# 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.* December 9, 2019



## Owner Operated Companies

**Alphabet Inc.** – Google co-founders Larry Page and Sergey Brin are stepping aside as leaders of the Internet behemoth they founded 21 years ago, ending an extraordinary run that saw them build one of the world's most valuable and influential companies. Trusted lieutenant Sundar Pichai, who has run the core Google search business since 2015, will immediately take the reins as CEO of parent Alphabet Inc. "While it has been a tremendous privilege to be deeply involved in the day-to-day management of the company for so long, we believe it's time to assume the role of proud parents — offering advice and love, but not daily nagging!" Page and Brin wrote in a blog post. Page, Brin and Pichai have shared an emphasis on developing artificial intelligence software to make web searching faster and more personalized, while expanding the range of information and services available from a simple text query. Page and Brin, both 46, remain directors of the parent company but will cede their respective CEO and president titles immediately, Alphabet said. The president role will not be filled, it said, describing the changes as long discussed. "With Alphabet now well-established, and Google and the Other Bets operating effectively as independent companies, it's the natural time to simplify our management structure," the co-founders said. "We are deeply committed to Google and Alphabet for the long term." The co-founders still control the company through their ownership of preferred shares. As of April 2019, Page held 26.1% of Alphabet's total voting power, Brin 25.25% and Pichai less than 1%. Page and Brin developed the core Google search technology while they were still graduate students at Stanford, and it quickly proved far superior to competing search engines of the early Internet era.

## Energy Sector

**OPEC production cuts** – Saudi Arabia spearheaded a deal that will see the OPEC+ group of oil producers commit to some of the sector's deepest output cuts in a decade aiming to avert oversupply and support prices. Saudi with OPEC peers and allies led by Russia backed a plan that could see cuts of as much as 2.1 million barrels per day (bpd). The figures include an extra 500,000 bpd in cuts to take the OPEC+ target to 1.7 million bpd, or 1.7% of global demand, plus Saudi is continuing to cut 400,000 bpd, which is more than its quota. Producers will meet again in early March to decide their next move. Of the 500,000 bpd additional cuts, OPEC will shoulder 372,000 bpd and non-OPEC producers an extra 131,000 bpd, OPEC announced. Eleven of OPEC's 14 member states are participating while Iran, Libya and Venezuela are exempt.

**Suncor Energy, Inc.** announced 2020 production guidance, which was in line with consensus. The range of production guidance reflects the uncertainty associated with the government's potential rollback of the mandatory curtailment program. Capital Expenditure (CAPEX) was below expectations, but in line with consensus. Of note, the lower end of Suncor's budget assumes the mandatory production curtailments announced by the government are in place for 2020, whereas the upper end assumes most of the year is not impacted by the mandatory curtailments. Production guidance was 800 to 840 million boed (100% liquids), in line with estimates of 837 million boed (100% liquids) and consensus of 829 million boed (100% liquids). Capital spending guidance was $5,400 to $6,000 million in line with consensus of $5,479 million. Suncor's 2020 capital program is around 50% focused on sustaining capital, with the major planned maintenance at the oil sands upgrading operations and downstream refineries. Oil Sands cash operating cost guidance was $24.00 - $26.50 per barrel, down 8% from 2019. It is estimated, Suncor will generate after dividend FCF of around $3.0 billion at US$55 per barrel WTI in 2020, suggesting the company will continue its focus on cash returns to shareholders. We believe this means that Suncor will look to increase its dividend in early 2020 and renew its Normal Course Issuer Bid (share buyback program) for about $2.5 billion at the least.

