News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 16, 2017

Energy Sector

U.S. land rig count decreased by 6 rigs week/week to 634 rigs, which is the first weekly decline since mid-September 2016. The rig count is up on average 26% Quarter to Date quarter/quarter. Rig count declines in Vertical Oil (-8), Vertical Gas (-3), Horizontal Oil (-1), were partially offset by Horizontal Gas (+4) and Directional Oil (+2), while Directional Gas remained flat week/week. Total horizontal land rig count is down 61% since the peak in November 2014. The Permian currently makes up 54% of all oil rigs.

U.S. horizontal oil land rigs decreased by 1 rig week/week to 428, the first weekly decline in 11 weeks, as declines in the DJ-Niobrara (-2), Williston (-1), Granite Wash (-1), Mississippian (-1) were offset by gains in "Other" (+2), Permian (+1), and Eagle Ford (+1), while Woodford remained flat week/week.

U.S. Gulf of Mexico offshore rig count increased by 1 rig week/week to 24 and is down 56% since June 2014.

Canadian rig count increased by 109 rigs week/week as rigs came back online after the holiday shut down and is up 38% from the level this time last year.

International rigs averaged 929 in December, with land rigs up 5 and offshore rigs down 1 month/month, led by gains in Asia Pac (+9 land, -5 offshore), Latin America (-1 land, +4 offshore), Europe (0 land, +2 offshore), offset by declines in Middle East (-3 land, -1 offshore; 2 consecutive months of declines) and Africa (0 land, -1 offshore).

Veresen Inc. remains committed to the development of the Jordan Cove Liquefied Natural Gas (LNG) export project after the Federal Energy Regulatory Commission (FERC) decided against reopening the case for the project, saying the developer had not demonstrated there were "extraordinary circumstances" proving the need for a re-hearing. Veresen said it will review all options in light of the FERC denial, including appeal or the submission of a new application with FERC. The commission's decision was "without prejudice", meaning the company may look to re-apply with the FERC following the new presidential administration taking office. Veresen had requested a re-hearing after FERC denied its application for a permit in March on the grounds that it had not demonstrated there was a commercial need for the project without sufficient contracts. Following that denial, Veresen said it had signed with JERA Co. Inc. and ITOCHU Corporation and asked for the re-hearing for the facility and attached Pacific Connector pipeline.

Financial Sector

Bank of Nova Scotia intends to purchase for cancellation up to three million of its common shares pursuant to a private agreement between Scotiabank and an arm's-length third party seller. The purchase will form part of Scotiabank's normal course issuer bid announced on May 31, 2016, which provides authorization for the purchase of up to 12 million common shares during the 12-month period beginning on June 2, 2016, and ending on June 1, 2017. Scotiabank has filed an amendment to its notice of intention for its normal course issuer bid in connection with the proposed purchase.

Bank of America Corporation reported Q4 2016 Earnings Per Share (EPS) of $0.40, better than consensus ($0.38 per share). Lower credit costs, a lower tax rate, and core business unit revenue growth helped. Solid organic consumer banking loan (+2% quarter/quarter) and deposit growth (+2% quarter/quarter), $20 billion of net positive inflows in Global Wealth Investment Management; lower net credit losses and lower Non Performing Assets. Core Equity Tier 1 ratio at 10.8% with another 1% sequential quarter decline in Risk Weighted Assets. Return On Tangible Equity at 10% in Q4 2016. Also, the Federal Reserve approval for $1.8 billion of additional share repurchase in 1H 2017; and Global-Systemically Important Bank surcharge reduced by 50bps, further improving prospects for capital return to shareholders. A lower Global-Systemically Important Bank surcharge, more share repurchase, more Net Interest Income coupled with anticipated/hoped for operating leverage, and a lower run rate for credit costs. We believe this franchise can grow and all the more so in a rising rate environment. Better revenue growth coupled with visible operating leverage and manageable credit cost increases will be the keys to realization of franchise potential.

