News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. September 26, 2016

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Energy Sector

U.S. land rig count increased by 6 rigs week/week to 488 and is trending up 17% quarter/quarter. The rig count increase was driven by increases in Horizontal Oil (+6), Horizontal Gas (+2), and Vertical Gas (+2), partially offset by declines in Vertical Oil (-3) and Directional Oil (-1), as Directional Gas remained flat. Total horizontal land rig count is 71% down since the peak in November 2014. The Permian currently makes up ~51% of oil rigs.

U.S. horizontal oil land rigs increased by 6 rigs week/week to 331, driven by gains in Permian (+3), Williston (+1), Eagle Ford (+1), Mississippian (+1), and Woodford (+1), slightly offset by declines in "Other" (-1), as DJ-Niobrara and Granite Wash remained flat week/week.

U.S. offshore rig count remained flat week/week at 20 and is down 63% since June 2014.

Canadian rig count increased by 6 rigs week/week and is still 22% off the level this time last year.

Crescent Point Energy Corp. has closed its previously announced bought deal financing. A total of 33,700,000 Crescent Point common shares have been issued at a price of $19.30 per share for gross proceeds of approximately $650 million. The associated over-allotment option granted to the underwriters can be exercised at any time until and including 30 days from today's closing. In the event that the option is exercised in whole or in part, the Company will announce the proceeds at that time. Net proceeds of the Financing are expected to be used to fund approximately $600 million of incremental growth capital expenditures during 2016 and 2017 and reduce bank indebtedness.

Financial Sector

Barclays Plc - Offers to buy back 8 bonds worth as many as $2.1 billion as part of program to shift debt to holding co. level as required by regulators. Deadline is 5 p.m. ET, Sept. 27. Repurchase offer includes issue of £455 million of 5.75%, Fixed Rate Subordinated Notes due 2026; and $414 million Undated Floating Rate Primary Capital Notes Series 2.

Berkshire Hathaway Inc. / JPMorgan Chase and Co. (JPM) - Todd Combs, one of Berkshire Hathaway's primary portfolio managers, has been elected to JPMorgan Chase's board of directors. Mr. Combs (age 45) is well known as one of Warren Buffett's top investment deputies. Berkshire does not own any JPM shares according to its latest 13-F filings. Mr. Buffett personally owned JPM shares as of 2012 although it is unclear if this is still the case. The companies have not stated whether the appointment represents any potential interest by Berkshire in taking a stake in JPM. We think Berkshire is unlikely to establish a position in JPM based on its already significant equity investments in the banking industry including Wells Fargo and US Bancorp. Other Berkshire executives and directors are currently serving on outside boards. For example, BNSF Railway chairman Matt Rose serves on the boards of the Federal Reserve Bank of Dallas, Fluor Corporation, and AT&T Inc. Berkshire vice chairman Charlie Munger is on the board of Costco Wholesale Corporation and is also chairman of Daily Journal Corporation. Meanwhile, Berkshire director Susan Decker serves on the boards of Costco and Vail Resorts.

Deutsche Bank AG (not held in Portland Funds) - Chancellor Angela Merkel has ruled out any state assistance for Deutsche Bank in the year heading into the national election in September 2017, Focus magazine reported, citing unidentified government officials. The German leader also declined to step into the Frankfurt-based bank's legal imbroglio with the U.S. Justice Department, which may seek as much as $14 billion in sanctions against Deutsche Bank's mortgage-backed securities business, the magazine said. This follows reports of market positioning which implies Deutsche is being used as a combination of market hedging and a wipeout scenario. Our view is with the European Central Bank set to keep up momentum by rolling out more Quantitative Easing and deposit rate cut of -5-10bp by December, the break-up of the first Global Systemically Important Bank since the financial crisis is increasingly possible. Whether regulators can manage an orderly wind down (i.e. state aid) or not (i.e. bail-in) represents the risk of a European Lehman moment. Our view is the German banking sector is in crisis and represents an enormous tail risk to the financial system including possibly the French banks sector which will also struggle if the German banking sector falls as French/German opposition to higher Basel capital requirements fades.

