News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. March 30, 2020

Owner Operated Companies

Facebook, Inc. named the U.S. Treasury's former deputy secretary, Robert Kimmitt, to its board as lead independent director. "The lead independent director is an important role for us and we've been looking for a leader who can bring significant oversight and governance experience," Facebook Chief Executive Officer Mark Zuckerberg said in a statement. The company also said Jeffrey Zients, CEO of Cranemere Group Ltd, would not stand for re-election at the annual meeting of stockholders. Zients, however, will continue to serve as a director until the day of the meeting.

Energy Sector

Royal Dutch Shell is taking all the action it can to reduce the break-even of its business with a 20% reduction in capex to $20 billion or below versus prior budget of $25 billion; and a US$ 3 bllion / 10% reduction in operating expenses vs. 2019 plus a material reduction in working capital and suspension of the share buyback. One can't assume that this means the dividend will remain untouched – but the update is a sensible response, protecting cash flow and the balance sheet and gives the board time until the Q1 results to assess a rapidly evolving situation.

Suncor Energy decreased its capital spending plans for 2020 by $1.5 billion in response to the impact of COVID-19 and decline in oil price exacerbated by increased Saudi production. The company has also decreased production expectations for 2020 to 740-780 million boed. Analysts view the updated guidance as encapsulating a focus on value preservation given the company's already strong liquidity position entering the oil price pullback and these two focal points: it's expected the net-net impact of the lower production guidance as driving a higher degree of integration (60% of corporate production or ~70% of oil sands production is covered by refining exposure), insulating Suncor from a protracted low oil price; and the continued financing of projects that generate near-term value (it's estimated the projects that have remained in the budget have a 1-2 year payback on strip).

U.S. Shale – U.S. shale producer EOG Resources, Inc. does not expect the current oil oversupply to ease as quickly as it did in the last downturn, as a company executive told an energy conference. "Long term, I don't see the supply side reacting as significantly as it has in the past," said Ken Boedeker, executive vice president for exploration and production. Oil prices have fallen by more than half this year as the coronavirus pandemic cut demand and a price war erupted between Russia and Saudi Arabia. The two top producers have vowed to pump full bore to gain market share, reversing years of production curbs to prop up crude prices. EOG planned its 2020 spending budget assuming around $40 a barrel oil, below where crude oil was trading at the beginning of the year, but above current prices. The shale producer earlier this month said it would cut its 2020 budget by 31% to between $4.3 billion and $4.7 billion and targeted flat year-over-year oil and gas production. Oilfield service firms Schlumberger and Baker Hughes Co. said they would reduce spending, joining dozens of oil and gas companies slashing budgets since prices began plunging in early March. Spending in the upstream sector could fall by more than 25% this year, estimated energy consultancy Wood Mackenzie. Among recent expense reductions, Royal Dutch Shell Plc and Chevron Corp. cut by 20% and ConocoPhillips by 10%. Most of EOG's activity this year will be in the Eagle Ford and Delaware shale basins, Boedeker said, adding it could reduce some plans if necessary. EOG will continue to evaluate shale patch acquisitions, but it is not interested in expensive corporate deal making.

Financial Sector

Citigroup, Inc. will temporarily close up to 15% of U.S. branches amid the coronavirus outbreak. "As our clients and communities increasingly self-isolate, we have noticed shifts in foot traffic and market dynamics - so to best meet our changing customer needs we have begun to temporarily close branches," spokesman Drew Benson said. The closures are expected to be in effect by the end of the week. Citigroup has roughly 700 branches primarily located in 6 cities across the U.S.

Activist Influenced Companies

Pershing Square Holdings – Billionaire investor William Ackman, who hedged his Pershing Square Capital management portfolio weeks ago to guard against coronavirus-inspired panic selling, told investors his private hedge fund is making money this year. The Pershing Square LP fund reportedly gained a net 6.8% this month, leaving it up 0.8% after fees for the year to date. The publicly traded Pershing Square Holdings fund is up 7.9% for the month and 0.2% for the year. The numbers were released just hours after Ackman wrote to investors to say he had taken off the hedges and was becoming "increasingly positive" on stock and credit markets. The moves helped inoculate his portfolio from the type of losses that many hedge fund investors are bracing to see when managers finalize their March numbers next week. Ackman earned $2.6 billion in proceeds from the hedges and said that he had reinvested most of the money in existing holdings Agilent Technologies, Berkshire Hathaway, Hilton Worldwide Holdings and Lowe's. One week after taking to Twitter, television and text interviews with impassioned pleas for a 30-day shutdown of the United States to stop the virus' spread, Ackman said his outlook had brightened. Moves by states and federal and Treasury monetary helped, he said. Performance however may remain volatile, the manager warned, saying he might have to sell recently bought holdings or go back on the defensive. Last year his fund earned a 58% return.

