News Highlights

Owners. Operators. And Insightful Investors.

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Established in 2007

PORTLAND INVESTMENT COUNSEL®

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

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Owner Operated Companies

BlackRock Inc. is reporting closing in on an industry-record $6 trillion in assets under management. The world's biggest asset manager reported an 8.2% rise in quarterly profit, ahead of the expectations. During the quarter, the firm attracted $96 billion, with about half of that moving into relatively low-cost exchange-traded funds. None of BlackRock's publicly traded peers are expected to have gathered even 10% of that amount in the same quarter and four in 10 will report outflows. BlackRock's third-quarter profit jumped to $947 million from $875 million a year earlier. Excluding items, the company earned $5.92 per share, topping analyst expectations of $5.56, according to Institutional Brokers' Estimate System. Active funds overall took in $5.8 billion for BlackRock during the quarter, and helped the company book more fees for beating performance targets. Such fees rose by $133 million to $191 million from a year ago.

Energy Sector

U.S. land rig count decreased by 6 rigs to 907 rigs week/week. This is the 7th time in the last 10 weeks the rig count has declined and is now 21 units off of the July peak. The rig count was driven by declines in Horizontal Oil (-3), Vertical Oil (-3), and Horizontal Gas (-3), partially offset by gains in Directional Oil (+2), Vertical Gas (+1), and Directional Gas (+1). Total horizontal land rig count is down 43% since the peak in November 2014. The Permian currently makes up 53% of all oil rigs.

U.S. horizontal oil land rigs decreased by 3 rigs week/week to 638, as declines in Eagle Ford (-4), DJ-Niobrara (-2), Granite Wash (-1) and "Other" (-1) were partially offset by gains in Permian (+4) and Williston (+1) with Mississippian and Woodford remaining flat week/week.

Canadian rig count increased by 3 rigs week/week, and is up 29% from the level this time last year.

U.S. Gulf of Mexico offshore rig count decreased by 2 rigs to 22 rigs week/week and is down 63% since June 2014.

Financial Sector

Bank of America Corporation reported Q3 2017 EPS of $0.48. Consensus was $0.45. Results included a $125 million of securities gains, up from $101 million in the prior quarter. Its tax rate was 29%, compared to expectations of 30%. And, it had a $66 million net loan loss reserve release (though added $200 million to card), compared to an $182 million release in the prior quarter. On the other hand, mortgage banking income was negatively impacted by less favorable valuations on Mortgage Servicing Rights, net of related hedges, as well as a $0.1 billion increase in rep & warranties provision. It also had negative net Debt Value Add of $21 million. It is estimated these impacts probably come close to neutralizing each other out. Revenues increased 1% year/year, but declined 4% sequentially, to $21.8 billion (consensus: $22.0 billion). Tangible book fell 3.1% to $17.23 (1.5x) due to an increase in common shares outstanding associated with the conversion of preferred shares held by Berkshire Hathaway Inc. into common stock. Its ROE was 8.1%. Its CET 1 ratio increased 40bps to 11.9%. It repurchased nearly $3 billion in common stock or a little less than 25% of its regulated 2017 allowance. Average diluted shares declined by 0.9%. Its preferred dividend was $465 million, up from $361 million last quarter. Net interest income increased 1.6%, reflecting the benefits from higher short-end interest rates, loan growth and one additional interest accrual day. Its net interest margin increased 2bps to 2.36%. Fee income fell 5% (-6% year/year), with almost every major category lower. Expenses declined 3% year/year, reflecting reduced operating costs, lower litigation expense and a reduction from the sale of the non-U.S. consumer credit card business. Its efficiency ratio was 59.5%, matching last quarter. Its Non-Performing Assets ratio declined 3bps to 0.78%. It added $200 million to its credit card reserve increasing its reserve/loan ratio 15bps to 3.52%. Its consolidated reserve/loan ratio dropped 4bps to 1.16%.