Royal Bank of Scotland Group Plc (RBS) – Financial Times (FT) reports Banco Santander SA has pulled out of talks with RBS to acquire Williams & Glyn in a blow to the state-backed lender's attempts to offload the challenger bank. The Spanish bank submitted a formal offer to buy the 300 Williams & Glyn branches from RBS last month. But Santander has now dropped the acquisition negotiations. Clydesdale & Yorkshire Banking is considering offering for the 300 Williams & Glyn branches, FT says. Separately, Reuters reports RBS starts winding down shipping finance business, ending efforts to sell it amid a worsening downturn across the freight industry. CEO Ross McEwan is battling to complete a restructuring, which includes asset sales and thousands of job cuts, amid a low-interest rate environment that makes finding profitable new business tough. "We understand

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how difficult this will be for our staff and we will be offering support to those affected, including redeploying people in to other positions where we can." Shipping industry sources have told Reuters that RBS had been trying to sell its Greek shipping business, valued at around $3 billion, for over a year.

Standard Chartered Plc is in talks about spinning off its $5 billion private equity arm to its employees, following the path already taken by most big banks under pressure from regulators. A spin-off of the division, which is run by Joseph Stevens, would create one of the larger emerging market focused private equity investors with operations across Asia, the Middle East and Africa. It's understood to manage more than $2 billion for the bank and $3 billion for third-party investors. The unit has increasingly become a drag on the bank's performance, hit by the recent volatility in many of its main markets. The principal finance unit, which includes the private equity business, made $167 million of losses in the first half of the year. (Source: Financial Times)

U.K. Banks - Moody's says Britain's largest banks can withstand loss of passporting rights. The Financial Times reported on an earlier report published by Moody's, which said that Britain's biggest banks and financial services can withstand the loss of much of their passporting rights should the U.K. leave the EU's single market. It noted that Moody's said the impact would be varied due to the notion of "equivalence", where market access can be retained through existing compliance with EU regulation under MIFID 2 (Markets in Financial Instruments Directive), which could allow many firms to continue their European operations in key areas. However, it pointed out that "equivalence" provides less certainty than passporting, because it depends on a European Commission determination, which is a political decision that can take time and could be withdrawn at a future date. Recent reports highlight that U.K. Chancellor Hammond has been looking at the importance of passporting rights as he prepares a blueprint for Brexit.

Wells Fargo & Company - In our view, management did not recognize its aggressive sales targets created a toxic sub-culture in many branches that ran counter to the culture touted at the top; the bank did not act quickly enough to end fraudulent sales and/or change incentives; and has not acted quickly enough to demonstrate executive-level accountability and responsibility (clawbacks, leadership changes, etc.) and did not communicate the sales issues to investors prior to the recent settlement announcements. Financial penalties are likely to remain small as Wells Fargo was not unjustly enriched by fraudulent sales (i.e. didn't help profits or materially inflate cross sell metrics) and its customers were not likely materially harmed. Counter to this view would be the big payouts and criminal guilty pleas for also relatively minor (in revenue terms) FX misconduct. The reputational damage among customers and the impact on employee morale are still to be determined. Also, any broader changes to Wells Fargo's sales culture could potentially "overshoot" and modestly affect the company's long term growth rate and strategy, which were elements that investors viewed as historically unique to Wells Fargo.

The shares offer an above-average dividend yield of 3.3%, but are still trading in a valuation range which is at a slight premium to universal banks, and a slight discount to non-GSIB (global systemically important banks) superregional banks. This is consistent with our view that post the global financial crisis, Wells Fargo shares have been undergoing a multi-year re-rating to reflect the company's status as a hybrid – with historical returns and business mix more similar to smaller superregional banks, but a size that puts it squarely in the too-big-to-fail camp and subjects it to a litany of post-crisis regulatory measures including GSIB surcharges requirements.

Activist Influenced Companies

Brookfield Business Partners LP (BBU) – Brookfield Asset Management Inc.'s private equity arm has reportedly bought almost 11% of Performance Sports Group (PSG), signalling a show of support for the troubled sports equipment maker. Brookfield Capital Partners and related entities have bought 4.9 million shares of PSG since Aug. 26, according to filings with the U.S. Securities and Exchange Commission. As a private equity fund, Brookfield Capital often takes a controlling stake in underperforming companies to steer a turnaround.