## Financial Sector

**Bank of Montreal (BMO)** reported adjusted cash EPS of $2.43 (+5% year/year), slightly ahead of consensus at $2.41 and the bank's adjusted ROE was flat sequentially at 13.5%. We believe results are positive relative to some concerns on credit and margin heading into the quarter. Credit provisions were down sequentially in each operating segment, except for capital markets (impacted by U.S. oil & gas). While U.S. margin declined 11 bps quarter/quarter (relatively similar to recent U.S. peer reporting), Canadian Net Interest Margin increased 4 bps quarter/quarter, minimizing the overall impact. In the quarter, BMO reflected a large restructuring charge ($357 million after tax) mainly related to severance that will provide cost reductions going forward. The bank workforce will be cut by 5%. Total bank Provision for Credit (PCL) Losses of $253 million (23 bps) matched consensus and compared to $175 million last year. PCL ratio on impaired loans was 21 bps (-1 bp quarter/quarter), while provisions on performing loans were $22 million (vs. $63 million last quarter). For fiscal year 2019, BMO's total PCL ratio was 20 bps, in line with the low-20 bps guidance. Going forward, BMO guides for a PCL ratio ranging between low 20 bps to 25 bps, representing no thematic weakness. CET-1 ratio was flat quarter/quarter at 11.4%, slightly below consensus of 11.5%. The variance mainly related to the restructuring charge impacting capital by 11 bps.

The restructuring charge was bank-wide, totaling $484 million pre-tax, mainly related to severance and partially to real estate. Overall, internal capital generation (+16 bps; including restructuring charge) was generally offset by higher Risk Weighted Assets (-16 bps). Once again, BMO did not repurchase any shares in the quarter. As expected, BMO increased its quarterly dividend by about 3% to $1.06 per share (up 6% year/year).

**BNP Paribas SA** is considering laying off around 250 employees in Switzerland, France's biggest bank stated, blaming "major challenges" in the Swiss financial environment and as it seeks to cut costs group-wide. The bank said it has begun an employee consultation period, which will to run through Jan. 14 2020, to consider measures that could reduce the number of job cuts which will be implemented in 2020 and 2021.

**Canadian Imperial Bank of Commerce (CM)** - CM's Q4 2019 adjusted EPS was $2.84, below consensus of $3.06. Adjusted EPS this quarter excluded several adjustments totaling to -$0.26 per share including a goodwill impairment charge (-$0.30 per share) related to the expected sale of its controlling interest in FirstCaribbean International Bank Limited, among several other items. On a segmented basis, lower results versus forecast were largely driven by Canada P&C and Capital Markets partly offset by better than expected results in U.S. P&C. The bank's CET-1 ratio was 11.6%, up 20 bps quarter/quarter and in line with estimates. Lower results versus our forecast were driven by lower than expected revenues and higher than expected Provisions for Credit losses (PCLs) in Canada P&C and Capital Markets.

**DNB ASA** is closing its Shanghai branch and replacing it with a smaller representative office after years of slow business in China, the bank told Reuters. "Over the past few years DNB's business in the branch has been very limited, and we expect it will continue to be so in the future," said Vidar Andersen, who heads the international part of the bank's corporate banking unit. The current branch has 15 employees, while the new office will have a staff of three or four, he added

**National Bank of Canada** - Q4 2019 adjusted EPS was $1.69, above consensus of $1.62. Canada P&C earnings were up 5.1% year/year in Q4 2019 and 6.8% in 2019, the strongest result among the banks that have reported to-date. The segment benefited from about 2% expense growth in 2019 and management guided to modestly higher expense growth around 3% in 2020. U.S. and International earnings were up about 51% year/year in Q4 2019 and about 30% in 2019, the strongest result we have seen thus far. Credit was relatively benign in our view, and the bank maintained its 20–30 bps guided Provision for Credit Losses (PCL) range for 2020.

