under the general anti-avoidance rule of the Income Tax Act (Canada). If the deduction of losses continues to be disallowed, Baytex estimates that it ultimately would owe approximately $120 million for taxes and an additional amount for late payment interest (currently estimated at $14 million).

Whitecap Resources Inc. has now closed its previously announced acquisition of premium oil assets in southwest Saskatchewan for cash consideration of $595 million. Since Whitecap announced the acquisition on May 10, 2016, crude oil prices have increased by 12% to approximately US$50 per barrel WTI, further increasing the company's projected free funds flow estimates. The acquisition is highly accretive on all key operational and financial measures, and the shallow decline assets provide additional production stability, enhancing the company's ability to grow production and funds flow per share while providing a sustainable dividend to shareholders. The company is on track to meet its 2016 annual production guidance of 45,300 barrels of oil equivalent per day (78% oil and natural gas and liquids), which generates $368 million of funds flow based on a cash netback of $22.2 per barrel of oil equivalent. With the closing of the acquisition, Whitecap's borrowing base has a lending value of approximately $1.3 billion. However, Whitecap has elected to maintain the credit facility at the current $1.1 billion. Whitecap has considerable financial flexibility, with estimated year-end net debt of $830 million, providing $270 million of unused credit capacity and a Q4 net-debt-to-funds-flow ratio of 1.8 times.

Financial Sector

European Banks - We are currently long European banks, principally on valuation grounds (Price/Earnings and Price/Book relatives at near historic lows) and in the context of our expectation that the UK would have voted to Remain (polls and betting). In our view, following the UK referendum to exit the EU, uncertainties plaguing banks are going to peak and there are very few places to hide in banks, especially with inconclusive Spanish elections on Sunday. We believe the sector is likely to underperform, pending some clarity. We expect the European Central Bank to extend Quantitative Easing and so sacrifice the short term profitability of banks for the longer term greater good. We note that the European bank sector had rallied +14% since last Thursday's low, on expectation that the vote would be Remain. In the short term, we expect the market to focus on safe-haven banks, for instance we currently invest in the Nordic bank Nordea Bank AB which is already yielding about 8% (assuming dividend flat on 2015). As the discussion moves rapidly to the implications for the Eurozone, who might be next, etc, banks outside the Eurozone should have relative safe-haven qualities. We continue to believe Barclays plc to be well placed but with the market likely to focus on safety in the short term it is unclear when attention will return to fundamental value criteria, as currently, UK banks are the clear underperformers. We expect Eurozone banks to be punished heavily as uncertainty on outlook grows, particularly peripheral banks are likely to suffer for instance across Italy where opinion polls suggest a very low level of satisfaction with EU membership. Financial-services firms have a long list of concerns but the most important is "passporting." That's the legal regime that allows a bank domiciled in one EU country to do business in any other. Without it, international lenders will probably have to move substantial operations out of the UK in favor of Frankfurt, Dublin, Paris or other hubs. Another issue is euro-denominated trading and settlement -- the EU is wary of allowing those transactions to continue unrestricted out of reach of its regulators. Asset managers' ability to sell mutual funds across the continent is another privilege that may be up for review. Those rules will be a major focus for the UK, since finance is so important to its economy.

Looking further out, we are hopeful that this decision will be the catalyst that starts the EU on a path of implementing the structural reforms that are so vital if it is to break out of the cycle of consistently poor economic performance that stretches back many years. In the meantime, many European banks are better capitalised than they have been for generations and have earnings expectations that we currently believe are not unreasonable. We therefore suspect that we will be looking for attractive buying opportunities in the coming weeks.

Nordea - After months of headlines linking it to tax evasion, money laundering and most recently an alleged capital shortfall, Nordea Bank AB is assessing the damage. But in several key areas, there's little to see, Bloomberg reports. Scandinavia's biggest bank is outperforming European rivals in the stock market, the yield on its riskiest debt is at its lowest in eight months and business appears to be booming. The bank last Tuesday shot down media reports alleging it was severely under-capitalized, with the regulator corroborating the bank's defence. "In the equity capital markets, we have never done more business and never had as big a lead vis-a-vis our Nordic and international peers, ever, in our history," Chief Executive Officer Casper von Koskull said in an interview.

