News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. October 15, 2019

Owner Operated Companies

Alphabet Inc.'s Google unveiled new Pixel smartphones with higher quality cameras, a radar sensor and faster virtual assistant. Google also announced its first moderately priced laptop, first wireless earbuds and upgrades to its well-reviewed Wifi router and burger-sized smart speaker. The fourth-generation Pixel starts at $799 for a 5.7-inch display and $899 for a 6.3-inch display, and for the first time all four major U.S. wireless carriers are selling the product.

Linamar Corporation estimated a profit impact of up to $1 million per day due to a fall in orders from its customer General Motors Co. GM workers have been on a two-week long strike, forcing the number one U.S. automaker to halt production at its pickup and transmission plant in Mexico and crippling its operations across North America. Linamar said the strike was hurting the automotive market and forecast a decline in the global light vehicle production. The company, which also supplies equipment to agriculture and construction sectors, said the prolonged U.S.-China trade war coupled with stagnant commodity prices could hurt its sales as farmers delay investment decisions.

Energy Sector

Nothing significant to report.

Financial Sector

Barclays PLC has muscled into the price war in the gold investment market with the launch of the world's first zero-fee precious metals exchange traded products. The aggressive move by Barclays will push competitors, including BlackRock Inc. and State Street Corp., to respond with fee cuts at a time when demand for gold from investors is nearing an all-time high.

Brookfield Property Partners L.P. (BPY) : national law-firm Cravath, Swaine and Moore LLP agreed to take 481,000 square feet (sf) (floors 25-37) at BPY's 58-story building located at 2 Manhattan West in New York for occupancy in 2024, re-locating from 825 Eighth Avenue (Worldwide Plaza; Eighth Ave. and 50th St.) where it has been for around 30 years. The terms include a lease duration of 20 years, with initial contractual rent bumps bringing gross rent/sf into triple-digit territory. The lease is around 25% of 2 Manhattan West, a 56%-owned with about 2 million square feet for development that BPY started "on spec" this year, and one BPY hopes will be over 50% leased by Q4 2020, ahead of planned 2023 stabilization. It's estimated the deal increases the pre-let portion of BPY total office development pipeline by around 500bp to around 59%. This development helps BPY's prospective net asset value per unit (NAVPU) growth. During its recent Investor Day, BPY noted around $2 billion of expected unrealized gains on completion of 1 Manhattan West and 100 Bishopsgate (slated for Q4 2019), or around $1.4 billion at BPY share ($1.48/share), It's estimated the Cravath lease alone could add around $0.20/share. BPY trades at about a 30% discount to estimated NAVPU (compared to a 20% historical average.).

Citigroup Inc. reported Q3 2019 earnings per share (EPS) of $2.07. Results included a net benefit of $0.10 related to discrete tax items. Excluding this impact, EPS was $1.97. Consensus was $1.95. Relative to consensus, fee income was better than expected, while net interest income/margin (trading-driven) was lower than anticipated. Expenses and loan loss provision approximated expectations. Excluding a $250 million gain in Q2 2018, revenues increased 2% year/year to $18.6 billion. Revenues slipped 1% from Q2 2019. Tangible book increased 2.1% to $69.03 (1.0x). It posted a 10.4% ROE and 12.2% ROTCE. The company stated it achieved a year to-date ROTCE of 12%, in-line with its full year target. Its CET1 ratio was 11.6% (-30bps as net income was offset by share repurchases and dividends, along with an increase in Risk Weighted Assets). It repurchased 76 million shares. Average diluted shares dropped by 3.1%. Its preferred dividend declined from $296 million to $254 million. Net interest income declined 3%. Average earning assets rose 1% with increases in trading assets (+2%), securities (+1%) and loans (+1%). Period-end loans increased 2% year/year. Period-end deposits increased 9% year/year. Its net interest margin declined 11bps to 2.56%. Its yield on average earning assets dropped 19bps to 4.21% (loans -12bps, securities -18bps), while it's cost of interest bearing liabilities decreased 10bps to 2.04% (deposits -3bps). Its Non-Performing Assets ratio rose 1bp to 0.55%.

