News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. April 24, 2017

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Energy Sector

U.S. land rig count increased by 11 rigs to 834 rigs (6th consecutive double digit gain). The rig count was driven by gains in Horizontal Oil (+9), Horizontal Gas (+3), Vertical Oil (+2), Directional Gas (+2), partially offset by Directional Oil (-5) while Vertical Gas remained flat. Total horizontal land rig count is down 48% since the peak in November 2014. The Permian currently makes up 51% of all oil rigs.

U.S. horizontal oil land rigs increased by 9 rigs to 581 as gains in Eagle Ford (+3), Williston (+2), "Other" (+2), Permian (+1), DJ-Niobrara (+1), and Granite Wash (+1), were slightly offset by declines in Woodford (-1), while Mississippian remained flat.

Canadian rig count decreased by 19 rigs, but is up 148% from the level this time last year.

U.S. Gulf of Mexico offshore rig count decreased by 1 rig to 20 and is down 63% since June 2014.

Financial Sector

Bank of America Corporation exceeded expectations and reported Q1 2017 earnings per share (EPS) of $0.41, whereas consensus was $0.35. A lower than expected tax rate and loan loss provision, as well as higher fee income (trading & Investment Bank fees) more than offset increased expenses. Net interest income rose 7%, reflecting the benefits from higher interest rates. Its net interest margin expanded 16 basis points to 2.39%. Looking out, it expects net interest income to increase in Q2 2017 assuming rates remain at current levels and modest growth in loans and deposits. A +1% parallel shift in the interest rate yield curve is estimated to benefit Net interest income by $3.3 billion over the next 12 months, with nearly 75% of the benefit driven by short-end rates (was $3.4 billion at Q4 2016). Of note, it posted solid operating leverage across its main business unit with relatively strong loan growth. Core EPS also looks to be around $0.40. Results included a $222 million tax benefit related to new accounting guidance that went into effect in 2017 for the tax impact associated with stock-based compensation, a $99 million loan loss reserve release, and $52 million in securities gains. Still, these were mostly offset by $274 million in litigation expense and a $130 million net Debt Value Adjusted mark. Results included $1.4 billion in annual retirement-eligible incentive costs and seasonally elevated payroll tax, compared to $1.2 billion in Q1 2016. Revenues increased 7% year/year and 11% linked quarter to $22.2 billion (consensus: $21.7 billion). Tangible book increased 1.7% to $17.23 (1.3x). It posted a Return On Equity (ROE) of 7.3%, and Return On Tangible Common Equity (ROTE) of 10.3%. Still, if one assumes annual retirement-eligible incentives and seasonally elevated payroll tax costs were allocated evenly throughout the year, it ROTE was 11.8%. Its Core Equity Tier 1 ratio (fully phased-in) was 11.0%, up 20bps. It repurchased a net $2.3 billion in common stock. Recall, last quarter it increased its planned repurchases for 1st Half 2017 from $2.5 billion to $4.3 billion. Its Non-Performing Asset ratio declined 5 basis points to 0.84%. Its loan loss provision increased $61 million to $835 million, driven by consumer. Its provision was $99 million less than net charge-offs, compared to a $106 million release in the prior quarter, reflecting continued improvements in consumer real estate and energy. Its reserve/loan ratio declined 1 basis point to 1.25%.

Citizens Financial Group Inc. reported Q1 2017 EPS of $0.61. Excluding a $23 million ($0.04) benefit related to the settlement of certain state tax matters, EPS was $0.57. Consensus was $0.51. Higher than expected net interest margin and fee income (capital markets and card on revised contract terms) coupled controlled costs and a lower than anticipated loan loss provision drove the upside. Its average loan growth was the strongest to date. It added $9 million to its loan loss reserve, while securities gains were $4 million. Operating revenues rose 13% year/year and increased 1% from the prior quarter. Net interest income increased 1.9%. Average earning assets rose 1.2%. Average loans increased 1.4%, while average securities/interest-bearing deposits grew 0.3%. Its net interest margin increased 6bps to 2.96% reflecting the benefit of higher commercial and consumer loan yields given higher interest rates and continued portfolio mix shift towards higher-return assets, as well as improved investment yields, partially offset by higher funding costs. Tangible book increased 1.3% to $26.02 (1.3x). Its Core Equity Tier 1 ratio (transitional) was 11.2%, consistent with Q1 2016. Adjusted for the tax benefit it posted a ROTE of 8.98% (10%-plus medium-term target) while its efficiency ratio was 62% (~60% target). During the quarter, Citizens repurchased 3.4 million shares. Fully diluted average common shares outstanding declined by 2.5 million or 0.5%. Its Non-Performing Asset ratio declined 1bp to 1.01% and its reserve/loan ratio declined 2 basis points to 1.13%.

