News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. April 4, 2016

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Energy Sector

Baytex Energy Corporation - As flagged several times by the management, Baytex securitized its bank credit facilities and gained significant covenant relief as a result. The timing of the announcement, we believe, is about right as Baytex would have been in a position to potentially breach its previous covenants at the end of the second quarter. The amendments to the bank credit line include reducing credit facilities to US$575 million (approximately C$750 million), granting its bank lending syndicate first priority security with respect to its assets and restructuring its financial covenants. With these amendments Baytex expects to have adequate liquidity and financial flexibility to execute its business plan. The company, we believe, is well positioned to benefit from an oil price recovery as its three core oil plays provide some of the strongest capital efficiencies in North America.

U.S. land rig count fell 12 units to 420, led by horizontal oil (-8), horizontal gas (-5), and directional gas (-1), slightly offset by gains in directional oil (+1) and vertical gas (+1), while vertical oil remained flat week/week. Total horizontal land rig count has declined 75% since the peak in November 2014 and ended the quarter down 26% quarter to date (QTD) quarter over quarter.

U.S. horizontal oil land rigs decreased by 8 to 280 and down 30% over the last 10 weeks led by the Permian (-4), Williston (-2), "Other" (-2), Granite Wash (-1), and Mississippian (-1), slightly offset by giants in the Eagle Ford (+2), while DJ-Niobrara and Woodford remained flat. This is the 14th consecutive week of declines for horizontal oil land rigs. Additionally, the Permian gained 1 vertical oil land rig.

U.S. offshore rig count decreased by 3 to 24 units, and is down 56% since June 2014.

Canadian rig count was down 6 rigs and remains 53% off the level this time last year. Despite 1st Quarter historically being the seasonal high in Canada, the rig count ended the quarter -2% quarter over quarter on average QTD as Canada never saw the post-December holiday rebound and warm weather pulled forward the seasonal breakup period (typically late-March to mid-May).

Financial Sector

Berkshire Hathaway Inc. – Warren Buffett's Berkshire Hathaway said it has increased its ownership stake in Wells Fargo & Company to 10%, a level that could mean increased federal scrutiny over the investment. Berkshire owns 506.3 million shares of Wells Fargo, worth about $24.7 billion, mainly through subsidiaries, according to filings with the U.S. Securities and Exchange Commission. The ownership stake has risen from 6.5% at the end of 2009 and 9.8% as of Dec. 31, according to Buffett. Berkshire has paid close to $13 billion for its Wells Fargo shares, based on Buffett's shareholder letters and the bank's recent stock price. Wells Fargo is based in San Francisco, and is the third-largest U.S. bank by assets. "We value Berkshire Hathaway as a long-term shareholder and customer and appreciate the confidence that Berkshire's executive team has shown in Wells Fargo," a spokesman said. The Federal Reserve exerts special oversight when investors take large stakes in banks. In a September 2008 policy statement, the Fed said it often lets investors take double-digit bank stakes not designed to exert a "controlling influence," but would review any resulting business relationships "case-by-case." The U.S. Treasury Department, meanwhile, has said it will not deem a 10% stake to result in "control" of a big bank if the investor agrees in writing to limits on its involvement. In one of the filings, Buffett certified that Berkshire's Wells Fargo shares "were not acquired and are not held" with the intent of changing how the bank operates. Buffett called Wells Fargo "a terrific operation" and said Chief Executive John Stumpf has done a "fabulous job." As of Dec. 31, Omaha, Nebraska-based Berkshire also owned a 15.6% stake in American Express Company, having crossed the 10% threshold two decades earlier. Berkshire also operates close to 90 businesses including Geico Insurance Company, BNSF Railway, various utilities and International Dairy Queen, Inc. ice cream.

Goldman Sachs Group Inc. closed the first stage of fundraising for its newest infrastructure fund with about $1.5 billion, according to people familiar with the matter. The fund, which completed its first close late last year and is targeting $3 billion, has since reached $1.8 billion in capital raising. Goldman's last infrastructure fund raised $3.1 billion in 2010. According to its website, Goldman has raised more than $10 billion in investments in infrastructure since 2006. (Source: Reuters)