JPMorgan Chase & Co. reported a 24% rise in fourth-quarter profits on Friday, beating analyst expectations, as its Wall Street business benefited from a surge in trading activity following the U.S. election. JPMorgan, the largest U.S. lender, said earnings rose to $6.7 billion, or $1.71 per share, from $5.4 billion, or $1.32 per share, in the year-ago period. Excluding an atypical tax benefit (of $0.13 related to the utilization of certain deferred tax assets), the bank earned $1.58 per share, well above the average analyst estimate of $1.44 per share. Managed revenues increased 2% year/year and fell 5% sequentially to $24.3 billion (consensus: $23.9 billion). Relative to the prior year, revenues increased in Corporate & Investment Bank (+20%), Commercial Banking (+12%) and Asset Management (+1%) but declined in Credit Card Business (-2%; card down). Tangible book rose 0.4% to $51.44. Its Return On Equity was 11%, and Return On Tangible Capital was 14%. Its Basel III Core Equity Tier 1 ratio (advanced fully phased-in) was 12.2%, up 30bps. It repurchased $2.1 billion of shares in Q4 2016, in-line with Q3 2016.

Wells Fargo & Company reported Q4 EPS of $0.96, below consensus of $1.00. The miss was driven by lower fee-based income, partially offset by higher net interest income, a lower loan loss provision and lower operating expenses. Additionally, EPS included a $0.07 negative impact due to hedge ineffectiveness, which management guided towards. Fallout from unauthorized account openings continued, as December retail banking growth metrics continued to show slowing growth trends. We maintain our view that additional inquiries, fines, and lawsuits will materialize from recent events, creating uncertainty in the near term around future financial results and capital deployment plans.

Activist Influenced Companies

Pershing Square Holdings, Ltd. – Valeant Pharmaceuticals International Inc. (debt securities only are held in Portland fund) is selling its Dendreon cancer treatment business and three skincare brands for $2.12 billion as the troubled Canadian drugmaker looks to reduce more than $30 billion in debt. The company is trying to regain investor confidence after its stock plunged over the past year. French cosmetics group L'Oreal is buying CeraVe, AcneFree and Ambi from Valeant for about $1.3 billion in cash. Valeant is also selling its Dendreon unit to China's Sanpower Group Ltd. for $819.9 million. Valeant had acquired the bankrupt Dendreon in 2015 for about $300 million. "We think these two assets we sold today certainly go a long way toward helping us," Valeant Chief Executive Joseph Papa said in an interview. Valeant's gastrointestinal, dermatology and eyecare businesses are core to the company's operations, but management would listen to significant offers, Papa said. The deals could be the first of a series of divestitures for Valeant, whose growth was fueled by an acquisition spree that left it saddled with debt. L'Oreal said the three brands would stand alongside the likes of Vichy and La Roche-Posay in its Active Cosmetics division, which is among its strongest in terms of growth and resilience to slowdowns in consumer spending in the past three to four years. L'Oreal paid nearly eight times the brand's combined annual revenue of $168 million as it expands into one of the fastest-growing areas of the beauty industry. Separately, Valeant said its lotion for plaque psoriasis, IDP-118 was more effective and reduced irritation in patients in a key study.

Canadian Dividend Payers

AT&T Inc. – The CEO of Dallas-based AT&T, Randall Stephenson, met with President-elect Donald Trump, apparently about the company's pending $108.7 billion merger with Time Warner Inc. The meeting comes as AT&T seeks approval for the merger with New York-based media company Time Warner. If approved by federal regulators, AT&T would gain ownership of valuable TV networks and shows, including HBO, Warner Bros. Studios and CNN, a news network that's been repeatedly criticized by Trump. In early December, Stephenson and Time Warner CEO Jeff Bewkes made a case for the merger before a Senate subcommittee on antitrust issues.

Johnson & Johnson (J&J) plans next month to disclose average price increases of its prescription drugs, as the industry tries to calm the storm over soaring prices. The health care giant will divulge its 2016 average increases in list price and net price, or what middlemen such as insurers and distributors pay J&J after discounts and rebates. "We hope that can create a better understanding of the industry and … ultimately improve patient access to medicines," Joaquin Duato, head of J&J's prescription drug business, said in an interview. Next month J&J will issue its first annual report listing the average list and net price increases - but not the figures for individual drugs, as the discounts it gives middlemen are competitive information. Many drug companies and their industry trade groups have been trying to shift public debate away from high prices to the value medicines provide. J&J, the maker of immune disorder treatment Remicade and Xarelto for preventing heart attacks, will also disclose what it spends on patient assistance, marketing versus research and payments to physician consultants. The company hasn't taken its customary January increase yet, but Duato said prices will be increased this year.