The Goldman Sachs Group Inc. reported Q1 2017 EPS of $5.15 which fell short of expectations as management admitted they could have navigated markets better. Results included a $475 million ($1.13) tax benefit and $139 million ($0.22) in litigation expense. Net, EPS was $4.23. Consensus was $5.31. Goldman said the operating environment was mixed, with client activity challenged in certain market-making businesses and a more attractive backdrop for underwriting. Investment banking fees increased 16% year-on-year and rose 15% from Q4 2016 to $1.70 billion. Relative to the prior quarter, both equity (+47%; increase in industry-wide activity) and debt (+13%; increase in industry-wide leveraged finance activity) underwriting increased, as did advisory (+7%). Its investment banking transaction backlog decreased compared with both Q4 2016 and Q1 2016. Institutional Client Services (trading) declined 2% year-on-year and fell 7% sequentially to $3.36 billion. Fixed Income, Currency and Commodities (FICC) increased 1% year/year to $1.7 billion (-16% from Q4 2016) reflecting significantly higher revenues in mortgages and higher revenues in interest rate products, offset by significantly lower revenues in commodities and currencies and lower revenues in credit products. Goldman's compensation ratio was lower than expected (41% vs. 42% in Q1 2015 & Q1 2016). It also announced it increased its quarterly dividend by $0.10, or 15%, to $0.75. Revenues increased 27% year/year but slipped 2% sequentially to $8.03 billion (consensus: $8.45 billion). Expenses increased 15% on both year/year and linked quarter basis. Tangible book rose 1.4% to $175.05. Its reported ROE was 11.4%. Still, excluding the $475 million tax benefit, its ROE was closer to 8.9%. Its Core Equity Tier 1 ratios (transitional) were 14.2% (standardized, -30bps) and 12.9% (advanced, -20bps). During the quarter, it repurchased 6.2 million shares for $1.5 billion. It also repurchased $1.5 billion in Q4 2016. Average diluted shares declined by 0.8%.

Morgan Stanley reported Q1 2017 EPS of $1.00 and so comfortably ahead of consensus of $0.89. Relative to expectations Fixed Income Currency and Commodities (FICC) and Investment Banking fees drove the upside, while its compensation ratio declined year/year. FICC rose 96% year/year to $1.7 billion (+17% from Q4 2016) reflecting strong performance across all products and regions on improved market conditions. The effective tax rate for the current quarter was 29.0%, which reflected a "recurring-type of discrete tax benefit" of $112 million ($0.06) associated with new accounting guidance related to employee share-based payments. Its tax rate was 25.2% in the prior quarter and 33.3% a year ago. It also recorded a $22 million loss in discontinued operations, which we believe is tied to legacy litigation matters. Revenues increased 25% year/year and rose 8% from Q4 2016 to $9.75 billion (consensus $9.27 billion). Expenses increased 15% year/year and gained 2% from Q4 2016. Compensation rose 21% year/year and 9% sequentially, while non-compensation expenses increased 4% year/year and declined 8% from Q4 2016. Its compensation ratio was 46%, compared to 45% in the prior quarter and 47% a year ago. Headcount increased 2% year/year. Its efficiency ratio was 71%, improved from 74% last quarter. Its ROE was 10.7% (10.1% ex. tax benefit). Tangible book increased 1.6% to $32.49 (1.3x). Its Core Equity Tier 1 ratios (fully phased-in) were 16.7% (standardized, unchanged) and 16.6% (advanced, +70bps. Its average diluted share count declined by 0.6%.

Activist Influenced Companies

Brookfield Business Partners LP – Loblaw Company Limited said it would sell its gas station business to asset manager Brookfield Business Partners LP for about $540 million. Brookfield said it intends to rebrand the gas stations, through an agreement with Imperial Oil Ltd,. to Exxon Mobil Corp's Mobil fuel brand. The sale includes Loblaw's 213 retail gas stations and convenience stores adjacent to the gas stations across Canada. This deal will mark the introduction of the Mobil fuel brand in Canada, the companies said in a joint statement. Chevron Corp also sold its Canadian gasoline stations and refinery in British Columbia to Parkland Fuel Corp, a marketer of petroleum products, for $1.46 billion.

Pershing Square Holdings, Ltd. announced a share buyback program and change in central securities depositary. Pershing will increase the ownership limit to 4.99% from current limit of 4.75%. Cash for the buyback program will come from general corporate funds on hand. The buyback program, which will commence shortly, targets up to 5% of Pershing's outstanding public shares. It is also expected that there will be change in Pershing's primary central securities depositary, from Nederlands Centraal Instituut Voor Giraal Effectenverkeer BV to Euroclear U.K. & Ireland Ltd.

