News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

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

Energy Sector

U.S. land rig count increased by 5 rigs to 422. The rig count has seen a weekly increase in 6 of the last 7 weeks. This week's increase was driven by directional oil (+5) as horizontal oil (+1) was offset by vertical oil (-1) while vertical gas, horizontal gas and directional gas remained flat week/week. Total horizontal land rig count is 75% down since the peak in November 2014.

U.S. horizontal oil land rigs increased by 1 rig week/week to 283, led by gains in Woodford (+2) and "Other" (+2), which were offset by losses in Permian (-2) and Williston (-1), while Eagle Ford, DJ-Niobrara, Granite Wash and Mississippian remained flat week/week.

U.S. offshore rig count was up 3 rigs week/week to 21, and is down 61% since June 2014.

Canadian rig count was up 14 rigs week/week as we come out of breakup season and is 51% off the level this time last year.

Baytex Energy Corp. has announced the appointment of Ed LaFehr as president, effective July 18, 2016. He will report to James Bowzer in his capacity as CEO. He most recently served as COO at Abu Dhabi National Energy Company (TAQA) in Abu Dhabi, UAE. He has 35 years of global experience leading large organizations, directing projects, managing assets and overseeing joint venture partnerships including 30 years at BP Plc/Amoco Corporation. He has served on the board of directors of many industry associations and was Chair of the Alberta Energy Policy Group for the Canadian Association of Petroleum Producers in 2013. James Bowzer, CEO of Baytex, said: "We are very excited to have Ed joining Baytex. He is a proven executive having held senior leadership positions in numerous major hydrocarbon basins throughout North America and internationally. Baytex will benefit greatly from Ed's strong operational knowledge, strategic vision and asset leadership as we chart our future growth and manage our business during this volatile commodity cycle."

BP Plc's announcement that it can now reliably estimate all of its remaining material liabilities with respect to Macondo is, in our view, a positive. At $5.2 billion on a pre-tax basis and $2.5 billion post tax, the remaining amounts are $4.2 billion and $3.7 billion lower, respectively, than consensus expectations. The remaining charges relate to liabilities outside of the settlement reached a year ago for the federal, state and local government claims and covers the estimated cost of settling all outstanding business and economic loss claims that has been a key uncertainty in terms of cash flow for the group since the settlement was reached in 2012. The total charge pre-tax has now reached $61.6 billion and post tax is $44 billion. The reassurance and certainty that this new estimate provides should be helpful to investors in assessing with confidence BP's plans for its financial framework. It is now over six years since the tragic events that took place at the Macondo well and much has changed at BP since that point. The group's first priority is to ensure safe, reliable operations and it has refocused its efforts on creating a simpler and more efficient organization. With certainty over the Macondo liabilities and a business that is set to deliver top-line momentum, better operational efficiency and lower costs over the coming four years, we see an attractive investment case for BP.

Financial Sector

Bank of America Corporation reported Earnings Per Share of $0.36, which adjusts to ~$0.40 (after negative adjustments for Financial Accounting Standards 91 and Debt Value Adjustments). Core Net Interest Income was down 1% Quarter-on-Quarter (Q-Q) as the Net Interest Margin dropped 7bp, but the balance sheet grew. Investment Banking/trading results were stronger with Fixed Income, Currency & Commodities up 22% and equities down 12%. Investment -banking fees were $1.5 billion in 2nd Quarter, down 8% Year-on-Year (Y-Y). Mortgage banking fees were down 30% Q-Q driven by a $100 million lower hedge gains and lower "other" production fees, but core mortgage production fees were stronger. Expenses were well controlled in our view, down 4% Q-Q to $13.5 billion while Loan growth slowed to 2%Y-Y. Non Conforming Obligations declined 7% Q-Q to $985 million and provision matched. Non Performing Assets (NPA) declined 5% Q-Q as ~$550 million fewer consumer NPAs were slightly offset by ~$70 million greater commercial NPAs. Provision of $1 billion was down 2% Q-Q and reserve release was near zero. Core Equity Tier 1 ratio was up 40bp to 11.4% (standardized), advanced to 10.5% after revisions. Tangible book value was up 3% to $16.68 with some help from lower rates.

Berkshire Hathaway Inc. – Warren Buffett, the billionaire chairman of Berkshire Hathaway, has donated another roughly $2.86 billion of his holdings in the company's stock to the Bill & Melinda Gates Foundation and four family charities, as part of his plan to give away nearly his entire fortune. Buffett, 85, remains the world's third-richest person, according to Forbes magazine. Buffett still owns about 18% of Berkshire's stock, down from 32.3% before the donations began in 2006. He controls about 31.7% of Berkshire's voting power. Buffett typically makes his donations in July, reducing the number of shares by 5% from the prior year. The charities usually sell the Berkshire shares to finance their activities, reflecting Buffett's desire that his money be spent. Buffett also makes smaller donations to other charities.