Morgan Stanley - Article in last Thursday's Handelsblatt titled "Brexit and Other Banking Risks" with a lengthy interview with Morgan Stanley CEO James Gorman. Select quotes include: a) "A (U.S.) recession is unlikely. The U.S. economy is developing much better than many believe. Unemployment has dropped to 5%, housing prices have recovered, and bank balance sheets have been cleaned up. There are obviously challenges, for example in the energy industry as a result of the drop in oil prices, but I do not believe that we are moving towards a recession."; b) "Although it is always difficult to predict the actions of a central bank, I think that we may see one or two more rate hikes in the U.S. this year, but not more. As far as the economic prospects in the United States are concerned, I am fairly optimistic, but no more bullish than that."; c) "There is no question that lending by banks to the energy industry will lead to losses, but this will not be systemic and cannot be compared in any way to the upheaval during the financial crisis. Banks are very well capitalized these days."; d) "As far as legal risks are concerned, by now the banks know pretty much what we are standing in line for and further fundamental problems have not surfaced yet. As to how fast things progress, it depends on where you are in the line. We are fairly certain at Morgan Stanley that we have mostly addressed the key issues."; e) "Right now, I do not see any indications of a crisis (with the European Banking system). We are not seeing any serious credit losses in Europe, no liquidity problem, and no financing difficulties; instead it is the business models that are the issue."; f) "Over time, we might consider small add-on purchases, for example in the area of asset management, but I consider larger acquisitions very unlikely."; g) "The securities trading environment is quite tough, the capital markets business for equity and bond issuance is almost non-existent and private investors are very restrained as far as asset management is concerned. There are really not too many positive factors driving the business right now. The first quarter will probably be more subdued than during the previous years."; h) "At the beginning of this year, many investors feared a global recession, but this fear is slowly fading and bond markets are opening up a little. The somewhat better mood is certainly not sufficient to rescue the first quarter, but I wouldn't write off 2016 just yet."

State Street Corporation announced an agreement to acquire GE Asset Management Inc. (GEAM) from General Electric (GE). GEAM is an institutional asset manager that offers end-to-end solution capabilities across products (including outsourced chief investment officer (OCIO), alternatives, and public investment), and boasts more than 80 years of heritage in fiduciary management. As of year-end 2015, GEAM houses $110 billion in AUM for more than 100 institutional clients, and has seen AUM decline by $10 billion since its 2012 peak. The distribution of assets is heavily tilted towards fixed income (47%) and equities (38%), with private equity, hedge funds/funds of funds, real estate and cash rounding out the mix. Total purchase price is $485 million, which includes an initial purchase price of $435 million (subject to adjustments), with up to an additional $50 million tied to incremental opportunities with GE. State Street plans to finance this acquisition through the issuance of preferred stock, and the transaction is expected to close in early 3Q16 subject to regulatory approvals. Per management, this deal adds scale, leverages existing passive offerings, adds new capabilities within the alternatives arena and also bolsters the firm's OCIO and insurance capabilities. The company does expect an internal rate of return (IRR) of 11% off a deal price of $485 million, and believes they can boost the IRR to the high-teens over time. Per company guidance, the deal will be funded with additional preferred issuance, and will result in a 40-50 bps reduction of fully-phased in standardized and advanced Core Equity Tier 1 ratios (11.6% and 12.0% as of 4Q15, respectively). The firm expects $70-$80 million in total merger and integration costs to be realized through 2018.

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Barrick Gold Corporation recently filed detailed technical reports on two of its key assets (Cortez and Lagunas Norte) which included updates on two pipeline projects (Deep South and Lagunas Refractory). Overall, we believe the results are conservative of the continued exploration potential. We believe Cortez is expected to remain a major contributor for Barrick for at least the next 10 years while the Lagunas Refractory option still needs some help from the gold price and/or the drill bit in our opinion. The remaining development pipeline remains robust with Goldrush, Alturas, and the Turquoise Ridge (TR) expansion with a potential combined forecast to provide ~1.6mozs of new internally funded production, all with potential strong IRR (Goldrush estimated at 38%, TR at 33% and Alturas at 15% and likely to rise as capital comes down, all at prevailing gold prices).

Global Dividend Payers

Carnival Corporation, owner of Carnival Cruise Lines, reported Earnings Per Share (EPS) of $0.39 versus consensus of $0.31. Net yields improved 5.7% (constant currency) versus guidance of 3.5% to 4.5%, reflective of stronger pricing and a shift in the industry to limit close-in booking discounts. Importantly, we continue to believe Carnival will attract a stream of incremental buyers as U.S. recession fears subside.

Nestlé SA has entered an agreement with Guthy-Renker, one of the leading direct marketing companies, to acquire a majority stake in a Joint Venture focused on the global consumer acne market thanks to the Proactiv brand, the world's leading non-prescription brand. Non-prescription business accounted for one third of Nestlé's sales last year. With this deal, Nestlé will be able to double its sales to CHF 1 billion in the acne market. Nestlé is therefore strengthening its position in the Over The Counter business. This will partly offset the upcoming expiry of certain patents.

Economic Conditions

Canada - The Globe & Mail reported last week that Canadian house prices climbed 27% over the five years from February, 2011, to February, 2016, according to the Teranet-National Bank Composite House Price index. But many foreign buyers are seeing price declines, after currency conversion. The currencies of China, the United States and Switzerland have gained so much against the Canadian dollar that they have outrun the increase in Canadian house prices. As a result, the citizens of these countries can buy at a

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lower price than in 2011: For the Chinese and Americans, it is nearly 10%; for the Swiss, it is 5% less. In most other countries, currencies rose less than Canadian house prices. Some, like the British pound, came up just a bit short – leaving a small price increase of 2.6%. Others were further behind. Although the decline in the dollar hasn't boosted Canadian exports a great deal yet, it may have played a role in propping up the Canadian real estate market. There is considerable anecdotal evidence that Chinese buyers have been active in Toronto and Vancouver, both of which are seeing house prices go up despite economic sluggishness. In the five years to February, 2016, Vancouver house prices rose 36.2% while Toronto house prices went up by 43.1%. The increases are roughly in line with the upward trend in the strong currencies, so house prices in these cities are now more or less unchanged for buyers in strong-currency countries.