The Goldman Sachs Group, Inc. reported Q3 2019 EPS at $4.79 – on target with consensus of $4.81. Book value: $218.82; Return on Equity 9.0%; Return on Tangible Equity 9.5%.

JPMorgan Chase & Co. reported Q3 2019 EPS of $2.68, higher than the consensus of $2.45. Relative to consensus, net interest income (balance sheet growth driven as core net interest income was lower than anticipated) and fee income both came in higher than expected. Results included $350 million of gains related to loan sales in Home Lending. Still, it stated these gains were predominantly offset by a charge in net interest income for the unwind of the related internal funding from treasury associated with these loans. This net interest income charge was offset by corresponding income recognized in treasury. Results benefited from $53 million net mortgage servicing rights risk management gains, $32 million in legal expense benefits, and $78 million in investment securities gains ($163 million or $0.04 in all). In addition, Corporate included small net gains on certain legacy private equity investments. It added $143 million to its loan loss reserve. Managed revenues increased 8% year/year and rose 2% linked quarter to $30.1 billion. Tangible book increased 1.6% to $60.48 (1.9x). Its CET1 ratio was 12.3%. It posted an 18% ROTCE and 55% managed overhead (cost/income) ratio. Average diluted shares declined by 1.6%. Net interest income declined 1% from Q2 2019. Average earning assets rose 1% with securities jumping 22%. Trading assets declined 4%, while loans decreased 1% (though up around 2% ex. sales). Its net interest margin fell 8bps to 2.41% (also -8bps in Q2 2019). Its effective tax rate was 20.4% and managed was 25.1%, up from 14.9% and 20.1%, respectively last quarter. Non-performing assets increased 2%, or $83 million, to $5.3 billion. Its reserve/loan ratio increased 4bps to 1.32% (1.42% as reported).

Wells Fargo & Company reported Q3 2019 EPS of $0.92— adjusting out what we consider to be noncore items, our estimate puts operating EPS at $1.14, ahead of forecasts. Q3 2019 non-core items: (i) $1.9 billion of operating losses predominantly reflecting litigation accruals including a $1.6 billion discrete litigation accrual for previously disclosed retail sales practices matters; (ii) $1.1 billion gain on sale of the Institutional Retirement and Trust business; (iii) $302 million gain on sale of consumer real estate mortgage loans; (iv) $105 million impairment of capitalized software; and (v) $0.05 share tied to preferred stock redemption. Net Interest Income came in marginally above forecast even with 16bps of sequential Net Interest Margin compression; average loans were up 1.1% year/year; average deposits were up 2% year/year. In terms of credit, the net charge off rate of 0.27% was lower than the forecast and was down 1bps from Q2 2019. Reported cost/income efficiency was at 69%.

Activist Influenced Companies

Brookfield Business Partners L.P. – South Africa's Impala Platinum Holdings Limited (Implats) announced it would buy Canada-based North American Palladium Ltd. for about $1 billion, marking the miner's first purchase outside of Africa. Prices for palladium, widely used in vehicle exhausts to reduce harmful emissions, have doubled from a low in August last year as tighter environmental regulations force carmakers to buy more of the precious metal. Implats pursued North American Palladium for three years, and the deal adds the Lac des Iles Mine in Thunder Bay, Ontario to the South African company's portfolio. Canadian investment manager Brookfield Business Partners L.P. will get $16 per share in cash for about 81% of North American Palladium owned by the investor and its partners.

Dividend Payers

Dufry AG will be entitled to reclaim CHF 40-50 million in taxes: The Federal Court in Rio de Janeiro has decided on the lawsuit between Dufry and the Brazilian tax authority. The company will be entitled to reclaim tax payments made in prior years in a range of CHF 40-50 million. The decision is final and non-appealable. The timing and exact amount are currently being evaluated, but should trigger a positive one-off in fiscal year 2019. This would boost EPS by CHF $0.7-$0.9 or consensus 2019 estimated adjusted EPS by 13-17%. Although the exact timing is still not known, Dufry expects to book this positive one-off in fiscal year 2019. However, to enforce the tax reclaim, Dufry will need to initiate enforcement proceedings, which are expected to last a few years.