Citigroup Inc. - EPS was $1.42, results included a $580 million ($0.13) gain on the sale of a fixed income analytics business (Yield Book). EPS was $1.29 excluding this gain. Consensus was $1.32, though unclear how the gain was treated. Core EPS grew 4% year/year, driven by a 7% reduction in average diluted shares. Tangible book increased 1.8% to $68.55 (1.1x). It posted a Return on Equity of 7.3% or 9.9% ex. Deferred Tax Allowances. Its CET 1 ratio was 13.0% down 10bps from the prior quarter. Period-end assets rose 1%. It repurchased 81 million shares for roughly $5.5 billion. Average diluted shares declined 2.0%. Revenues increased 2% on both a year/year and linked quarter basis to $18.2 billion. Global Consumer Banking revenues (GCB) rose 3% year/year and gained 5% sequentially to $8.4 billion, while Institutional Clients Group (ICG) revenues rose 9% year/year and approximated the prior quarter at $9.2 billion. Corporate/other was a $509 million addition down from $1.1 billion in Q3 2016 and $653 million last quarter. Revenues increased 8% year/year in LatAm and grew 6% each in North America (NA), Europe, Middle East and Africa (EMEA) and Asia. Fixed Income, Currency and Commodities (FICC) fell 16% year/year (-11% linked quarter) to $2.9 billion, given low volatility in the current quarter and the comparison to higher Brexit-related activity a year ago, as well as lower activity in spread products. Within FICC, rates & currencies declined 9% year/year, while spread products/ other dropped 32%. Equities rose 16% year/year (was +10% quarter/quarter) to $0.8 billion, reflecting client-led growth across cash equities, derivatives and prime finance. Investment banking fees fell 17% linked quarter to $1.2 billion with advisory (-25%), debt underwriting (-20%) and equity underwriting (-2%) all lower. Net interest income increased 2%. Reported expenses declined 2% year/year and decreased 3% from Q3 2017 to $10.1 billion. Its effective tax rate was 31.1% compared to 31.6% last quarter. Citi added $194 million ($0.05) to its loan loss reserve, compared to a $16 million release last quarter. NA GCB had a $460 million reserve build, which was comprised of a modest reserve release in commercial banking and a $500 million build for credit card. The build in cards was driven by forward Non-Conforming Loan expectations in both its retail services and branded card portfolio, as well as volume growth and portfolio seasoning and a reserve build for the estimated impact of the hurricanes.

JPMorgan Chase & Co. reported Q3 2017 EPS of $1.76 - above the consensus $1.65. Earnings upside was revenue-driven with better operating leverage evident and credit costs lower than forecast. The 13.4% ROTE ought to again exceed the peer group average. The group showed 7% core loan growth, 9% deposit growth in the Commercial Bank, and the benefit of the card revenue margin firming, to 10.95% (expected to normalize to 11.25% in 1st Half 18); operating efficiency was better than forecast—scale economies are becoming increasingly evident; credit costs were below forecast inclusive of additions to consumer-related loan loss reserves with 12.5% CET 1 ratio (well above the 11% minimum). JPMorgan remains well positioned in our view to drive growth, markets and macro willing. JPMorgan is most representative of the value inherent in the universal banking model in our view. Look to JPMorgan for best-in-class execution - sustainable organic revenue growth and market share gains (leveraging the benefits of its complete, scaled and well-integrated product set), a willingness to drive down unit operating costs (capacity for investment to drive incremental growth; a virtuous circle) and an ability to optimize capital; this should sustain better-than-average earnings growth and returns on equity. The upside catalyst is fundamental outperformance – above average EPS growth and ROE, much like what's been observed in year to date results.

Wells Fargo & Company reported Q3 2017 EPS of $0.84. Excluding the impact of a discrete litigation accrual of for previously disclosed mortgage-related regulatory investigations ($1.0 billion or $0.20/ share), EPS was $1.04. Consensus was $1.03. An increased use of gains was used to help compensate for sluggish loan growth and a lower than expected net interest margin. Excluding Q3 2017's litigation charge, it's estimated the bank's YTD efficiency ratio at 61.6%, marking its 60-61% 2017 target appear challenging in our view. Revenues declined 3% year/year and slipped 1% sequentially to $21.9 billion. Tangible book increased 1.3% to $31.03 (1.7x). Its CET 1 ratio (fully phased-in) was 11.8%, up 20bps due to lower Risk Weighted Assets. Net interest income was little changed as the impacts of lower securities yields driven by accelerated prepayments and lower average loans were offset by the impact of one additional day and a modest benefit from all other growth and repricing. Its net interest margin declined 3bps to 2.87%. Fee income declined 1%. Core expenses were little changed year/year and declined 1% sequentially. Its Non-Performing Asset ratio declined 5bps to 0.98%. Its reserve/loan ratio was stable at 1.27%.

Activist Influenced Companies

Nothing new to report.

Dividend Payers

AT&T Inc. said its third-quarter results took a hit from a string of hurricanes that tore into parts of the U.S. and earthquakes in Mexico. The No. 2 U.S. wireless carrier said third-quarter consolidated revenue was hurt by about $90 million and pre-tax earnings by about $210 million, or 2 cents per share. AT&T also said it lost about 90,000 U.S. video subscribers in the quarter due to intense competition in traditional pay TV markets as well as the impact of the recent hurricanes. However, the company reiterated its full-year forecast of mid-single digit growth in adjusted earnings and capital expenditures in the $22 billion range.