Restaurant Brands International Inc.'s Tim Hortons is providing its solution to a world of long-winded, overwhelming coffee orders -- its new, perfectly uncomplicated latte. Tim Hortons guests need only say latte to receive the new made-to-order specialty beverage that is one size, one price and the perfect balance of just two simple ingredients -- freshly ground premium 100%-Arabica espresso beans and freshly steamed Canadian milk. Tim Hortons and its restaurant owners have equipped over 3,500 restaurants across Canada with new, innovative espresso machines, so guests from coast to coast can experience the same perfectly uncomplicated latte, wherever they are. To celebrate the launch, Tim Hortons opened an unbranded, minimalist cafe in Toronto called perfectly uncomplicated lattes with only one item on the menu -- a latte. Today, it was unveiled that this new Queen West coffee shop was in fact Tim Hortons all along.

Canadian Dividend Payers

Veresen Inc. – Gary Cohn, chief economic advisor to U.S. President Donald Trump and director of the National Economic Council, said the government would seek to permit a liquefied natural gas (LNG) export facility in the Northwest. "Just think of the transport time from the Northwest to Japan," Cohn said, according to a statement by FBR & Co., an investment bank. Cohn said the White House supported the country becoming the world's biggest LNG exporter. The U.S. is expected to become the third biggest LNG exporter behind Australia and Qatar in 2018. Cohn made his comments on Thursday at an Institute of International Finance event in Washington, D.C. The White House later said Cohn was referring to Veresen's Jordan Cove project in Oregon, according to local media reports. The Federal Energy Regulatory Commission (FERC) denied the project in 2016.

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Global Dividend Payers

ABB Ltd. delivered clean earnings before interest tax and amortization (EBITA) 1.5% ahead of consensus on sales 1.2% ahead with a 12.1% margin (flat year on year but against Q1 2016 that contained a $50 million positive one off). Orders came in 2% below. The below the line one-off adjustments are limited to the Cables transaction and as expected about $100 millions of other items, making this a clean quarter in our view, which we see as a positive after several adjustments in Q4 2016 that received investor criticism. Although orders declined 3% year/year in Q1, we find the 2% growth in base orders encouraging, especially given the tougher comparisons in Grids from China. Management outlook message remains unchanged (mixed macro, geopolitical uncertainties, 2017 transitional year) but we note a clear improvement in confidence over 1) Short cycle demand improving, as evidence in Robotics and Motion base orders growth and as management decided not to adjust capacity in the division and to 'ride out' the backlog impact in Q1 with confidence on revenues pick-up coming through in later quarters and 2) Process industries demand stabilising with Industrial Automation base orders flat or up for two quarters (although we note that the lower backlog is likely to continue impacting revenue growth through 2017).

Bunzl PLC trading in the first quarter was in line with expectations from the time of the annual results at the end of February. The group's revenue grew 18% year/year in Q1, made up of 14% foreign exchange, organic growth of 2%, acquisition contribution of 3% and a 1% drag from fewer working days. Organic growth has picked up from 1.5% in Q4 to 2%, as the previously disclosed grocery contract win in the U.S. has begun to contribute. We expect organic growth to improve further in the coming quarters as the U.S. grocery contract continues to ramp up, the contract win with Compass in the U.K. begins and price increases in the U.K. have a positive impact. No further acquisitions were announced last week but it has been a very active start to the year; £260 million of committed spend. That is already above the £184 million in 2016 and the pipeline is said to remain promising.

GEA Group AG pre-released its Q1 headline figures (full results are due May 9th). The order intake/ revenue /adjusted earnings before interest, tax, depreciation and amortization (EBITDA) came in at €1,135 million /€1,000 million /€95 million, respectively. That compares to estimates of €1,151 million /€963 million /€88 million, so we believe a comfortably in-line quarter. The company says that good growth in base orders offset a lower level of large orders. That's in-line with our forecast given the strong intake of large orders (order size of >€15 million) in Q1 2016 (€136 million). The overall order intake of €1,135 million is -1% year/year and some -4% on an organic basis. The company has made no change to its full year 2017 guidance of "moderate growth" in sales and operating EBITDA of €620-670 million. However, the company does note that "the macroeconomic uncertainty is likely to intensify over the course of the year making it even more difficult to forecast from current perspective…it will depend in particular on the development of the second quarter in which area of our guided target range we will come out by the end of the year''. In our view such caution is to be expected following management's earlier need to issue a profit warning last quarter – and so the credibility of their guidance needs to be rebuilt to support rather than hinder this strong business / franchise.

Johnson & Johnson – Cost controls and lower taxes helped the healthcare conglomerate beat Wall Street profit forecasts for its first quarter of 2017 results. Overall sales of $17.77 billion in the quarter fell short of analysts' average estimate of $18.04 billion, according to Thomson Reuters I/B/E/S. The company, which is on track to close its $30 billion acquisition of Actelion in the current quarter, issued a new full-year forecast to include Europe's largest biotech. With Actelion, J&J expects 2017 sales of $75.4 billion to $76.1 billion and adjusted earnings of $7.00 to $7.15 per share. It forecast Actelion will contribute 35-40 cents to EPS in 2018.