Dufry AG - Brazil's president Jair Bolsonaro announced by Twitter that the duty free allowance at airports will be doubled from US$500 to US$1,000 for Brazilians who are returning from overseas trips. Also border store allowance (crossing Paraguay) will be increased from US$300 to US$500. The detailed regulations are expected to be published in the coming weeks. Brazil has for more than a year been negative growth for Dufry – however, that should now turn around as the new duty free allowance offers even more growth potential as Dufry is the clear market leader in Brazil's airports. Latin America (18% of group sales) has seen negative organic growth since Q3 2018 (-11%) which continued until Q2 2019 (-10.5%) due to the FX issue in Brazil/ Argentina. The group had organic growth of 2.2% in the first half of 2019 but excluding South America growth was at 5.4%. We estimate for Brazil a sales contribution of 8% to the group. It is estimated that duty free arrivals in Brazil make 60% of sales. The increase in duty free allowance will lead to sales growth on existing products but also new products priced in the range of US$500-$1,000 can complement existing product sales in duty free stores.

Pattern Energy Group Inc. announced agreements to acquire ownership interests in two operating wind power facilities, the Henvey Inlet Wind facility in Ontario and the Grady Wind facility in New Mexico. The company has also entered into an agreement for a $260 million private placement of perpetual preferred stock with certain institutional investors and intends to use a portion of the net proceeds to finance the two acquisitions. The $293 million acquisition of two operating wind facilities with 20- and 25-year power purchase agreement contract terms, respectively, is in line with the company's business plan. At a 10x multiple of the five-year average cash available for distribution, the acquisitions significantly contribute to the company's 2019/2020 growth objectives. The two projects add up to 520 megawatt (MW) of operating capacity (251 MW owned capacity) and were purchased from Pattern Energy Group LP and Pattern Energy Group 2 LP. "These acquisitions increase our portfolio by 13% to 4.4 gigawatts of operational capacity across 28 renewable energy facilities," said Mike Garland, CEO of Pattern Energy. "The Henvey Inlet and Grady acquisitions are immediately accretive to CAFD [cash available for distribution] per share with each facility characterized by strong cash flow profiles that are backed by long-term power contracts with investment-grade offtakers."

Walmart Inc. announced that U.S. CEO Greg Foran will leave the company and be replaced on November 1, 2019 by John Furner who is currently President and CEO of Sam's Club. Mr. Foran has been CEO

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of Walmart U.S. since 2014 (having joined Walmart in 2011 as a Senior Vice President Walmart International) and will remain with the company through January 2020. Mr. Furner is a Walmart veteran having been at the company for over 25 years in various leadership roles both in the U.S. and overseas.

Economic Conditions

Canada's employment surged 54,000 in September according to the Labour Force Survey, significantly above the 8,000 increase expected by consensus. Thanks to this huge gain, the jobless rate dropped to 5.5% with the participation rate dropping to 65.7%. The gain was driven by self-employed (+42,000) and government jobs (+33,000) while private sector employment (-21,000) posted a pullback. Employment in the goods sector rose 4,000 as gains in construction (+10,000), manufacturing (+2,000) and agriculture (+1,000) more than offset declines in resources (-7,000) and utilities (-1,000). Services-producing industries employment jumped by 491,000 as gains in several sectors including healthcare, accommodation & food services, educational services and other services more than offset losses in finance and information/recreation. Full time employment increased 70,000 while part-timers were down 16,000. Hourly earnings increased to 4.3% year/ year (vs. 3.8% in August). Given current global uncertainties, the September's drop in private sector jobs could be seen as worrisome although this pullback follow a massive 94,000 jump in August, so some giveback was in the cards. Despite September pullback, private jobs gains so far in 2019 are the highest since 2010 (for the first 9 months of the year). Total employment, meanwhile, is up a huge 358,000 this year in Canada, the highest since 2002, with no less than 83% of those jobs being full-time. Such a development definitely helped the housing sector to get back on its feet. It's worth noting that, once again in September, gains were not evenly distributed on a regional basis with Ontario and Quebec explaining all national gains. So far this year, 88% of job gains took place in those two provinces representing 62% of the Canadian labour market. While trade disputes remain a concern for global growth going forward, the booming labour market in Canada is far from indicating the need for monetary stimulus at this point in our view.

