News Highlights

Owners. Operators. And Insightful Investors.

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PORTLAND INVESTMENT COUNSEL®

Established in 2007

Our views on economic and other events and their expected impact on investments. March 9, 2020

Owner Operated Companies

Alphabet Inc. – said it has cancelled its annual developer event, Google I/O, amid concerns related to the coronavirus outbreak. "Over the coming weeks, we will explore other ways to evolve Google I/O to best connect with and continue to build our developer community," the company said. The company said it would move its annual cloud conference online. Google becomes the second FAANG (Facebook, Inc., Amazon, Inc., Apple Inc. Netflix, Inc. and Google) member after Facebook to cancel its conference as the virus, that originated in the Chinese city of Wuhan, spreads globally. The event was to take place between May 12 and May 14 and is Google's most important event of the year, where it highlights new services and products.

Energy Sector

The failure of OPEC+ to reach an agreement last week, Russian oil minister Alexander Novak leaving the meeting indicating that all nations are free to pump what they want starting April 1st, and Saudi Aramco slashing their official selling prices (OSPs) for crude by $6-8/barrel wreaks havoc in the oil markets and on the equities. Adding insult to injury are the unknown tenure and economic impact of COVID-19, which continues to accelerate outside of China. In an article over the weekend, a Rosneft Oil Company spokesman is quoted as saying, "Let's see how American shale exploration feels under these conditions." Only time will tell how everything plays out, but if signals indicate that this <$40 West Texas Intermediate (WTI) price environment will persist, what we think happens is that Exploration & Production (E&P) capital discipline holds: E&Ps will get down to maintenance mode this year and then in 2021 the Large Cap E&Ps will target as close as they can to being cash flow neutral after the dividend. While some E&Ps have pledged to be cash flow neutral under 'any reasonable' price environment, we doubt the current $35 WTI is what they had in mind. Thus, since it takes time to significantly reduce activity in an efficient way, we think getting to maintenance mode in 2020 is more realistic than a trying to cut deeper to be cash-flow neutral after the dividend (although 2020/1 is another story). $40 WTI for any extended period of time is just plain ugly for the equities as the entire compounding FCF/return of capital narrative for the sector evaporates at these prices. However, leverage and production for the larger capitalized E& P companies are, we believe, manageable which speaks, we believe, to the durability of these companies (at least over the nearer-term) and justifies an even more pronounced schism between the haves and have nots. Fortress balance sheets, low costs, favourable hedges, are all structural advantages.

Financial Sector

Nothing significant to report.

Activist Influenced Companies

Pershing Square Holdings, Ltd. – Bill Ackman said he has moved to protect the firm's $6.6 billion portfolio, which includes restaurant chain and hotel stocks, as the spread of the coronavirus has sparked prolonged panic selling in markets. Ackman said he expects the outbreak, which has been detected in roughly 80 countries, to weigh on growth in the United States and abroad and affect both stock and credit markets. Over the last 10 days, "we have taken steps to protect the portfolio from downward market volatility," wrote Ackman, who oversees Pershing Square Capital Management. "We believe that efforts to contain the coronavirus are likely to have a substantial negative impact on the U.S. and global economies, and on equity and credit markets," the statement said. Ackman said hedging was preferable to selling off his portfolio of companies whose businesses are otherwise strong and include Chipotle Mexican Grill, Inc., Hilton Worldwide Holdings Inc., home improvement chain Lowe's Companies, Inc., Burger King operator Restaurant Brands International Inc. and Berkshire Hathaway Inc., among others.

Dividend Payers

Nothing significant to report.

Economic Conditions

U.S. Nonfarm payrolls topped expectations by rising 273,000 in February and the prior two months' gains were revised up a total of 85,000. This raised the six-month average to 231,000, the highest since the second half of 2015. Private sector jobs rose 228,000, lifting the six-month trend to 208,000, the best since mid-2018. The pace of hiring was actually rising early this year despite worsening labour shortages. **That speaks to the fundamental health of the U.S. economy, in general, and consumers, in particular, before COVID-19** and at least suggests the economy is in good shape to rebound once it emerges from the hospital. We just don't know when that will be, or how bad things will get before then.

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U.S. non-manufacturing ISM rose for the third consecutive month, up 1.8 points (pts) in February (largest increase in one year) to 57.3, the highest reading since February 2019. Although **current production** slowed, businesses are still quite busy (the subindex was 57.8, the second highest pace in half a year). And there should be more coming down the road .... **new orders** jumped 6.9 pts (biggest increase since January 2018) to 63.1, the highest since July 2015. The backlog of orders is building up too (at 53.2). Anticipating the need for workers to fill the order books prompted the **employment** component to edge up to a half-year high of 55.6. But the coronavirus is disrupting the supply chain... supplier delivery delays were more delayed in February at 52.4 (from 51.7 in January), although less so compared to manufacturers (57.3).

The U.K. Report on Jobs for February shows further signs of improvement following a rather lacklustre performance for most of 2019. Permanent staff appointments rose again in February for the third successive month, the quickest increase in 14 months. Although only fractional, temporary billings fell for the second month, possibly due to the upcoming IR35 legislation. Candidate availability fell at the slowest rate since June 2013 and starting salary inflation picked up again in February, the highest in eight months for permanent staff. Overall, there are continued signs of improvement in hiring following the general election and Brexit. The degree to which this is a temporary release of pent up demand or something more sustainable will be a theme throughout 2020. An additional uncertainty for 2020 is the impact and influence COVID-19 may have on market confidence.

