News Highlights

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. June 5, 2017

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Owner Operated Companies

Restaurant Brands International Inc. (RBI) – This morning we attended the third annual general meeting of Restaurant Brands International since the takeover of Tim Hortons. Unlike some of Tim Hortons' annual general meetings of the past, the most recent one was a more muted affair, with the three management proposals, including 12 board members through the end of 2018, the appointment of the company's auditor and say on pay, being swiftly approved. A fourth proposal, demanding more gender diversity in the company's board composition, failed to meet the necessary votes. As a reminder, the outcome of the shareholder voting was never up for debate, as a consortium led by the 3G Group has a controlling stake in the company. CEO Daniel Schwartz highlighted a succinct number of metrics pointing to the company's performance over the past year. RBI reported robust same store sales growth for both Tim Hortons and Burger King combined with sustained restaurants growth. RBI's most recent acquisition, that of Popeyes Louisiana Kitchen, is seen by the management as having unique complementary features relative to the existing portfolio of brands.

Energy Sector

U.S. land rig count increased by 8 rigs to 889 rigs, which is the 20th week of consecutive gains. The rig count was driven by gains in Horizontal Oil (+7), Directional Oil (+2), and Vertical Oil (+1), partially offset by declines in Horizontal Gas (-2), while Vertical Gas and Directional Gas remained flat week/week. Total horizontal land rig count is down 44% since the peak in November 2014 (see Fig 1). The Permian currently makes up 51% of all oil rigs.

U.S. horizontal oil land rigs increased by 7 rigs to 633 as gains in "Other" (+5), Williston (+1), Eagle Ford (+1), and DJ-Niobrara (+1), were partially offset by declines in Mississippian (-1), while Permian (first time in 12 weeks without a weekly gain), Granite Wash, and Woodford remained flat week/week.

Canadian rig count increased by 6 rigs, and is up 134% from the level this time last year.

U.S. Gulf of Mexico offshore rig count remained flat week/week at 23 and is down 57% since June 2014.

Cardinal Energy Ltd. – U.S. oil and gas producer Apache Corporation is selling Canadian light oil assets to Canada's Cardinal Energy Ltd. to focus on high-growth areas like the UD Permian basin shale play. The $330 million cash deal includes the House Mountain assets in Alberta and Apache's share of the Midale and Weyburn oil assets in southeast Saskatchewan, which together produce 5,000 barrels of oil equivalent per day (boed). Apache becomes the latest international oil firm to sell Canadian operations in favor of concentrating on U.S. shale plays. This year alone international oil majors including ConocoPhillips and Marathon Oil Corporation have sold off $22.5 billion of Canadian assets. Canadian domestic producers like Cardinal, Cenovus Energy Inc. and others have stepped up to buy the assets from the retreating global firms. Canadian light oil is cheaper to produce than northern Alberta's oil sands crude, but is not as fast-growing as the booming Permian shale play. Junior producer Cardinal Energy will fund the acquisition with a $170 million share sale and the remainder using debt. It expects to sell royalty interests and fee title lands associated with the Apache assets by the end of the year, which will help pay down debt. Cardinal upped its 2017 production guidance to 19,200-19,700 boed as a result of the deal. The assets acquired by Cardinal represent a good strategic fit as their low decline rates further depress corporate decline rates to below 10%, improves the company's light oil weighting to 45% (from about 25%) and adds a deep inventory of drilling locations (over 300).

Financial Sector

Barclays PLC - Barclays increased the size of its Africa placing to 33.7% stake, up from ~22% citing strong demand. Shares placed at ZAR 132 a share. Barclays stake was 50.5% before this sale so takes its holding to 16.8% and including giving a 1.5% stake to the black empowerment scheme it takes its holding down to their 15% target, which is importantly below the 20% level which should allow regulatory deconsolidation. We don't think they will get the regulatory deconsolidation by 1st half 2017 but expect it by year-end which will see the benefit ~0.73 basis points of capital benefit. At first half stage as it will still be treated as an associate with significant influence, we think it will crystallize only 0.27% of the benefit. Completing the sale now is clearly earlier than expectations which is positive. Barclays has also agreed to the sale of majority shareholding in Barclays Bank of Zimbabwe. The sale is to FMB Capital Holdings (listed on Malawi Stock Exchange). Completion of this transaction is currently expected to conclude by the end of the Q3 2017. The sale will see a reduction of £292 million in Risk weighted assets.