Brookfield Asset Management Inc. – announced that it held the final close on Brookfield Infrastructure Fund III (BIF III) with an aggregate of $14 billion of equity commitments, creating a global infrastructure fund that invests in high-quality, core infrastructure assets on a value basis. BIF III marks the largest private fund raised by Brookfield and the largest private infrastructure fund ever raised in the industry. In the last 18 months, Brookfield has raised approximately $27 billion across its flagship private fund strategies, including the close of its flagship real estate fund, Brookfield Strategic Real Estate Partners II at $9 billion, and its flagship private equity fund, Brookfield Capital Partners IV at $4 billion. Brookfield's commitment will be funded through Brookfield Infrastructure Partners L.P. and Brookfield Renewable Partners L.P. To date, the Fund has committed to invest over $3 billion in assets consistent with the Fund's investment strategy, including a portfolio of U.S. hydroelectric facilities, a portfolio of Brazilian electricity transmission projects, a leading Colombian power generation company, a portfolio of Peruvian toll roads and a U.S. water infrastructure project developer.

Citigroup Inc. reported Q2 2016 Earnings Per Share of $1.24–exceeding the consensus of $1.11, with upside a function of better revenue growth and operating leverage in the Institutional Clients Group (ICG) and lower than forecast aggregate credit costs (net reserve release was a ~$0.04 per share benefit); Global Consumer Banking again fell short. Return On Tangible Core Equity was 8% and fully phased in Basel 3 Core Equity Tier 1 ratio was 12.5%. Citi's Trading business showed strength across Fixed Income Currency and Commodities and Equities, Debt Capital Markets, and accelerated growth in Treasury Services coupled with realization of operating leverage in the ICG; overall expense management was also good in our view. In terms of credit, loss rates actually moved down in aggregate (note commercial/ICG in particular); earnings also benefitted from a net loan loss reserve release. Citi Holdings showed further progress on strategic initiatives with assets declining and agreements for additional reductions between now and year end; $0.9 billion ($2.4 billion year-to-date) with further use of the Deferred Tax Allowance providing all the more capacity for capital return during 2016 and beyond with the bank trading at around a price to forecast year-end 2016 book value of 0.7x (0.8x Tangible Book Value).

JPMorgan Chase & Co. - Strong fees and lower-than-expected core expenses drove positive operating leverage in 2nd Quarter results. Excluding $0.04 in Visa/securities gains (legal benefit was largely offset by elevated tax rate), it's estimated an operating result of $1.51, which compares favourably to the consensus expectation of $1.41 per/share. The beat was due to both the top line and expenses, as Investment Bank and trading results came in above our expectations. Although Net Interest Margin was down 5bps sequentially, JPMorgan is now trading at a premium to its peer group which we believe is justified, as the bank is delivering on operating leverage, stronger-than-peer loan growth and a 13% Return On Tangible Common Equity, and it will likely be the only universal bank earning a meaningful spread to its cost of equity, with a dividend yield north of 3%. Nonaccrual loans to total loans improved 6bps to 0.82%, Tangible book value rose 2.6% to $50.21 (1.3x). Its Basel III fully phased-in Core Equity Tier 1 capital ratios were 11.9% (Advanced, +20bps) and 12.1% (Standardized, +20bps). Results included $2.6 billion of net share repurchase. Average diluted shares declined by 1%.

Royal Bank of Scotland Plc (RBS) is facing setbacks over a proposed sale of its Greek ship finance business, with potential suitors backing off, partly because of the British vote to leave the European Union, sources told Reuters although Sky News subsequently reported Deutsche Bank AG is exploring a bid for the shipping loans owned by RBS. Sky News has learnt that Deutsche Bank has expressed an interest in buying part or all of a $3 billion (£2.3 billion) Greek shipping portfolio owned by Royal Bank of Scotland; Deutsche is believed to be competing with China Merchants and at least one Japanese bank to acquire the RBS business, although the process remains fluid and may not result in a deal. Reuters reported on June 22 that Credit Suisse and China Merchants were among bidders for RBS's Greek shipping finance operations.

Standard Chartered Plc started its first brokerage business in Japan with 100 employees as institutional investors in the country seek products from emerging markets in Asia, the Middle East and Africa for better returns. The bank will deploy 20 salesmen to meet with Japanese life insurers, brokerages, banks and asset managers to sell products that invest in developing countries with potential for fast economic growth, said Taisei Takegami, president of Standard Chartered Securities (Japan) Ltd. All of the people in the unit already work for Standard Chartered's corporate banking arm in Japan and will perform dual roles, he said.