Royal Bank of Scotland Group plc (RBS) failed to launch the sale of Williams & Glyn in the first half of the year as planned, as months of technology complications deal a blow to the government's aim to privatize the lender. State-backed RBS said at the end of last year that it would begin the formal process of seeking a buyer for Williams & Glyn by the end of June, with a view to striking a "binding agreement to sell the business by year end 2016". However, the complex and costly task of separating the retail and business bank from RBS's technology has forced RBS to drop the sale negotiations, say bankers familiar with the process. RBS must divest Williams & Glyn by the end of 2017 under European Commission rules tied to its £45bn state bailout. (Source: Financial Times). RBS is planning to cut about 900 jobs in Britain, sources familiar with the process said, taking the total number of layoffs in the last four months to around 5% of the bank's British workforce.

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Bell Canada (BCE Inc.) - Manitoba Telecom (MBT) announced last Thursday that the arrangement resolution for its acquisition by BCE was approved by 99.66% of votes cast by MBT shareholders. The transaction now requires approval from the CRTC, the Competition Bureau and from the Ministry of Innovation, Science and Economic Development Canada (ISED). Given the critical issue of transforming the four-player Manitoba wireless market into a three-player format, we believe that the biggest hurdle is likely to be the Competition Bureau. Media reports suggest that the provincial government is supportive of the transaction, particularly in the backdrop of the proposed investments by BCE. BCE's recently announced plans to enhance broadband wireless coverage along Highway 75, the primary transportation line in Manitoba connecting Winnipeg with the US border, provides a precursor to potential benefits going forward. The major argument against the transaction, of course, is the likelihood of higher prices for wireless services in the province. There is clear evidence to suggest that regions with four players experience notably lower pricing. Recall MBT controlled 51% of the wireless market in the province, followed by Rogers' 33%, TELUS' 9% and BCE's 6%. The proposed transaction and the separate agreement with TELUS would see this transformed to a more even three-player market. The counter-argument is that, under the new market structure, there would be three strong players vs. two previously. It is also noteworthy that BCE and TELUS had no meaningful presence outside of Winnipeg. Thus, these regions would convert from two players to three effectively. Considering the above and the exit of the conservative government, we continue to believe there is a better-than 50% chance of approval of the transaction

Global Dividend Payers

Compass Group plc - a UK based company but with over 50% Sales exposure to North America (1st Half Organic Revenue Growth +8.3%). The company benefits from both Structural contract catering sector growth and market share shifts towards the largest/lowest cost providers. Ongoing returns to shareholders with share buy back (maintaining net debt/EBITDA (earnings before interest, taxes, depreciation and amortization) at 1.5x) and 5% Free Cash Flow yield.

Economic Conditions

UK decides to leave European Union: Firstly, I was wrong in thinking the undecided camp would be the swing vote (ie. Expats and younger voters being pro-EU but Brexit voters overall were much stronger than polls showed). Britain has voted to leave the EU, a stunning repudiation of the nation's elites that deals the biggest blow to the European project of greater unity since World War Two. The vote instantly creates the biggest global financial shock since the 2008 economic crisis, this time with interest rates around the world already at or near zero, stripping policymakers of the means to fight it. The pound suffered its biggest one-day fall in history, plunging more than 10% against the dollar to hit levels last seen in 1985. The vote will initiate at least two years of messy divorce proceedings with the EU and cast doubt on London's future as a global financial capital.

Impact on UK

Right now UK banks are the clear underperformers. One clear theme has been demand for UK based companies with revenues outside of the UK, especially USD earners, for instance Compass Group. The pound initially plunged against the US$ from 1.50 yesterday to ~1.32, a level not seen in 30 years, but has since firmed a little to 1.35. The 'comeback' was halted, though, after Scotland's First Minister Sturgeon said that "*there is no doubt that yesterday's referendum result represents a material change in Scotland's rejection of independence*" and that another referendum is now "*highly likely*".

