News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. January 13, 2020

Owner Operated Companies

Brookfield Asset Management Inc. – Brookfield Renewable Partners L.P. said it would acquire the remaining 38% stake in TerraForm Power, Inc. it does not already own, in a deal that values the electricity utility company at $3.93 billion, as it looks to boost its power portfolio. TerraForm said it has formed a special committee of non-executive, independent directors to review the unsolicited proposal it received. The transaction is expected to be immediately accretive for Brookfield Renewable unitholders, and further expand the company's portfolio in North America and Western Europe, said Brookfield Renewable. The company, which is the renewables arm of Canada's private equity firm Brookfield Asset Management, has $50 billion in total power assets.

Brookfield Asset Management has teamed up with Singapore state investor Temasek Holdings (Private) Limited in the auction for Thyssenkrupp AG's prized €15 billion elevator division. The tie-up creates another powerful private equity consortium for the asset, which Thyssenkrupp plans to sell or list, ahead of a January 13, 2020 deadline for binding bids. Thyssenkrupp, under pressure after numerous profit warnings, needs to rake in cash by selling all or part of its elevator business, the world's fourth-largest industry player and by far the group's most profitable asset. Rival bidders for the unit reportedly include a consortium consisting of The Blackstone Group, The Carlyle Group and the Canadian Pension Plan Investment Board. Advent International, Cinven and The Abu Dhabi Investment Authority have also teamed up for an offer. Apart from Finland's KONE, which could bid together with private equity firm CVC Capital Partners, Japan's Hitachi is also in the race. Thyssenkrupp's supervisory board will meet on January 15, 2020 to discuss the auction's progress and is expected to narrow the field of bidders, with only two to three bidders to be short-listed for a final round of talks.

Linamar Corporation provided an update on market conditions, ahead of the release of Q4 2019 and full year results. The update reflects a more pessimistic read in regards to performance for the group's three segments. The United Auto Workers' (UAW) strike at General Motors Company was the most significant impact to affect the automotive segment during Q4 2019, though more broadly, the industry as a whole is performing somewhat weaker than expected. Linamar is also concerned with developments in the global access market, as equipment rental companies have continued to reduce their capital expenditure for the year. The agricultural segment has been somewhat affected by trade tensions, but also by higher than usual inventory levels.

Oracle Corporation has hired Ariel Kelman to be its new chief marketing officer, who is joining from Amazon Web Services (AWS), where he had been vice president of worldwide marketing for six years. The move represents a victory for Oracle, which has trailed AWS in the market for cloud infrastructure companies rent to operate websites and applications. The two companies have become increasingly bitter rivals in recent years as Oracle executives have criticized AWS, and AWS CEO, Andy Jassy, has spoken negatively about Oracle. AWS said in October 2019 that Amazon's consumer business had switched off its last Oracle database. Kelman replaces Rupal Shah Hollenbeck, a former Intel executive who left earlier this month. At AWS he was a top executive. He joined AWS from Salesforce, where he had held marketing roles, as head of worldwide marketing in 2011, and in 2014 he became AWS' vice president for worldwide marketing, according to his LinkedIn profile. Before joining Salesforce Kelman spent two years at MicroStrategy and co-founded a start-up, Ventaso.

Energy Sector

Nothing significant to report.

Financial Sector

Barclays PLC: The Financial Times and Bloomberg comment on pressure from shareholders (institutional and retail) in Barclays, aimed at the bank phasing out its financing of fossil fuel companies that fall outside of the 2015 Paris agreement. This resolution will be voted on at the 2020 Annual General Meeting in about four months. Barclays is facing more scrutiny than many peers in Europe, due to its higher relative exposure to financing fossil fuel companies, although the bank argues that better comparisons would be to U.S. banks (given its own U.S. Investment Bank), and highlights its commitment to improving in this area. It is clear that climate change is becoming more of a topic for European Union (EU) bank investors (admittedly from a low base, in terms of shareholder focus) whilst also gaining more prominence in the media, and the Financial Times has written previously on the debate around whether The European Central Bank grants some capital relief to banks' financing of green projects.