Dividend Payers

Nothing significant to report.

Economic Conditions

The world will take years to recover from the coronavirus pandemic, the Organisation for Economic Co-operation and Development (OECD) has warned. Angel Gurría, OECD secretary general, said the economic shock was already bigger than the financial crisis. He told the BBC it was "wishful thinking" to believe that countries would bounce back quickly. The OECD has called on governments to rip up spending rules to ensure speedy testing and treatment of the virus.

U.S. Senate Republican and Democratic leaders, along with the White House, finally agreed on a massive $2 trillion support package for the U.S. economy. Here's some of what's reported to be in the package:

- $250 billion in direct payments to individual and families. Individuals earning up to $75,000 would receive $1200, which would be scaled back to zero by $99,000. Couples earning up to $150,000 would receive $2400, which would be scaled back to zero by $198,000. There is an additional $500 payment per child.
- $200-to-$250 billion in expanded unemployment insurance benefits. Beneficiaries will receive an additional $600 per week for four months on top of what the state programs pay, and benefits would be extended to nontraditional employees such as gig workers and freelancers.
- $350-to-$367 billion in loans to small businesses. Some of these could convert into grants if firms use them to maintain their payrolls. There might also be funding for an employee retention tax credit.
- At least $355-to-$375 billion in various new or expanded emergency funding programs. Reported so far is $150 billion for state and local governments, $130-to-$150 billion for hospitals, $30 billion for education, $25 billion for transit, and $20 billion for agriculture.
- $500 billion in loans to companies and industries, of which $425 billion will be used to backstop Federal Reserve loans and $75 billion is earmarked for industry-specific loans (e.g., $50 billion for the airlines). An inspector general and a five-person oversight board will be established to oversee the lending program. Earlier, the Fed announced a $300 billion lending program via special purpose vehicles that would purchase corporate loans and bonds along with asset-backed securities, and with Treasury kicking in $30 billion of capital. Using this rule of thumb, the new $500 billion could support up to $4.75 trillion in new lending for the U.S. economy.

On balance, this is a massive amount of support for the U.S. economy via direct cash injections and credit creation. While it won't prevent a horrendous GDP outcome for Q2, this greatly hoists the odds of a very strong and very rapid economic recovery once the COVID-19 crisis ebbs in our view.

Financial Conditions

Bank of Canada (BoC): In another unscheduled move, the Bank of Canada has last Friday March 27th cut its target for the overnight rate 50 bps to 0.25% (the lower effective bound). This latest interest rate cut, which brings cumulative conventional monetary easing to 1.50% in just 23 days, an unprecedented pace of easing as economic and financial market damage related to the COVID-19 global pandemic elicits a monumental policy response across the globe. In Canada, the virus is having "serious consequences", with the "abrupt decline" in oil prices also troubling.

A large fiscal response is being marshaled and the Bank is implementing a variety of liquidity/credit measures aimed at keeping the financial system from seizing up: "To promote credit availability, the Bank has expanded its various term repo facilities. To preserve market function, the Bank is conducting Government of Canada (GoC) bond buybacks and switches, purchases of Canada Mortgage Bonds and banker's acceptances, and purchases of provincial money market instruments." And now the BoC is going further, launching two new programs:

1. Commercial Paper Purchase Program (CPPP), which is designed to alleviate strains in short-term funding markets, preserving a source of funding for businesses.
2. Quantitative Easing, with the BoC set to begin acquiring GoC securities in the secondary market. To begin, the Bank will buy no less than $5 billion a week, across the yield curve, to be adjusted as appropriate. These purchases, which will expand the Bank's balance sheet, "will continue until the economic recovery is well underway".

So, the Bank has gone where it's never been before, taking truly extraordinary steps to combat the economic downturn, loss of confidence and disruption to credit markets due to the coronavirus. The policy response, in Canada and abroad, is monumental and in many ways wholly unprecedented. And the authorities aren't likely done fighting. As the statement makes clear: "Governing Council stands ready to take further action as required to support the Canadian economy and financial system and to keep inflation on target." Moreover, the fiscal policy response in Ottawa and a growing number of provincial capitals continues to evolve and grow.

The U.S. 2-year/10-year treasury spread is now 0.38% and the U.K.'s 2-year/10-year treasury spread is 0.19% - 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 3.50% (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 3.1 months' supply of existing houses. Therefore, 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 63.84 (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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