The Bank of Nova Scotia posted operating Earnings Per Share (EPS) of $1.63 in Q2 2017, up 17% Year/Year and ahead of consensus ($1.56). The results reflected solid 8% Year/Year increase in pre-tax pre-provision earnings on an all-bank basis, which was underpinned by the combination of (1) 10 basis points of sequential core Net Interest Margin (NIM) expansion; and (2) a fifth consecutive quarter of positive operating leverage (+1.5%). Operating Return On Equity (ROE) in Q2 2017 came in at 15.1%.

National Bank of Canada reported net income of $462 million v.s. $193 million year/year, although the prior year included a large sectoral provision to boost credit reserves. Its adjusted cash EPS was $1.30, which beat consensus of $1.26. The provision for credit losses was down to $56 million v.s. $317 million year/year, and was down modestly from the $60 million level quarter/quarter. Stronger business flows and lower costs both helped boost margins in the domestic banking segment, while both Wealth Management and Financial Markets were relatively stable. The Core Equity Tier 1 level improved to 10.8% v.s. 9.8% year /year (and up from 10.6% quarter/quarter). Also a 3.6% dividend increase and a six million share buyback were announced.

Activist Influenced Companies

Nothing new to report.

Canadian Dividend Payers

Nothing new to report.

Global Dividend Payers

Johnson Matthey PLC reported 2nd half 2016/2017 underlying Profit Before Tax (PBT) of £262 million, 5% ahead of consensus (£251 million). The 2nd half beat was clean in our view with no one-off benefits (following £16 million benefit in 1st half 2016/17). Guidance implies £494 million PBT in 2017/18 which is 2% below consensus at £504 million – this guidance includes a £12 million additional pension cost due to interest rate changes (presumably not implicit in consensus). Guidance is based on 2016/17 PBT of £481 million plus £13 million FX benefit. Organic growth is offset by pension cost headwinds where a £16 million one-off from 2016/17 (H1) and an additional £12 million of pension costs (due to rates) in 2017/18 will offset £10 million benefit from cost saves and £18 million of underlying growth. Across the business divisions: (i) Emission Control Technologies – beat- (£166 million vs consensus £157 million) – Sales outperformed vehicle production in almost every market; very strong growth in European light duty – driven by sales of higher value catalysts across diesel and gasoline and share gains in diesel. Heavy duty sales increased due to new business in the US and Asia and sales of higher value catalysts in Europe. (ii) Process Technologies – small beat - (£51 million v.s. consensus £47 million). Business maintained strong position despite challenging market. License income lower due to fewer chemical plants constructed in the year. Efficiency gains from last year's restructuring program realized. Precious Metal Products – in line - (£45 million v.s. consensus £41 million). Stronger 2nd half due to actions taken to drive efficiency. (iii) Fine Chemicals – small miss- (£38 million v.s. consensus £43 million). Strong sales from active pharmaceutical ingredients (APIs) for two newly approved drugs offset lower sales of the higher margin ADHD APIs. (iv) New Business – in line - (£-6 million v.s. consensus £-4 million). Widened portfolio of battery materials developing more high energy materials. Focus has been improving productivity in fuel cells. Dividend: H2 Ordinary dividend of 54.5p v.s. consensus 58p.

Pattern Energy Group Inc. has inaugurated the 324MW Broadview Wind power unit and 35-mile, 345kV Western Interconnect transmission line in U.S. Broadview Wind unit in U.S. states of Texas and New Mexico is supplying clean energy to California though the Western Interconnect transmission line. The wind unit can electrify about 125,000 homes every year. It consists of 141 Siemens 2.3MW wind turbines whose blades were manufactured in Fort Madison, Iowa, and nacelles in Hutchinson, Kan. The wind farm can be expanded up to a limit of 297MW. Broadview Wind has signed long-term, firm, point-to-point transmission service contracts to supply the generated power to the California Independent System Operator system through Western Interconnect, Public Service of New Mexico and Arizona Public Service transmission systems. The wind farm will supply the generated power to Southern California Edison for 20 years. Pattern Energy, president and CEO, Mike Garland said, "This innovative facility is generating inexpensive renewable energy in eastern New Mexico and delivering clean power into California helping that state transition to a carbon-free, low-cost, renewable grid. We are especially excited to open this facility because it demonstrates the value of bringing wind power from where it's created to where it's needed. We see exciting development opportunities in this area of the country. Pattern Development is actively developing several significant opportunities in New Mexico and the southwest U.S. as part of the region's increasing demand for low-cost, renewable energy."