Fortis Inc. announced its five-year capital investment plan of approximately $14.5 billion for the period 2018 through 2022, up $1.5 billion from the prior year's plan. The Corporation's Board of Directors also announced a 6.25% increase in the fourth quarter 2017 common share dividend. Fortis President and CEO Barry Perry said "The Corporation is focused on sustainable investment in its utilities. Our high-quality and diverse portfolio of utility businesses are driving low-risk, visible growth." The company's capital investment plan is comprised mostly of a diversified mix of highly executable, low-risk projects and is fully funded through debt raised at the utilities, cash from operations and common equity from the Fortis' dividend reinvestment plan. As a result, consolidated rate base is projected to increase from over $25 billion in 2017 to approximately $32 billion in 2022. Today's utility environment is characterized by a demand for cleaner energy, the need for a more resilient grid and increased use of technology. The five-year capital investment plan is driven by projects that improve the transmission grid, address natural gas system capacity and gas line network integrity, replace aging wooden poles, increase cyber protection and allow the grid to deliver cleaner energy.

GEA Group AG – U.S. activist shareholder Elliott Advisors has built a 3% stake in GEA (3% threshold crossed on October 5th). This follows the 3% stake by Groupe Bruxelles Lambert SA (GBL) (European active investor) announced on August 3rd. The announcement from

Elliott comes after four quarters of disappointments. The addition of Elliott on the shareholder register is likely to add further pressure on management and the Elliott announcement – just as GBL's on August 3rd – is likely to catalyze further reversal of the stock's underperformance since Oct. 2016.

Economic Conditions

U.S. retail sales for the month of September were up 1.6%, a notch below the expected 1.7% reading. The core retail sales, which exclude sales of vehicles and parts, were actually a lot stronger than expected, up 1.0% compared to 0.3%. Much of the volume growth during the month, in particular as it relates to autos, gasoline and building materials, was on account of the hurricane activity during the month.

U.S. inflation, as measured by the changes in the consumer price index (CPI), picked up somewhat at the headline level, reaching 2.2% in September relative to August's 1.9%, though one tenth lower than the expectations. The core CPI, which excludes changes in prices of food and energy, was, at 1.7% year on year rate of change, in line with the previous month and also one tenth short of the consensus.

Canada's home prices slipped 0.8% in September from their peak in August, according to new data from the Teranet-National Bank House Price Index. The retreat marks the first notable monthly decline in the national index since January of 2016 and the largest in seven years. A 2.7% drop in heavyweight Toronto pulled the national index into negative territory. Four of the 11 cities that make up the composite index also experienced month-over-month declines. In September, the composite index gained 11.4% from the same month last year to stand at 220.33. The national index, which looks at pricing trends based on a large sample of the sales of properties registered at land title offices, has dipped for two months in a row after a lengthy run-up. The average sale price for various housing types in the national survey was $617,839 for the 11 markets last month. (Source: The Globe & Mail)

Catalonia has until Thursday to decide on declaring independence. Catalan President Puigdemont sent an ambiguous four-page letter calling for dialogue but that was dismissed by Madrid. Prime Minister Mariano Rajoy had originally set a Monday deadline to confirm if Catalonia had declared independence or not but a three-day grace period has been allowed. On Friday, the government will invoke Article 155 and use the constitutional tool that allows the government to suspend Catalonia's autonomy.

Sebastian Kurz, leader of Austria's conservative People's Party, is set to be the world's youngest national leader at age 31 (since William Pitt – UK's PM aged 24). The People's Party is set to win more than 31% and seek an alliance with the ant-immigration Freedom Party in order to form a government. Kurz gained popularity by pledging to shut down migrant routes to Europe, cap benefit payments to refugees and bar immigrants from receiving benefits until they have lived in Austria for five years. This will put Austria at odds with Chancellor Merkel and her German government and drive another wedge into European unity.

Financial Conditions

Comments on the weekend from the Group of Thirty's Annual International Banking Seminar in Washington seems to be weighing on the currency markets this morning. Fed's Chairmam Janet Yellen stayed relatively optimistic saying that low inflation has been the "biggest surprise in the US economy" but expects higher wages and inflation on the horizon. Bank Of Canada Governor Poloz says there is "comfort" that the global economy continues to improve and that Canada has led the Group of Seven in growth but that not all Canadian citizens have benefitted equally. Poloz warned that the Canada' economic growth will slow in the second half of the year and that the central bank was in "intense data-dependent mode".

The U.S. 2 year/10 year treasury spread is now .78% and the U.K.'s 2 year/10 year treasury spread is .89% - 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 costs of capital.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.91 (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 4.2 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 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 9.87 (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 8 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
- Portland 15 of 15 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

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

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Glossary of Terms: 'boe' barrel of oil equivalent, a measurement of a unit of energy, 'boed' refers to barrel of oil equivalent per day, 'CET' core equity tier, 'EBITDA' earnings before interest, taxes, depreciation and amortization, 'EPS' earnings per share, 'FCF' free cash flow, 'ROE' return on equity, 'ROTE' return on common equity.

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