Canada's Big 6 Banks - The Globe & Mail reported that Canada's banks are under intense pressure to prove to nervous shareholders that banks are adequately prepared to absorb loan losses when the next economic downturn arrives, according to Bank of Nova Scotia's chief executive officer. One day after Scotiabank abruptly announced it will add new, more pessimistic assumptions to its models for predicting losses on credit, at a cost of $150 million before tax, CEO Brian Porter revealed the bank's move was a response to concerns from investors.

"The marketplace is really concerned about credit," Mr. Porter said at a Toronto conference last week. However, he feels they may be "overly concerned' even as the current economic cycle creeps into its later stages. His peers at rival banks are equally keen to demonstrate how conservative they have been in making provisions for an eventual spike upward in credit losses, in a broader effort to placate mounting unease among investors. At last Tuesday's conference, bank CEOs also tempered expectations for earnings growth this year. Most of them appear to have reined in their ambitions for large acquisitions for the time being, preferring instead to stockpile capital and buy back shares – Toronto-Dominion Bank is a notable exception, as they are showing interest in mergers. Other banks, such as Royal Bank of Canada (RBC) and Bank of Montreal (BMO), began building up forward-looking provisions for loan losses earlier. In the previous fiscal quarter, RBC added $41 million to its provisions on loans that are still performing, while BMO's models incorporate some of the most pessimistic economic forecasts. But both banks are still at pains to show they have built sufficient cushions against future losses.

Activist Influenced Companies

Nothing significant to report.

Dividend Payers

Bunzl plc has announced the acquisition of Joshen Paper & Packaging Co. Inc. based in Cleveland, U.S.A., which primarily engages in the distribution of packaging and other goods for customers operating mainly in the grocery sector. This is Bunzl's main competitor in the space and has been a target for some time. The margin is in the 2-3% range, lower than we would usually see, but Bunzl aspires to increase this to 4-5% over time through synergies and other improvements. We see Joshen contributing around £7 million to profits in Fiscal Year 2020, around a 2% contribution to North American profits and around 1% to group profits. Revenue for Joshen Paper & Packaging is expected to be £225 million in 2020 per company disclosures, adding around 3% to North America Fiscal Year 2020 sales and 2.5% to group sales. The company paid 7.5x EBITA pre synergies, which is in the usual 6-8x range, and this could reduce to 5-6x post synergies. There are no anti-trust issues so the deal has completed last week and will be included in financials immediately. Bunzl shares have an estimated Fiscal Year 2020 price-to-earnings ratio of 16x, a 7% FCF yield and around a 2.5% dividend yield.

Economic Conditions

Canada's employment bounced back in December 2019 (up 35,000) according to the Labour Force Survey, above consensus expectations calling for a 25,000 rise. As a result, the jobless rate dropped to 5.6% with the participation rate dropping to 65.5%. Private sector (up 57,000) surged while public sector (down 22,000) posted a second consecutive pullback. The self-employed rate remained essentially unchanged. Employment in the goods sector increased to 16,000 as gain in construction (up 17,000) and manufacturing (up 4,000) more than offset declines in agriculture (down 3,000), natural resources (down 1,000) and utilities (down 1,000). Services-producing industries employment (up 19,000) also rebounded as gains occurred in several sectors including accommodation/food services (up 25,000), healthcare (up 7,000) and information/recreation (up 6,000). Full-time employment was up 38,000 and part-timers posted a 3,000 pullback. Hourly earnings were up 3.8% year/year, a four ticks decline compared to a month ago.

Canada / Toronto Home sales: The Globe & Mail reported last week that Toronto's housing market rebounded last year as buyer demand climbed while new home listings fell, pushing the average residential sale price close to a record high. Home sales in the Greater Toronto Area reached 87,825 last year, according to the Toronto Real Estate Board. That is an increase of 13% year/year, when activity slumped because of a raft of new policies designed to cool the region's overheated real estate market. "Many home buyers who were initially on the sidelines moved back into the marketplace starting in the spring," the real estate board's president, Michael Collins, said in a statement. Sales rose as the number of new listings fell 2% compared with the previous year, to 152,739, increasing the competition and pushing up real estate prices. The average sale price across all types of homes rose 4% to $819,319 last year. That was close to the historic high of $822,727 reached in 2017. The value of every type of housing increased in Toronto and its suburbs. The average selling price of a detached house in the GTA rose 1% compared with the previous year, to $1,016,776.