Global Dividend Payers

Cheung Kong Property Holdings Limited (CKP) together with Cheung Kong Infrastructure Holdings Limited (CKI) and Power Assets Holdings Limited (PAH): announced that they had entered into a Consortium Formation Agreement for the acquisition of DUET Group, a utility company listed in Australia for AUD$7.3 billion (HK$41,823 million) and, subject to the obtaining of the necessary Independent Shareholders Approvals, the target Company will be 40%, 40% and 20% owned by these consortium members, respectively. For a 40% share, the maximum financial commitment of will be up to HK$17,259 million (AUD$3,012 million). If the necessary Independent Shareholders' Approvals in respect of both CKI's and PAH's participation in the joint venture transaction are not obtained, the scheme acquisition will remain unaffected and proceed with CKP acquiring 100% of the target Company with total consideration and transaction costs of HK$43,147 million (AUD$7,530 million). The total consideration payable is estimated to be HK$42,448 million (AUD$7,408 million), after adjusting for the income distribution from July 1, 2016. DUET is an owner and operator of energy utility assets in Australia, the United States, the United Kingdom and Europe. It consists of four separate legal entities involving in 1) Multinet Gas, a gas distribution business located in Victoria, Australia; 2) United Energy, an electricity distribution located in Victoria, Australia; 3) Energy Developments, an international provider of safe, clean, low greenhouse gas emissions energy and remote energy solutions; and 4) Dampier Bunbury Pipeline, Western Australia's principal gas transmission pipeline. At end of June 2016, the total net asset value of DUET was approximately AUD$3,411 million (or HK$19,545 million) and the profit after taxation for the year ended June 30, 2016 was AUD$217 million (or HK$1,243 million).

Economic Conditions

The U.K. Report on jobs, a survey of recruitment consultants, for December shows a slight weakening in the rate of growth of permanent placements while temporary billings increased at a sharp and accelerated pace that was the fastest since April. This was reflected in pay inflation, with growth in starting salaries for permanent jobs easing to a five month low but temporary rates increasing at the fastest pace since May. This is the first time since the immediate post Brexit period that pay growth has been higher for temporary than permanent placements. It's possible this provides early evidence employers will choose to manage the uncertainty of the U.K.'s withdrawal from the EU by using temporary staff where possible, rather than making permanent appointments. Overall, the report signals growth and the U.K. jobs market continues to fare better than feared immediately after the EU referendum.

Financial Conditions

U.S. retail sales grew 0.6% in December, not far from expectations while November was revised up slightly. Much of the gain stemmed from a 2.4% jump in autos (an industry which saw another year of record sales). Excluding autos, sales were up a more subdued 0.2%. The range of sectors had a mixed end to 2016. Furniture, building/garden equipment, gasoline had a strong finish, while electronics, food, general merchandisers, and dining out, took a step back. Non-store retailers (aka shopping online) increased 1.3%, the 3rd biggest move in the past eight months. Core sales (excludes autos, gas and building materials) grew a low 0.2% in December, but for Q4, that is an encouraging 3.6% annualized gain.

Italy: DBRS Ratings Limited (DBRS) on Friday downgraded the Republic of Italy's (Italy) Long-Term Foreign Currency - Issuer Rating and Long-Term Local Currency - Issuer Rating to BBB (high) with a Stable trend from A (low). At the same time, DBRS has confirmed the country's Short-Term Foreign Currency - Issuer Rating and Short-Term Local Currency - Issuer Rating at R-1 (low) with a Stable Trend. This concludes the Under Review with Negative Implications for all ratings. The rating action reflects a combination of factors including uncertainty over the political ability to sustain the structural reform effort and the continuing weakness in the banking system, amid a period of fragile growth. DBRS considers that, following the referendum rejecting constitutional changes that could have provided more government stability and the subsequent resignation of Prime Minister Renzi, the new interim government may have less room to pass additional measures, limiting the upside for economic prospects. Moreover, despite recent plans for banking support, the level of non-performing loans (NPLs) remains very high, affecting the banking sector's ability to act as a financial intermediary to support the economy. In this context, low growth has resulted in lingering delays in the reduction of the very high public debt ratio, leaving the country more exposed to adverse shocks. With all 4 rating agencies used by the European Central Bank (ECB) now rating Italy in the "BBB" range, this will trigger additional collateral requirements for Italian banks seeking ECB funding although for the moment Italian banks generally still have adequate funding so the higher funding costs are manageable in our view.

The U.S. 2 year/10 year treasury spread is now 1.20% and the U.K.'s 2 year/10 year treasury spread is 1.17% - 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 4.12% (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 4.0 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 still supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now at the low end of a more normal range of 4-7 months.

The VIX (volatility index) is 11.23 (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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