U.S. – The U.S. Purchasing Managers Index (PMI), issued by the Institute for Supply Management, swung back to expansionary territory in March, when it clocked-in at 51.8 index points, well ahead of the expected 50.70 points read, from February's 49.50 points level. The strong performance of this composite index, a bellwether of the US business activity, was helped by a jump in new orders, as well as an increase in production and inventories.

U.S. nonfarm payrolls rose largely as expected by 215,000 in March, slowing only moderately from the prior month (245k) and six-month average (246k). Virtually every industry created jobs last month, outside of manufacturing (-29k) though we believe this could change soon given recent signs of life in the sector. The household survey identified another 246,000 new positions, taking the six-month tally to a stunning 2.4 million. Nonetheless, the **jobless rate rose one-tenth to 5.0%** as the participation rate climbed for a fourth straight month (bouncing off four-decade lows in the fall). The number of discouraged workers continues to retreat due to solid job growth. However, the "all-in" jobless rate ticked up to 9.8% because of a bounce in the number of involuntary part-time workers.

Greece - The International Monetary Fund (IMF) is considering forcing Germany's leadership to quickly grant wide-ranging debt relief for Greece or allow the IMF to exit Athens' bailout programme after six years, according to a transcript of an internal IMF teleconference published by WikiLeaks. The teleconference, between the head of the IMF's European operations and its top Greek bailout monitor, is the clearest sign to date that the IMF wants to leave Greece's €86 billion rescue to the EU alone and wash its hands of a programme that has led to a torrent of criticism. German officials have repeatedly said they could not participate in Greece's bailout without the IMF on board, and senior members of the Bundestag have warned Ms Merkel they would reject new eurozone loans to Greece if only EU authorities were monitoring the programme. The IMF teleconference came just days after Wolfgang Schäuble publicly said he was opposed to Greek debt relief — despite the fact eurozone leaders agreed to restructuring last July at a high-drama EU summit that agreed to a third bailout programme. Note, the IMF Managing Director Christine Lagarde denied on Sunday that IMF staff would push Greece closer to default as a negotiating tactic on a new Greek bailout deal, which she said was "still a good distance away." Separately, Bloomberg reports that Greece could again face the threat of being pushed into default and out of the euro area if its current bailout review drags on into June and July, according to European officials monitoring the slow progress of Prime Minister Alexis Tsipras's negotiations with creditors. Greece still hasn't cut a deal on pensions, tax administration or its fiscal gap, and other issues like non-performing loans and a proposed privatization fund continue to slow the talks, said the European officials. The IMF presents another obstacle, they said. (Source Keefe, Bruyette & Woods)

Financial Conditions

U.S. This week Federal Reserve Chairman Janet Yellen maintained her caution of the March meeting statement which, in light of recent softer data, means we believe she is unwilling to lift rates in April, though a move in June remains on the table if the economy picks up in the second quarter. Importantly, the Chair will seek some assurance that global and financial market risks are easing before pulling the rate trigger again. Yellen argued the case for "*only gradual increases*" in policy rates in coming years, not because she has meaningfully marked down her outlook for growth (though that could change in light of recent data), but because "*global developments have increased the risks associated with that outlook*". She said the Federal Reserve needs to "*take into account the potential fallout from recent global economic and financial developments*". The former includes a slowing Chinese and global economy, lower oil prices (which weaken several of the U.S.'s trading partners), and lower earnings expectations. Weaker equity and credit markets remain a concern, though they have largely reversed earlier losses, and, with long-term interest rates falling this year, overall financial conditions aren't hurting growth. But it's the risk that financial conditions could head south again—notably if investors start to price in more than the one rate hike that the fed funds futures market is currently pricing in for the year—that seems to bother the Chair. Noting that "*no one can be certain about the pace at which economic headwinds will fade*", Yellen may proceed slowly in normalizing policy. She also continued to play down the recent upturn in core inflation, even noting some (limited) "*signs that inflation expectations may have drifted down,*" even if the evidence is "*far from conclusive*" and market-based measures have reversed higher recently. Neatly summarizing, the Chair said "*Given the risks to the outlook, I consider it appropriate… to proceed cautiously in adjusting policy.*" This cautiousness, in her view, is also warranted by the Fed's "*asymmetric*" ability to achieve the inflation target when rates are already so low (i.e., it's harder to cut rates to lift inflation, notwithstanding negative rates and Quantitative Easing).

The U.S. 2 year/10 year treasury spread is now 1.03% and the UK's 2 year/10 year treasury spread is 1.00% - 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 3.71% (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 5.2 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 finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months.

The VIX (volatility index) is 13.80 (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 offers 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

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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