The biggest question mark we believe is if the market will begin to speculate against the pound over the next 3-6 months - this would be extremely problematic given the high twin deficit financing UK growth post the financial crisis. If the pound weakens substantially from here, de-leveraging is going to become a major theme with the specter of recession with higher rates. We believe UK housing market is poorly positioned for this scenario given the structure of the market which favors 2-year fixed rates (HSBC was offering 0.99% 2-year rate this week). UK Prime Minister David Cameron announced his resignation with a replacement from the Conservative party expected to be in place by October. The Bank of England Governor Mark Carney has pledged to provide liquidity (£250 billion) for the financials system as markets deal with volatility. Economists expect a UK recession in the next 2 quarters, with a significant shock for the euro area and global economy. Economists have cut UK GDP growth forecasts for 2017 to 0.2% from 2.3%.

Three issues in particular will be in focus for investors and executives: What new agreement will regulate the $575 billion of annual trade between Britain and the rest of the EU? On what terms will UK companies be able to access the EU's $13.6 trillion single market? And will banks domiciled in the UK continue to be able to do business in the rest of the EU? There appear to be three broad options:

- The Norwegian Model: By staying in the looser European Economic Area, the UK would still have access to the EU's single market and participate in free movement of workers -- but without any say in how they evolve -- and it would still contribute to the EU budget. We believe banks prefer this model because it would preserve their access to EU customers.
- New Deal: Negotiating its own free-trade agreement would limit most trade tariffs between the UK and the 27-nation bloc but it would take years to work out the extent of Britain's market access. The EU's trade agreement with Canada took seven years to negotiate and still isn't ratified.
- WTO Rules: Trading with the EU under World Trade Organization rules would avoid the hassle of setting up a complex new agreement and the UK could set its own trade tariffs just like Russia and Brazil do. But it would have no favorable relationship with the EU or any other country.

Impact on Europe

European GDP growth forecasts are being cut: for 2017 to 1.1% from 1.6%. The UK is not going to walk away immediately. The country must give formal notice of its intent to Brussels (aka Article 50), and at that point, the clock starts ticking (there is a 2-year maximum). But European Council President Tusk assured one and all that EU law (rights and obligations) "*will continue to apply to and within the U.K.*" until a formal exit. But the uncertainty, the not knowing, will not bode well for financial markets in our view. Neither do rumblings from the likes of France's National Front ("*There must be a referendum now in France! The European Union is crumbling and it's a good thing!*"), Italy's Northern League ("*Thanks U.K., not it's our turn*") and the Netherland's Dutch Freedom Party ("*Hurrah for the British! Now it is our turn*")….comments which do not give one great comfort in the EU and of course Greece….the UK decision may well embolden Greek politicians again to talk about a Eurozone referendum or EU ministers to initiate Greece's exit.

Impact on US

US real GDP growth forecasts are also being cut, by 0.2% over the next 6 quarters, driving down 2016 and 2017 annual GDP growth to 1.8%. Our expectations for a Federal Reserve interest rate rise have been delayed to December versus September previously.

Impact on Canada

Few of the Canadian financial services companies have material direct exposure to the UK (Great West LifeCo and Royal Bank of Canada being the exceptions) and by and large, the direct impact in our view is not significant. However, as the implications of the vote likely have negative ramifications for UK and European economic growth, we believe that the spillover impact will still be negative and that the outlook for the Canadian financials has weakened. As such, we would expect to see weakness in valuations in sympathy with the European financials, but not in the same order of magnitude. We think that the Canadian dollar will not escape the fallout from the exaggerated moves in Eurozone foreign exchange for much longer. Although our economic ties with the UK are small, the Canadian dollar has one of the most over-extended long positions yet one of the strongest links to global risk of late. We do not believe the Canadian dollar is a safe haven like the Japanese Yen and Swiss Franc, where extended longs make sense during this latest round of global turmoil.