U.S. CPI (consumer price index) inflation eased in September despite a raft of new tariffs, potentially opening the door for another Fed rate cut at month end. After a run of strong advances, core prices surprised to the downside with a light 0.13% advance, holding the yearly rate at 2.4%. This took some pressure off the shorter-term metrics, though they are still running warm (an annualized 2.8% for 3-months and 2.5% for 6-months). After recent rebounds from earlier weakness, clothing and used vehicle prices retreated in the month. The former was unexpected given that a new 15% tariff on $112 billion of China's goods kicked in on September 1 2019, and many applied to consumer goods such as clothing. It may take longer to show up in prices, but it's also possible that the tariffs are simply coming out of profits. Prescription drug prices also sank. On the upside, shelter costs continue to progress at a 0.3% monthly rate and 3.5% yearly. Shelter is the key reason the core CPI is hovering materially above the Fed's preferred inflation measure, the core PCE deflator, which carries a lower weight. Meantime, the headline CPI was flat, held down by a further decline in gasoline prices and benign food costs (partly due to depressed crop prices). The yearly CPI rate stayed at 1.7%.

U.K. - Brexit - According to The Daily Telegraph, there was more optimism about the possibility of a Brexit deal taking shape, as both sides seemed to be inching towards a "hybrid compromise solution" on the complex issue of customs. It's unclear whether the solution is closer to the UK's preferred dual customs zone model or the EU's preference for Northern Ireland to be de facto in the EU customs territory but modified with rebates and able to enjoy the benefits of future UK trade deals. It is said that Prime Minister Johnson has postponed a cabinet meeting to take place on October 15th in order to stem any leaks which might have derailed negotiations. It is not clear if agreement can be reached ahead of the EU leaders summit on October 17th / 18th, but the EU is apparently open to talks continuing next week ahead of possible ratification at an emergency summit before October 31st 2019.

Financial Conditions

The Federal Reserve said last week that it will start buying about $60 billion per month in Treasury bills to ensure "ample reserves" in the banking system, but emphasized the new program does not mark a change in monetary policy. The purchases, which will begin October 15, respond to recent disruptions in short-term money markets that pushed the target federal funds rate to the top of its target range, and at least once above it. The "technical" program, which Fed Chair Jerome Powell had signaled earlier this week was on its way, will continue at least until the second quarter of 2020, the central bank said. (Source: Reuters)

The U.S. 2 year/10 year treasury spread is now 0.1368% and the U.K.'s 2 year/10 year treasury spread is 0.128% - 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. Also, the narrowing gap between yields on the 2 year and 10 year Treasuries is of concern given its historical track record that when shorter term rates exceed longer dated ones, such inversion is usually an early warning of an economic slowdown.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 3.57% (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 6.4 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 14.24 (compares to a post-recession low of 9.14 achieved in early November 2017) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 bodes 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:

- Bay & Scollard Development Trust
- ITM AG Investment Trust
- Portland Advantage Plus - Everest Fund
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

The Net Asset Values (NAV) per unit of our investment funds are published on our Portland website at www.portlandic.com/prices

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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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, 'GDP' gross domestic product, 'netback' is a measure of oil and gas sales revenues net of royalties, production and transportation expenses and is used to compare performance in the oil and gas industry, 'ROE' return on equity, 'ROTE' return on common equity, 'ROTCE' return on tangible common equity.

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