**Royal Bank of Canada** reported adjusted cash EPS of $2.22 (-1% year/year), below consensus of $2.28. Almost similar to last quarter, Canadian Banking and Wealth Management delivered strong earnings, while market-sensitive businesses were soft (e.g. Capital Markets, Insurance, and Investor & Treasury Services). The firm was impacted by higher credit provisions, but also benefited from a lower tax rate. Total bank Provisions for Credit Losses (PCLs) of $499 million (32 bps; +5 bps quarter/quarter) was higher than consensus of $446 million. PCLs on impaired loans represented 27 bps mainly from higher provisions in P&C Banking, Capital Markets, and Wealth Management. PCLs on performing loans were 5 bps and impacted by unfavourable changes in portfolio mix, slightly offset by favourable changes in macroeconomic factors and model updates. CET-1 ratio of 12.1% (+20 bps quarter/quarter) was modestly higher at 12.0%. Sequential improvement benefited from solid internal capital generation (up 32 bps), partially offset by share repurchases (down 9 bps; $474 million in FQ4) and Risk Weighted Asset growth (-5 bps). For 2019, RBC bought back 10.3 million shares for about $1 billion through its Normal Course Issuer Bid. As expected, RBC maintained its quarterly dividend at $1.05 per share, while the bank's adjusted ROE fell slightly to 16.5%. Although the bank's results included severance costs no details were provided about the number of job cuts.

**The Toronto-Dominion Bank (TD)** reported adjusted EPS of $1.59, below consensus of $1.74. TD's definition of adjusted EPS this quarter included a restructuring charge of about $0.06 per share ($154 million pre-tax) split across all segments, and a derivative valuation charge in Wholesale Banking of about $0.04 per share ($96 million pre-tax, assuming an approximately 20% tax rate). Excluding these charges, TD's adjusted EPS could be viewed closer to $1.69 but still below consensus. All segments came in below forecast with the largest miss in Canadian Retail Banking. The bank's CET-1 ratio was 12.1%, up 10 bps quarter/quarter. Provisions for Credit Losses (PCLs) were well above forecast and the efficiency ratio was much higher than expected.

## Activist Influenced Companies

**Brookfield Business Partners L.P.** – GrafTech International Ltd. (the "company") announced that a majority stockholder, an affiliate of Brookfield Business Partners L.P., a publicly listed business services and industrials company of Brookfield Asset Management Inc., has launched a Rule 144 secondary block trade to sell 11.18 million shares of the company's common stock to Morgan Stanley. Subject to the completion of the block trade, the company will repurchase from the selling stockholder $250 million of common stock at a per share price equal to the price per share payable by the broker-dealer in the block trade. The company expects to fund the share repurchase from cash on hand. GrafTech's decision to repurchase its shares is consistent with management's stated intent regarding potential uses of cash flow. David Rintoul, GrafTech's CEO, stated, "GrafTech is pleased to announce the repurchase of a meaningful amount of its shares in-line with GrafTech's capital allocation strategy. As we've previously indicated, we view share repurchases as a tax-efficient and accretive use of cash."

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## Dividend Payers

**Pattern Energy Group, Inc.** announced the expiration of the 35-day "Go-Shop Period" under the merger agreement between Pattern Energy and Canada Pension Plan Investment Board (CPPIB) that was previously announced on November 4, 2019. Pursuant to the terms of the merger agreement, Pattern Energy has now ceased such solicitation. On November 4, 2019, CPPIB and Riverstone Holdings LLC concurrently entered into an agreement pursuant to which, at or following the completion of the proposed acquisition of Pattern Energy by CPPIB, CPPIB and Riverstone will combine Pattern Energy and Pattern Energy Group Holdings 2 LP ("Pattern Development") under common ownership, bringing together the operating assets of Pattern Energy with the world class development projects and capabilities of Pattern Development. Under the terms of the merger agreement, Pattern Energy shareholders will receive $26.75 in cash consideration for each share of Pattern Energy, representing a premium of approximately 14.8% to Pattern Energy's closing share price on August 9, 2019, the last trading day prior to market rumours regarding a potential acquisition of the company. The Pattern Energy management team, led by Mike Garland, will lead the combined enterprise. The transaction with CPPIB is expected to close by Q2 2020, subject to Pattern Energy shareholder approval, receipt of the required regulatory approvals, and other customary closing conditions.