Canadian Dividend Payers

Brookfield Infrastructure Partners LP (BIP) – Brookfield Asset Management is reportedly close to finalizing the purchase of Brazilian engineering firm Odebrecht SA's stake in a water and sewage firm after due diligence procedures previously slowed the transaction, Reuters reported, citing two people with direct knowledge of the matter. Brookfield has agreed to buy the 70% that Odebrecht SA has in the unit, Odebrecht Ambiental SA. The deal would value Odebrecht Ambiental at around $1.5 billion. An announcement is reportedly due within weeks. Brazil's state-run oil company Petrobras agreed to sell 90% percent of its natural gas pipeline unit for $5.2 billion to a group of investors led by Brookfield Asset Management. The Brookfield-led group agreed to pay $4.34 billion upon closing the deal and the remaining $850 million in five years. The consortium includes sovereign wealth funds CIC Capital Corporation of China and GIC Private Ltd. of Singapore. The deal, which is still subject to approval by shareholders and Brazilian regulators, is the largest yet in a plan by Petrobras to sell $15.1 billion of assets in 2015 and 2016 and raise another $19.5 billion through divestments and partnerships between 2017 and 2018. Under the accord, Brookfield Infrastructure Partners Ltd will invest at least 20% of value of the deal, while Brookfield Asset Management has an initial investment of about 30%. The Petrobras pipeline unit, Nova Transportadora do Sudeste SA, transports natural gas in south-central Brazil, providing Rio de Janeiro, São Paulo and Minas Gerais with natural gas coming from Bolivia and Brazil's offshore oil and gas fields.

Global Dividend Payers

ABB Ltd. Power Grids is divesting its High Voltage (HV) Cable business which has sales of US$ 524 million in 2015 and employs 900 people. Also included in the deal is a cable laying vessel that is under construction. Shifting out the cable business is estimated to be diluting ABB Power Grids margins by around 20bp. However management points to the deal increasing the CROI (cash return on investments) for Power Grids given that the cable business is very capital intensive. ABB states that the divestment of the HV cable business is part of the portfolio management in Power Grids to focus the business and according to management not part of the strategic overview of Power Grids.

Diageo Plc no longer issues detailed quarterly trading updates but ahead of last week's Annual General Meeting the group has given a steer on current trading. The key headline is that financial year (FY) 2017 has started well. The tone of the announcement reads very positively in our view and management point to improvement in India, Scotch and the U.S. as the key drivers. Generating ~50% of group profit, the news about the U.S. market in particular is very welcome. From a profit perspective there was an early warning that 1st half profitability will be impacted by the cost of delivering the £500 million cost saving program (which will be not be treated as exceptional). However, that is expected to wash out in 2nd half 2017 as implementation costs fall and cost savings start to come through. Looking to the longer term, management remain committed to delivering on their medium term guidance to generate at least 100bps of margin expansion over the three years to FY 2019.

Johnson & Johnson (JNJ) - JNJ announced that it is acquiring Abbott's wholly-owned subsidiary Abbott Medical Optics for $4.325 billion in an all cash deal, expected to close in Q1 2017. The acquisition includes products in three core business segments: cataract surgery, laser refractive surgery, and consumer eye health. Other deal terms were not disclosed. In our view, while this transaction adds to the breadth of JNJ's portfolio and leverages existing eye care brands, it doesn't add significant diversity to the med-tech portfolio. That said, with $1.1 billion in 2015 sales, the acquisition is expected to be modestly accretive to JNJ's earnings in 2017 and with a valuation under 4X trailing 12 months earnings it isn't a pricy transaction, in our view.

Pattern Energy Group Inc., an independent power company held in the Portland Advantage Plus – Everest and McKinley Funds, announced its commitment to acquire a 90 MW interest in the operating 180 MW Armow Wind power facility in Ontario, Canada from Pattern Energy Group LP. Pattern Energy will acquire the interest in Armow Wind for a total cash funding commitment of $132 million. The acquisition will be funded with available liquidity and is expected to close within 45 days. The acquisition will grow the company's portfolio to 18 wind power facilities with a total owned capacity of 2,644 MW.

Syngenta AG announced last week the appointment of Jeff Rowe to the new role of President Global Seeds and North America. In this new role Jeff will be responsible for the global seeds strategy and execution, combined with the leadership of the North American business across seeds and crop protection. Jeff brings over 20 years' experience in the industry covering a broad array of roles of increasing seniority including regional commercial leadership, biotechnology and regulatory affairs, supply chain and global strategy. In addition, Jon Parr, currently COO, is appointed President Global Crop Protection and EAME, LATAM and APAC. Jon has an excellent track record of success in his 30 years in the agriculture industry, combined with a deep understanding of crop protection across all disciplines.

