News Highlights

Owners. Operators. And Insightful Investors.

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

Established in 2007

PORTLAND INVESTMENT COUNSEL®

Our views on economic and other events and their expected impact on investments. May 28, 2018

Owner Operated Companies

Alphabet Inc. – Google has reportedly beat Amazon.com, Inc. for the first time as the search giant shipped 3.2 million units of its Home and Mini devices globally, compared to 2.5 million units of Echo devices shipped worldwide in Q1 2018. Smart speakers are the fastest-growing consumer technology segment, with year/year growth of 210% in Q1. The total shipments reached nine million units. This is the first time that Google has replaced Amazon to take the top spot in the segment, which has been dominated by Amazon so far. Alibaba Group Holding Limited took the third position in the worldwide smart speaker shipments, while retaining its number one position in China. The company shipped a total of 1.1 million Tmall Genie speaker units in China in Q1 2018. Xiaomi took the second spot in China in Q1 as it shipped over 600,000 units of its Xiao AI speakers.

Energy Sector

Cardinal Energy Ltd. – We had the opportunity to re-connect with the management of Cardinal last week and review the investment case for the company in the improved commodity environment. The company is maintaining its focus on improving its cost structure, most recently by reducing its reliance on on-grid electricity for its production equipment by switching to self-cogeneration utilizing its natural gas by-product resource. Longer term, Cardinal continues to leverage its best-in-class low base production decline rate to pay (and likely increase) a sustainable dividend and modestly increase production per share. In a $65/barrel (bbl) West Texas Intermediate (WTI) crude oil price environment, Cardinal expects to generate about $175 million of cash flows for 2019, of which about $50 million would be allocated to maintaining and slightly increasing production and about $50 million to pay its dividend, which currently yields over 7.5%. A couple of well-timed acquisitions in the past twelve months allowed the company to significantly increase its overall production and decrease its reliance on medium grade crude oil by adding significant light oil production and resources. Going forward, the company's acquisitions are likely to be significantly smaller, bolting on the existing core production areas. Cardinal is aiming to reduce its debt to cash flow ratio to about 1x, which is likely to occur at the current pace sometime in early 2019 and further to about 0.5x the company's cash flow, which is in-line with its historical levels.

Financial Sector

Barclays PLC - John McFarlane, Barclays' chairman, is understood to have explored a bid for Standard Chartered PLC the emerging markets-focused bank and held informal conversations about it. However, the two banks are battling to play down expectations of a merger. Mr. McFarlane's position, which is supported by at least one other senior board member, puts him at odds with Jes Staley. Mr. McFarlane has been privately considering options for Barclays, including potential tie-ups with rivals as an alternative strategy, putting him at odds not just with Mr. Bramson, but the chief executive. Some of Mr. Staley's closest allies, many of whom are colleagues brought over from his former employer, JP Morgan Chase & Co., are understood to have become increasingly exasperated at the behaviour of the board.

Canadian Imperial Bank Commerce (CIBC) reported Q2 2018 adjusted EPS of $2.95, well ahead of consensus of $2.81. We would highlight that taxes were slightly lower than anticipated (tax loss carryforward for an undisclosed amount). Total adjusted revenues were $4,414 million for the quarter, modestly lower than forecast of $4,496 million. Lower revenues relative to our forecast were mainly driven by lower core net interest income. Adjusted non-interest expenses came in at $2,467 million versus our $2,487 million forecast, as cost / income efficiency at the all-bank level as 55.9%. Total Provisions for Credit Losses were $212 million this quarter, relatively in line with forecast. Canada Personal and Commercial (P&C) real estate secured personal lending growth slowed to approximately +7.5% year/year compared to approximately +10% year/year last quarter, while net interest margins were up 3 basis points (bps) sequentially to 2.41%. The bank's CET 1 ratio was 11.2%, up approximately 40 bps quarter/quarter. CIBC also announced its intention to seek approval for a normal course issuer bid (NCIB) to repurchase up to a maximum of 9 million (approximately 2%) of its common shares outstanding.

Royal Bank of Canada (RBC) reported Q2 2018 core cash EPS of $2.10 vs. consensus estimate of $2.05. The beat was driven by lower than forecasted provisions for credit losses, which added $0.03. Canadian P&C delivers good growth, with better than expected margin expansion; whereas Capital Markets experienced a relatively weak quarter, with negative pre-tax pre-provision profit growth in our view. The bank's CET 1 ratio of 10.9% was lower than expected and was down 10 bps quarter/quarter as the bank experienced higher Basel III Risk Weighted Asset risk parameters and share buybacks.