## Economic Conditions

**U.S. Nonfarm payrolls** jumped to 266,000 in November, beating the consensus call of around 180,000, and marking the biggest surge since January. Every sector except for wholesale trade added jobs. The auto industry rebounded 41,000 on returning General Motors Company workers. Private-sector jobs jumped 254,000, and the six-month average (174,000) actually stepped up from the prior half year (166,000), casting doubt on the jobs-slowdown story. If there's any slowing, it's partly due to labour shortages. The jobless rate slipped back to September's half-century low of 3.5%, while the more comprehensive U6 rate returned to 19-year lows of 6.9%. Still, wage inflation remains in check. Average hourly earnings rose 0.248%, though the yearly rate slipped to 3.1% from an upwardly revised level. That's still below the cycle high (3.4%) reached in February.

**U.S. non-manufacturing ISM** fell for the second time in three months, although it wasn't a huge decline. The headline dipped 0.8 points to 53.9, a 2-month low but still expanding. Nearly all of the setback was in current production as the **business activity** index took a 5.4 point dive to a decade-low 51.6. There didn't appear to be a specific reason, with half of the industries still reporting growth, with some citing "Major projects are nearing completion" and "Ramping into Q4 holiday season and new product launch." There were also **fewer supplier delivery delays** which, oddly, lowers the headline. The other two arguably more important components improved. **New orders**, a good indication of future business activity, rose for the second straight month, up 1.5 points in November to a 3-month high of 57.1. The **employment** component also rose for the second consecutive month, up 1.8 points to a 4-month high of 55.5.

**Canada job numbers** fell 71,000, compared to expectations of 10,000 gains. This was the result of job losses across the board (employment fell in 11 of 16 industries, led by manufacturing). Wage growth held at 4.4% year/year, but that does not provide much comfort in our view given the magnitude of the headline miss.

**The U.K.** Report on Jobs for November shows the U.K. jobs market remains lacklustre, as it has been for most of 2019, with many firms continuing to delay hiring decisions. Permanent staff appointments fell for the ninth consecutive period, marking the longest period of decline since the 2008/09 downturn. Temporary billings growth was again minimal in November, with the rate of growth edging down to a three-month low, impacted by lower demand for staff and subdued increases in vacancies. Overall vacancies increased only slightly, at the slowest rate since October 2009. The continued market uncertainty means candidate availability also fell in November 2019, at the quickest rate in the last five months. Although still sharp overall due to continued candidate shortages and greater competition for staff, average salaries increased at the slowest rate since December 2016. Similarly to recent months, the good news is, although the survey indicates a subdued market, it is not showing a further sharp deterioration.

**Australia's GDP** slipped to 0.4% quarter/quarter in Q3 2019, down from a revised 0.6 quarter/quarter reading in Q2 2019, and below expectations of 0.5% quarter/quarter. The below-trend 1.7% year/year annual expansion came in within expectations, a tad higher from the revised 1.6% year/year reading in Q2 2019. Growth continued to be dragged lower by weak household spending, with domestic final demand remaining subdued, contributing just 0.2%. Government spending was up 0.9% and was the main contributor to growth in domestic final demand, reflecting ongoing delivery of services in disability, health and aged care. Net exports contributed 0.2% to growth in Q3 2019.

**The Bank of Canada (BoC)** left the overnight rate unchanged at 1.75%, and the accompanying communiqué had an optimistic tone. The domestic economy was described in broadly positive terms, and the global economy was seen as stabilizing despite ongoing trade tensions. With the BoC continuing to flag data dependence, it's expected the next move in the overnight rate may be a 25 bps rate cut but not until around April 2020, whereas previously the thought was as early as January 2020.

T**he Reserve Bank of Australia (RBA)** kept its official cash rate (OCR) at the historic-low of 0.75% at its final meeting for the year. The decision comes on the eve of what is likely to be a lackluster set of

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GDP figures for Q3 2019, even as annual growth is expected to rise to 1.7% year/year from a decade-low of 1.4% year/year in Q2 2019. The RBA had made three quarter-point reductions to the OCR this year in June, July and October 2019.

## Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.20% and the U.K.'s 2 year/10 year treasury spread is 0.18% - 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 3.68% (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 3.9 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 14.38 (compares to a post-recession low of 18.00 achieved in early November) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 bodes well for quality equities.

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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 tangible equity, 'ROTCE' return on tangible common equity.




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