Economic Conditions

Canada – Retail sales in Canada retreated by 0.1% in July, which fell short of the expectations for a modest improvement (0.1%) in the month. Core retail sales, which exclude the contribution of vehicles and parts sales, were also lower by 0.1%, significantly below the expected 0.5% advance. The pull-back was chiefly driven by a 3% drop in gasoline sales, with sales of furniture also detracting from performance. Inflation readings meanwhile, at 1.1% for the headline figure and 1.8% for the core (excluding eight most volatile price series, including food and energy), down from 1.3% and 2.0%, respectively, provide more breathing room for Bank of Canada's accommodative monetary policy.

U.S. housing starts took a bigger-than-expected 5.8% drop in August to 1,142k units annualized, the lowest in three months and the first monthly fall over that span, with the South taking a 14.8% hit, as wet weather in the South over the course of August took a toll on the housing sector. The upward revisions in the prior couple of months helped cushion the blow. Outside of the South, housing starts actually rose 4.2% but given how large the region is (~50% of total starts), the drop in the South cannot be shrugged off. But look for a rebound in the next month or two. Building permits were also affected; requests to build in the South fell 3.4%, but were up everywhere else. Total permits slipped for the second consecutive month, down 0.4% in August to 1,139k annualized. With permits still below starts, we believe there is some room to slide a bit further but starts and permits remain at pretty high levels.

U.S. existing home sales unexpectedly fell in August, down 0.9% to 5.33 million units annualized. This worse-than-expected move was the second drop in a row, leaving sales at a half-year low. This is a supply problem in our view; not a demand problem, particularly as it applies to single-family homes, of which sales were down for two consecutive months. There are fewer "FOR SALE" signs dotting many neighborhoods across the U.S.—**single-family homes available for sale** have declined for three straight months and are also at half-year lows—and that lack of supply is holding back sales. This should be a good sign for new construction, although homebuilders (while more optimistic) are also facing higher input costs (for lumber, in particular). Low inventories are starting to push prices higher again, after cooling

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a bit over the summer. The **median sales price** for a single-family home rose 5.3% above a year ago, the fastest pace since April. Lack of options and higher prices are causing first-time homebuyers to hold off a bit, with their share of sales slipping again to 31% from 32% in July and the 4-year high of 33% in June. Nonetheless we remain supportive of the strengthening housing market, helped by easier credit conditions, steady job growth and modest wage gains (except for those workers who possesses job skills that employers are clamoring for), and low borrowing costs. Buyers just need a few more options to choose from.

Financial Conditions

The U.S. Federal Reserve as expected kept the policy FFTR (federal funds target rate) unchanged at 0.25-0.5% in September for the 6th consecutive meeting but the decision showed growing divisiveness within FOMC (Federal Open Markets Committee) as three Fed regional presidents dissented. The FOMC statement provided a positive outlook on the U.S. economy and labor market while the Fed eased up its cautious stance about risks to the U.S. outlook, even though 2016 growth forecast was downgraded again. The key inclusion in the September FOMC statement in our view is that "The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives".

The updated September dot-plot chart again predictably and consistently lowered the median policy rate forecasts across the years, indicating only one hike in 2016 (down from two) and just two 25-bps rate hikes in 2017 (down from three).

Bank of Japan (BOJ) central bank left rates at -0.1% (as expected) and left the annual pace of asset purchases the same at 80 Trillion JPY. The big news though was it dropped the average maturity target for its bond purchases (7-12 years) and introduced the new approach of "yield curve control". The BOJ may now buy anywhere along the yield curve and pledged to expand the monetary base until inflation remains above 2%. The BOJ says it will target approximately 0% for the 10 year yield and moving further into Negative Interest Rate Policy was left open in the near-term and seems likely the BOJ will cut its overnight policy rate again in the future. By adding short-dated maturities, it allows the BOJ to buy a larger universe of bonds and steepen the yield curve which also helps the Japanese banks. The new QQE (quantitative and qualitative monetary easing) yield curve control is being viewed as a policy change but no new easing.

The Reserve Bank of New Zealand (RBNZ) left the official cash rate (OCR) unchanged at 2.0% at its September monetary policy meeting. However, the RBNZ maintained a clear easing bias, suggesting that further rate cuts are likely. In the accompanying short statement, the Bank repeated the August conclusion that "Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range. We will continue to watch closely the emerging economic data".

The U.S. 2 year/10 year treasury spread is now .86% and the U.K.'s 2 year/10 year treasury spread is .62% - 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 3.48% (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 4.3 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 14.24 (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
- Portland Global Aristocrats Plus Fund

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