Wells Fargo Company reported Earnings Per Share of $1.01, in-line with consensus. Net interest income rose 2.1%, primarily due to loan growth which included the full quarter impact of the assets acquired from GE Capital that closed late in Q1 2016. Still, this was partially offset by lower income from investment securities, reflecting accelerated prepayments (primarily Mortgage Backed Securities), higher interest expense (higher debt balances) and lower interest income from trading assets. Average earning assets rose $35.2 billion (+2.1%) and net interest margin declined 4bps to 2.86%. The decline was primarily driven by the impact of growth in long-term debt, growth in deposits and reduced income on investment securities, reflecting accelerated prepayments. Non-Performing Assets decreased by $433 million, or 3%, to $13.1 billion. Its loan loss provision remained roughly flat at $1.1 billion. Results included a reserve build of $150 million (lower than last quarter at $200 million), primarily attributable to loan growth in the commercial, automobile and credit card portfolios. Its reserve/loan ratio declined 1bps 1.33%. Its oil & gas portfolio stood at $17.1 billion (1.8% of loans) down from $17.8 billion at Q1 2016 (1.9% of loans). Its energy reserve now stands at $1.6 billion (9.2% of loans) compared to $1.7 billion (9.3% of loans) at Q1 2016 driven by an increase in energy prices, slowed pace of deterioration and improved criticized asset levels in the quarter.

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Activist Influenced Companies

Restaurant Brands International Inc. board of directors appointed Ali Hedayat to the board to fill a recent vacancy, effective immediately. Also on July 15, 2016, the board increased the size of the Board to twelve members and appointed Cecilia Sicupira to the board, effective immediately.

Canadian Dividend Payers

Northland Power Inc. announced that its Board of Directors has commenced a review of strategic alternatives to further enhance the Company's growth, shareholder value and ability to capitalize on a growing pipeline of clean energy infrastructure development opportunities. "Northland has grown over the past three decades to become a leader in the clean and green energy infrastructure space," said James Temerty, Northland's founder, largest shareholder and chair. "As global demand for electricity increases and the world embraces more environmentally friendly energy sources, we are seeing more and larger opportunities than ever before. To ensure the company is best positioned to capitalize on these opportunities, we determined that this is an appropriate time to review the options available for the next phase of the company's growth. I can assure our shareholders, employees, customers and development partners that we will only embark on a new course if it offers superior value for shareholders and an even stronger platform for future growth than the one we have today." John Brace, chief executive officer of Northland, added, "It is business as usual while we undertake this important process. We are focused on expanding our near-term development opportunities, working with our partners to advance approximately $6 billion in construction projects currently underway, and continuing to operate safely and reliably." Northland does not intend to provide ongoing updates on this process unless further disclosure is required. Northland has retained CIBC World Markets Inc. and J.P. Morgan Securities LLC as financial advisors.

Global Dividend Payers

AT&T Inc. – The U.S. Federal Communications Commission (FCC) said on Friday that 62 bidders have made upfront payments in a forthcoming wireless spectrum auction, including AT&T, Verizon Communications Inc., Dish Network, T-Mobile US and Comcast Corp. The auction is set to begin on Aug. 16. Last month, the FCC said the price of 126 MHz of television airwaves taken from broadcasters to be sold for wireless use is $86.4 billion. If wireless companies and other investors are unwilling to pay $86.4 billion, the FCC may have to hold another round of bidding by broadcasters and sell less spectrum than had been expected. Wireless firms and other bidders had to put up 50% of the opening bid price to participate.

Novartis AG - The US Food & Drug Administration (FDA) advisory committee unanimously recommends Sandoz biosimilar version (GP2015) of Amgen's Enbrel (etanercept) for approval for all five indications of the reference product. If approved, Sandoz could be the first to launch biosimilar Enbrel in the U.S. In Europe, a biosimilar etanercept (Benepali) is already on the market by a joint venture between Biogen and Samsung Bioepis. However, even if the FDA follows the advisory committees advice, there could be a delay to the biosimilar's launch in the US as Amgen is suing Sandoz that it has infringed various patents of Enbrel.