Nestlé SA - A relatively uneventful start to the year for Nestlé with first quarter's like-for-like sales growth at +2.3% coming 30 basis points ahead of consensus expectations. Probing the shape of the delivery, the main surprise relative to our expectations was the weakness in Zone Americas (+0.4% Like For Like sales growth) which was offset by acceleration in Zone Asia/Africa (+4.5% Like For Like sales growth). In explaining these developments, Nestlé commented on soft consumer demand in North America, a difficult Brazil (both of these comments were echoed by Unilever) and deceleration in Mexico. In contrast, Zone Asia/Africa was driven by a robust performance in South East Asia, India and sub-Saharan Africa (China declined due to the timing of the New Year).

Roche Holding AG - Tecentriq was approved as the first immuno-oncology drug for 1L treatment of patients with mUBC who are not eligible for cisplatin chemotherapy. In May 2016, Tecentriq was already granted accelerated approved in the 2L mUBC setting. Roche was first to be granted approval in the 2L mUBC setting and now also wins in the respective 1L setting. Bristol's Opdivo was granted 2L approval in February 2017 and we await approval for Merck's Keytruda in the 1L and 2L settings on June 14, 2017. Roche still awaits European approval to be granted.

Economic Conditions

Canada – Inflation in Canada pulled back surprisingly in the month of March, to 1.6%, relative to expectations for a 1.8% reading and February's 2.0% rate. While a temporary pullback in gasoline prices contributed to the decline, the core inflation reading, which excludes more volatile price series, such as food and energy, was also lower in the month, at 1.7% from February's 2.0%, providing scope for Bank of Canada's continued accommodative policy.

France - In a race that was too close to call up to the last minute, Macron, a pro-EU ex-banker and former economy minister who founded his own party only a year ago, won 23.75% of the votes against 21.53% for Le Pen, final voting figures from the Interior Ministry showed. The race was very tight between 4 front-runners. A Harris survey taken on Sunday saw Macron winning the runoff by 64% to 36%. An Ipsos/Sopra Steria poll gave a similar result.

U.S. Manufacturing Production - A significant 3.0% drop in auto production held manufacturing activity back in March. Manufacturing production, which makes up 75% of total industrial production, unexpectedly fell 0.4% in March. Excluding motor vehicles & parts, production jumped 0.8%, the most in three years. Indeed, if the auto manufacturers make good on their promise to bring production back to America, and if auto sales pick up again, then this decline should be temporary in our view.

U.S. housing starts took a much bigger-than-expected spill in March, down 6.8% to 1.215 million units annualized (consensus was ~2%), the lowest since November. Revisions saw starts, on net, lower over the past two months. For the most recent move, there was no discrimination as singles dropped 6.2% (biggest decline since last March) while construction of multi-family units took a 7.9% dive. On a regional basis, the weakness was everywhere except in the Northeast, which is interesting given that the Nor'easter hit at the beginning of March. There is some good news though. Building permits rebounded 3.6% to 1.26 million units annualized, not quite enough to offset the prior month's 6% loss but it is above the level of starts. This suggests that there is some upside risk to April as builders need permission (or a permit) before they can break ground. And, sizeable declines in starts are normally followed by a rebound.

U.K. - Theresa May dramatically seized the initiative on Brexit last Tuesday by calling a snap general election on June 8, as she sought a direct mandate for her plan to deliver a smooth British exit from the EU. The pound rose on expectations that Mrs May would win a much increased Commons majority, allowing her to sideline implacable Eurosceptics in her Conservative party and ensure a phased Brexit concluding with a UK-EU free-trade deal. Polls predict a heavy defeat for the opposition Labour party, which has been in disarray under the leadership of leftwinger Jeremy Corbyn.

Financial Conditions

Italy - Ratings agency Fitch downgraded Italy's sovereign debt on Friday, citing the country's sluggish economic growth, fiscal slippage, weak government, banking problems and political risk ahead of elections due in 2018. Fitch cut Italy's sovereign credit rating to 'BBB' from 'BBB+', with a stable outlook.

U.K. - Bank of England policymaker Michael Saunders on Friday opened the possibility that he will soon join a minority calling for higher interest rates, predicting that both growth and inflation could well exceed the Bank of England's earlier forecasts.

The U.S. 2 year/10 year treasury spread is now 1.06% and the U.K.'s 2 year/10 year treasury spread is .98% - 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 3.97% (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 3.6 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 11.90 (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 manages the following 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

Individual Discretionary Managed Account Models - SMA

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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