Economic Conditions

Canada – The Canadian economy jumped by 3.7% in the first quarter of 2017, albeit short of the expected 3.9% improvement, though a full percentage point ahead of the 2016 fourth quarter's rate of growth. Growth was driven by business investment, consumer spending and, not surprising, housing. Government spending and inventory build-up contributed as well, though to a lesser extent, whereas net exports subtracted from growth in the quarter.

U.S. personal income advanced by 0.4% in the U.S. for the month of April, in line with consensus expectations and exceeding March's 0.2% growth rate. Part of the same report, the core personal consumption expenditures (PCE) price index rate of change, the U.S. Federal Reserve's favourite inflation gage, retreated one tenth, to 1.5% in the month, from 1.6% in March, providing flexibility for the central bank's actions.

U.S. housing prices, as measured by the Case Shiller index for 20 U.S. metropolitan areas, grew by 0.9% in March and it is 5.9% higher in year-on-year terms, the same level as for the February reading and a couple of notches ahead of the consensus expectations.

U.S. consumer confidence, as measured by the Conference Board, weakened somewhat in May, to 117.9 index points from April's 119.4 points index level and fell short of the expectations for a modest improvement, to a 119.8 level. Business sentiment however, as registered by the Institute for Supply Management's (ISM) purchasing managers' index (PMI), advanced one tenth of an index point, to a 54.90 reading, ahead of the expectations which were factoring in a weaker level, at 54.50 index points.

U.S. Nonfarm payrolls rose 138,000 in May, and the prior two monthly gains were knocked down by a total of 66,000. Payrolls growth has slowed to an average of 121,000 in the past three months from 201,000 in the previous three. The six-month trend 161,000 is also grinding lower. After a lengthy string of advances, manufacturing slipped in May. But the bigger story is the retail sector chopping jobs for a fourth consecutive month, as online competition has led to more bankruptcies in the sector, while advanced automation is culling the ranks of bricks-and-mortar cashiers and salespersons. On the bright side, construction jobs turned up after a soggy (literally) couple of months. The household survey was similarly weak, with employment dropping 233,000, though this followed sizeable gains in earlier months. The jobs setback, coupled with a two-tenths drop in the participation rate (as the leading wave of baby boomers punch out for the last time), dropped the unemployment rate for fourth straight month. **At 4.3%, the jobless rate has now breached the previous cycle low** (2006) to sit at a 16-year trough. The more inclusive U6 measure of joblessness also mined fresh lows at 8.4%, benefitting from a further decline in discouraged workers and involuntary part-timers. The available supply of workers continued to ebb (now 12.4 million persons unemployed or wanting to work). This means wage pressures will be mounting, although it seems not yet with average hourly earnings rising just 0.2% in the month, holding the yearly rate at 2.5%. However, with labour shortages spreading to lower-skilled work (according to the Beige Book), it's only a matter of time before wages start to heat up in our view.

U.K. - Terrorists brought carnage to Britain for the second time in as many weeks as pedestrians were mowed down by a van on London Bridge who then attacked nearby pedestrians with 12-inch knives, killing 7 and injuring 48. Chrissy Archibald, a Canadian woman, was the first victim to be identified. U.K. elections come on Thursday and it is uncertain how the recent events will affect the outcome. U.K. Prime Minister May's 20 point lead at the start of the campaign has been eroded but betting sites still have May at 87% chance of being the next Prime Minister and 83% chance of the Conservatives winning a majority government. The pound/sterling versus US$ support held steady over the weekend at 1.2850.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now .88% and the U.K.'s 2 year/10 year treasury spread is .94% - 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 3.94% (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 4.2 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 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 10.12 (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 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:

- 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

Individual Discretionary Managed Account Models - SMA

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