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Impact on Rest of World

With the world already in the midst of an earnings recession, we believe worries will grow over a global downturn. Although China does not want to weaken the currency, the country's hand may be forced if conditions start to deteriorate. Gold has benefited from a flight to safety as it touched a 2 year high overnight at $1,359/oz (currently $1,325/oz, up ~5%) while crude is down 4-5% below $48/bbl.

In Summary

Beyond these (rather obvious) near-term impacts, uncertainty is likely to rule for the foreseeable future. Brexit opens the possibility of a wider degeneration of the EU and possibly even the UK itself; Scotland was firmly in the "remain" camp and its first minister has already said a second referendum on independence was now "highly likely". The knock-on effects of Brexit on trade and investment are impossible to call right now and will only become apparent over the next two years as the UK negotiates new terms with the EU. Further adding to this uncertainty is the political change on tap in the UK with the Prime Minister, David Cameron, announcing his resignation in response to losing the referendum to remain in the EU. We also believe we face significant policy uncertainty in anticipation of elections in the US, Spain, Germany and France as well as a referendum on electoral reform in Italy. This uncertainty may delay the finalisation of bank regulation and dilute the effectiveness of the ECB's quantitative easing program.

US durable goods orders fell more than expected in May, down a worrying 2.2% in the month, while April's increase was trimmed modestly. Fewer orders were noted across the board…………… everywhere, it seems, but in communications and nondefense aircraft. The one bright spot was shipments. Core shipments rose for the 3rd consecutive month, which hints at stronger capex in Q2. But core orders (aka nondefense core orders excluding aircraft) took a 0.7% drop, the 3rd decline in the past four months. This component is a proxy for future capital spending and it points to continued weakness. Not very encouraging news on a discouraging news day.

US existing home sales came in as expected in May, up 1.8% to 5.53 million units annualized, the third increase in a row and the highest since February 2007. (April was revised lower to 5.43 million units from 5.45 million) The gain was supported by both single-family homes (+1.9%) and condos (+1.6%). And, 3 of the 4 regions of the country saw more buying activity, with the exception of the Midwest. The **supply of homes available to be bought** rose for the fifth month in row and, with the current pace of sales, held the **months' supply** at 4.7. Although that is the highest # of months in about half a year, it is still below what is considered 'normal', indicating a tight market. As the National Association of Realtors stated, inventories are still "*subdued*" and "*continues to lag even last year's deficient amount.*" This bodes well for the construction industry in our view, if buyers feel there isn't enough choice. Prices are still rising but perhaps the good news is that the pace of gains have slowed…….May's 4.7% year/year gain is below 2015's 6.4% increase, and the 11.5% jump in 2013. However, with prices still rising and limited choices, and being saddled by student debt, first-time homebuyers accounted for only 30% of total sales (down from 32% in April), which is disappointing and still far from the 40%'ish share during normal/healthy times. Investors made up 13% (unchanged from April) while repeat buyers saw their share rise to 57%.

Financial Conditions

Central Bank Reaction to UK's decision to leave European Union: the Bank of England's contingency plan now kicks in. Clearly, there will be no rate hikes for the foreseeable future; in fact, rate cuts and a resumption of Quantitative Easing are now a distinct possibility in the U.K. In a statement issued this morning, the Bank reassured that it "*will not hesitate to take additional measures as required as those markets adjust and the U.K. economy moves forward*" but signaled that they will wait and see how events play out. "*In the coming weeks, the Bank will assess economic conditions and will consider any additional policy responses.*".

We expect emergency finance minister's meeting this weekend followed by a round of global announcements from central banks. We believe the European Central Bank is likely to accelerate purchases (ie. front load) of sovereign and corporate bonds; whereas we believe the Bank Of Japan and Federal Reserve are both likely to stand pat (swap agreements already in place between central banks).

The US 2 year/10 year treasury spread is now .92% and the UK's 2 year/10 year treasury spread is .81% - 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 3.56% (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 4.7 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 23.16 (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 Focused Plus Fund
- Portland Private Income Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Advantage Plus Funds
- Portland Private Growth Fund
- Portland Global Aristocrats Plus Fund

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