U.S. Nonfarm payrolls rose 145,000 in December 2019, below expectations, but a decent showing after a 256,000 spurt the prior month (revised down only modestly from 266,000). Though slowing in 2019 (the 2.1 million new jobs was down from 2.7 million in 2018 and the fewest since 2011), job growth actually picked up in the second half of the year, averaging 189,000 versus 163,000 in the first half. The 1.4% year/year advance in December 2019 remains decent given labour shortages. The weakness in December payrolls was concentrated in manufacturing (down 12,000) and transportation/warehousing. Retail, however, belted out 41,000 new jobs, reflecting a merry holiday shopping season. Household survey employment stayed strong, up 267,000, which allowed the jobless rate to hold at 3.5% and cut the U6 "underemployment" rate to a new cycle low of 6.7%, implying even less slack in labour markets. Nonetheless, average hourly earnings rose a light 0.1%, shaving the yearly rate to 2.9%. Aggregate weekly work hours rose a mild 0.1%, though the 1.1% annualized gain in the quarter still suggests an upside risk to our 1.6% call for GDP growth given likely firm productivity gains. U.S. companies slowed their rate of hiring at year-end, but trend job growth actually picked up in the second half of the year, keeping the jobless rate at a half-century low. And, with wages rising only moderately and posing little threat to inflation, the Fed has, in analysts' view, every reason to claim that the economy is in a "good place".

The U.S. non-manufacturing ISM improved to an above-expected 55.0 in December 2019, the highest since August. Good news, but the details were a little concerning. First of all, the increase was fully supported by a big jump in **business activity** (such as production) to 57.2, the highest since August, and more **supplier delivery delays. New orders**, which are an indication of what's to come, fell to 54.9, still expanding, but the lowest reading since September. And, fewer industries reported an increase in new orders in the month (10 from 12 in November). Of the 18 industries in the survey, 11 **said they were growing**, the fewest since January. They were very mixed....good, bad, some mention of trade uncertainty, which makes it difficult to point to one single culprit in our view.

The pace of increase in China's Consumer Price Index (CPI) remained elevated at 4.5% year/year in December (November: 4.5% year/year) though this came in below consensus forecast of 4.7%. December-November 2019 inflation is at the highest level since January 2012 when it was at the same rate. Importantly, core CPI (excluding food and energy) was tame at 1.4% year/year, unchanged from November. Pork price was again the chief contributor to the high inflation, rising 97.0% year/year in December though it has moderated slightly from more than 100% gains in the two preceding months. The upcoming Lunar New Year celebration will likely keep pork prices elevated but gains appear to be coming off in analysts' view. Fresh vegetables prices were also higher at 10.8% year/year compared to 3.9% in November while transportation and communication price index remained in contraction for the 9th consecutive month at -0.7% year/year (November: -2.8% year/year).

The U.K. Report on Jobs for December 2019 shows potential signs of improvement following a rather lacklustre performance for most of 2019. Permanent staff appointments rose for the first time in a year following the longest period of decline since the 2008/09 downturn. Temporary billings growth was again minimal in December, with the rate of growth improving slightly following November's three-month low. Overall vacancies increased only slightly, a continuation of trends seen earlier in the year, with growth remaining close to decade-low levels. The continued market uncertainty means candidate availability also fell in December, although the rate of decline eased vs. November. Although still sharp overall due to continued candidate shortage and greater competition for staff, average salaries increased from November's recent lows though starting salaries remain amongst the lowest seen in over the last three years.

Financial Conditions

The U.S. 2 year/10 year treasury spread is now 0.26% and the U.K.'s 2 year/10 year treasury spread is 0.26% - 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 3.64% (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 12.72 (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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