Roche AG announced that the closely-watched GOYA trial, looking at Gazyva in front-line diffuse large B-cell lymphoma, failed to meet the primary endpoint, meaning it did not show it was better than current gold standard, Rituxan. Gazyva is meant to be a new and improved version of Rituxan, serving as an offset to eventual Rituxan biosimilars. Consensus has been cautious on GOYA so this news will not come as a total surprise. This can be seen in consensus forecasts for Gazyva, where peak sales of Gazyva top out at around CHF 1.7 billion (versus Rituxan's peak sales of more than CHF 7 billion annually, of which CHF 5.5 billion is in oncology). Gazyva is already on the market for two indications: chronic lymphocytic leukemia and relapsed follicular lymphoma. Its uptake has thus far been very gradual, and we believe this is now likely to continue.

Economic Conditions

Friday night's failed coup attempt in Turkey put a final dark blemish on a week already marred by tragedy. At this point, a key concern is the extent to which President Erdogan might seize this opportunity to rid himself of political opponents and consolidate power, as government forces continue to round up alleged conspirators, including large swathes of the judiciary. For global investors, the thwarted plot represents yet another geopolitical twist in a year that has brought no shortage of unwelcome surprises. Together with the recent terror attacks in Istanbul, the government's ongoing conflict with Kurdish insurgent groups, and broader violence in the region, demand for Turkish assets stands to cool meaningfully. All of this bodes poorly for Turkey's economy in our view, which relies on substantial inflows of foreign investment to fund a sizable current account deficit (at 4.5% of GDP last year), raising risks for lira assets, investment and growth in the country, and the already-fragile European continent. The Turkish lira dropped around 5% as word of the attempted overthrow hit markets–its steepest plunge since the global financial crisis–and has at this point recovered only around half of that decline.

U.S. Retail sales rose a strong 0.6% in June. Despite a downward trim to the previous month's tally, sales rose 8.4% annualized in the second quarter, with the core measure (ex-auto dealers, gas stations and building materials) up 7.1%. This cements strong Q2 real personal spending growth, and suggests real GDP growth more

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than doubled to around 2.6% in the quarter. The report showed wall-to-wall strength in spending, with even auto dealers inching ahead despite a reversal in new vehicle sales. Sales of building materials and furniture were very strong, reflecting the steady expansion in housing markets and, no doubt, the positive wealth effect of rising home prices. **Consumer prices rose an expected 0.2% in June**, holding the yearly pace at 1.0%. Core prices rattled off another 0.2% monthly advance, taking the yearly rate to a four-year high of 2.3% (versus 1.8% a year ago) and up a solid 2.5% annualized in the first half of the year. The usual suspects, rent (up 0.3% month/month and 3.2% year/year) and medical care (up 0.4% and 3.6%) are to blame, with some tempering influence from lower goods prices (notably clothing and new vehicles) due to the still-high dollar and global disinflation.

U.S. Industrial production jumped 0.6% in June, more than beating expectations, with small revisions to the prior two months (up and down). The monthly improvement was the 2nd largest gain since November 2014. And, even with utilities powering up 2.4%, production excluding utilities was still up a welcome 0.4%, a near one-year high. Manufacturing, which carries the biggest weight at 80.7% of Industrial Production, retraced all of the prior month's decline with a 0.4% advance although the auto sector—an important sector—was responsible for the entire gain and mining, which rose for the 2nd straight month…..even though hours worked in mining were down over 3%.

EU Finance Ministers have taken the symbolic gesture of citing Spain and Portugal for failing to take enough action to reduce 2015 budget deficits (Spain -5.1% vs. EC's -4.2% target; Portugal -4.4% vs. EC's -3% target). Spain and Portugal have 10 days to appeal the decision and European Commission (EC) has 20 days to recommend sanctions. EC must propose partial-to-total suspension of 2017 EU funding committed to both countries and could also propose a fine of up to 20bps GDP. In our view this public shaming is akin to a European bank failing prior stress tests (ie. lots of media coverage but there appears to be little appetite to impose significant penalties). The reality is a number of countries aren't even really trying anymore (including France) to meet fiscal targets, much to the chagrin of other member states.

Financial Conditions

The Bank of England surprised by keeping its benchmark rates unchanged at 0.5% for another month in a 8-1 vote last Thursday but officials said they expect to launch fresh stimulus on multiple fronts next month, as the economy stumbles under Britons' decision to exit the European Union. Overall the Bank kept its cards close to their chest and reveal little as to what measures will be used in August but most members felt looser policy was appropriate but want to take time with their decision to calibrate it carefully. Having a full new government in place this week instead of September is likely to help on this front.

The U.S. 2 year/10 year treasury spread is now .88% and the UK's 2 year/10 year treasury spread is .65% - 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 U.S. 30 year mortgage market rate has increased to 3.42% (was 3.31% end of November 2012, the lowest rate since the Federal Reserve began tracking rates in 1971). Existing U.S. 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 12.94 (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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