The International Monetary Fund (IMF) has announced $50 billion (£39 billion) in funding for countries hit by the coronavirus. The organisation also warned that the outbreak had already pushed this year's global economic growth below last year's levels. The emergency measure came after the virus has spread rapidly outside China to more than 70 countries. This week governments and central banks around the world have taken action to ease the impact of the virus. The IMF said it is making the money available to help poor and middle-income countries with weak health systems respond to the epidemic.

Canada - The Financial Post reported that some of Canada's biggest employers have begun imposing restrictions on staff and are crafting alternative working arrangements to ensure business continuity as the coronavirus continues to spread in North America. Among them is accounting firm Ernst & Young LLP (EY), which has placed limits on "non-essential international and domestic travel" on its 3,300 employees in Canada, in addition to asking staff to utilize "alternative ways of connecting" in getting their work done, according to a spokesperson. The company has also directed employees to defer travel to "countries at highest risk of coronavirus," specifically China, Hong Kong, Macau, Japan, South Korea and parts of Northern Italy. "EY people returning from those locations are required to abide by governmental recommendations for a 14-day self-quarantine period," said Camille Lariviere, the company's public relations specialist. At online retailer Shopify Inc., meanwhile, employees have been told to say home if they feel unwell or have travelled to a "high risk" region. Non-essential work travel is being cancelled and, last week, the company announced it was pulling the plug on Unite, its annual developer and partner conference due to COVID-19 concerns. Manulife Financial Corporation also told the Financial Post the company was encouraging employees to "work from home," in addition to ensuring "more frequent office cleaning." "If you are trying to limit the exposure of your employees getting sick, sure, it may make sense to have more telecommuting options," said Amesh Adalja, an infectious disease and public health specialist at the Johns Hopkins University Center for Health Security. "But I think it also depends on where you are in the world right now and what is going on in your community in terms of the virus spread."

Financial Conditions

U.S. - The Federal Reserve cut its benchmark rate by a half percentage point, delivering a booster shot to stem potential economic disruptions from the spreading coronavirus epidemic with its first between-meeting move since the financial crisis. The cut lowered the federal-funds rate to a range between 1% and 1.25%. The action was approved unanimously and the Federal Reserve in a statement held out the prospect for further stimulus. "The committee is closely monitoring developments and their implications for the economic outlook and will use its tools and act as appropriate to support the economy," the statement said.

Canada - 24 hours after the U.S. Federal Reserve rate cut, the Bank of Canada (BoC) has followed suit, lowering its policy interest rate 50 basis points (bps) to 1.25%. This marks the first rate cut from the BoC since 2015 and its first 50 bps easing since March 2009 (when the global financial crisis raged). So it's an aggressive move, but one many were primed for post-Fed. In justifying its decision, the BoC(to no surprise) highlighted coronavirus risks. COVID-19 amounts to a "material negative shock", which has led to reduced business activity and supply chain disruptions. The BoC points to corresponding weakness in commodity prices and a generalized re-pricing of risk (across most asset classes) which has eroded financial conditions. There's an expectation that activity will be further depressed as the virus spreads. In terms of domestic economic conditions, the BoC notes that while Q4 growth was in line with their forecast, the composition somewhat surprised (e.g., consumption/ housing investment stronger; business investment/exports weaker). It's increasingly clear to the BoC that Q1 will be weaker than previously assumed, with weaker terms of trade (if sustained) expected to weigh on income. Activity is being further impacted by rail blockades, Ontario teacher's strikes and winter storms. Inflation remains around 2%, "consistent with an economy that has been operating close to potential". The Bank left the door wide open to further easing, indicating that they "stand ready to adjust monetary policy further if required". Also noteworthy, the central bank is indicting that it stands ready to provide the financial system with sufficient liquidity "if needed".

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Australia - The Reserve Bank of Australia cut rates 25 bps (more or less as expected although some were looking for 50 bps) and stated they would do more as required. The Australian government also pledged fiscal stimulus to help the economy. The Australian economy will need both fiscal and further monetary stimulus to recover from the wildfires, the slowdown in China and coronavirus. Australian building permits numbers dropped -15.3% last month (January) vs. expectations of +1% increase.

Christine Lagarde, president of the European Central Bank (ECB), has said it is "ready to take appropriate and targeted measures" to address the economic impact of the coronavirus, signalling a growing willingness to intervene. The statement by Ms. Lagarde, issued after an executive board meeting of the ECB, marks an escalation in the central bank's communications about the deadly virus, which threatens to drag the eurozone economy into recession. "The coronavirus outbreak is a fast developing situation, which creates risks for the economic outlook and the functioning of financial markets," said Ms. Lagarde, facing her first major test since she took over as ECB president in November.

Mark Carney has signalled that the Bank of England (BoE) would be prepared to cut interest rates and allow banks to use "rainy day" funds to soften the impact of the coronavirus outbreak on the UK economy. Giving evidence to the parliamentary Treasury committee, the outgoing BoE governor said the central bank's role was "to help UK businesses and households manage through an economic shock that could prove large but will ultimately be temporary". "We don't want viable businesses to go out of business because of the very necessary steps that need to be taken to protect and serve the British public," he told the committee. "Supply disruption, as opposed to permanent impairment of supply, is important."

The U.S. 2-year/10-year treasury spread is now 0.17% and the U.K.'s 2-year/10-year treasury spread is 0.08% - 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 3.29% (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. 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 41.94 (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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