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

The Toronto-Dominion Bank (TD) reported adjusted cash EPS of $1.62 (+21% year/year), above consensus of $1.50 (+8% beat). Higher revenue, lower expenses and an elevated tax rate contribute to the quality of the beat. All segments demonstrated solid adjusted earnings growth, highlighted by a very strong Canadian Retail (+17% year/year), and U.S. Retail performance (+21%; in USD). TD's CET 1 capital of 11.8% (up 120 bps quarter/quarter, mainly due to the revised capital floor adjusted) puts the bank in one of the strongest capital positions in Canada, in our view, and gives TD significant flexibility in terms of acquisitions which we believe will be focused in the U.S. market. Total bank Provisions for Credit Losses were $556 million vs. consensus of $597 million driven by Canadian Retail. Similar to peers, TD cites the current credit environment as stable.

U.S. House Passes S.2155 – Economic Growth, Regulatory Relief, and Consumer Protection Act: The House last week passed a bipartisan bill that eases some elements of the Dodd-Frank Act. The bill, which passed the Senate in March, moved through the House without changes and will now go to the President for signing. Key elements of the bill include:

- The bill lifts the Systemically Important Financial Institutions asset threshold from $50 billion to $250 billion. Banks with assets between $50 billion and $100 billion would become immediately exempt from EPS (enhanced prudential standards), while banks with assets between $100 billion and $250 billion would become exempt after an 18-month waiting period, although the Fed would still retain authority to apply EPS at its discretion. We note that the new asset threshold would not apply to banks with global assets above $100 billion.
- Banks with more than $250 billion in assets would conduct company-run stress tests on a periodic basis from an annual basis, while Fed-run stress tests remain unchanged. Banks with $100–$250 billion in assets would be exempt from company-run stress tests but still have Fed -run stress tests on a periodic basis. Banks with less than $100 billion would have no company - or Fed-run stress tests.
- Custody banks, defined by the bill as banks predominantly engaged in custody, safekeeping, and asset servicing activities, would no longer have to hold capital against funds deposited at certain central banks to meet the Supplementary Leverage Ratio (SLR). They may exempt deposits up to an amount equal to their assets under custody. Under the current SLR, the same amount of capital must be held against any asset, irrespective of risk.
- The Senate bill provides an exemption from the Volcker rule for banks with assets not exceeding $10 billion, and with total trading assets and liabilities not exceeding 5% of their total assets.
- Banks and credit unions with assets of less than $10 billion would face more relaxed regulatory rules for mortgages and would be allowed to treat any held on the balance sheet as qualified mortgages.

Activist Influenced Companies

Pershing Square Holdings, Ltd. – Billionaire investor William Ackman said that his hedge fund had taken a roughly $1 billion stake in Lowe's Companies, Inc., revealing his third large investment this year. The news came hours after Lowe's affirmed its annual financial targets but reported slightly weaker-than-expected first-quarter results. One day earlier, Lowe's announced top management changes, naming J.C. Penney Chief Executive Marvin Ellison to replace CEO Robert Niblock, who will retire in July. In January, Ackman announced an investment in Nike, Inc. which he exited months later with a $100 million profit. He also exited his long-standing bet against Herbalife Nutrition and said his firm had made a new investment in United Technologies Corporation. Somewhat longer standing investments in Chipotle Mexican Grill, Inc. Inc. and Automatic Data Processing, Inc. have contributed to recent gains. With Lowe's, Ackman supports Ellison and is not seeking a board seat for Pershing Square. Earlier this year Lowe's reached a settlement with hedge fund D.E. Shaw & Co., L.P., which has a roughly $1 billion stake in Lowe's, to put three new directors on the board. Marvin Ellison, who became J.C. Penney's CEO in 2015, was a senior executive at Lowe's chief rival Home Depot a decade ago. In its quarterly results, Lowe's brushed aside lower-than-expected same-store sales as driven chiefly by cold weather. A prolonged winter in some U.S. states hit demand for outdoor products at Lowe's in the February-April period, but the company was optimistic about making up for lost business.

Dividend Payers

Aryzta AG reported -1.2% organic growth in Q3 on the back of a significant volume drop of -5% in Europe (insourcing in Switzerland and Germany, weak consumer spending in the U.K.). Excluding Cloverhill, organic growth amounted to -1.3%, following 1.4% in Q2 and 1.3% in Q1. Sales growth in North America was relatively stable at -1.5% excluding Cloverhill. Higher input, distribution and labour costs continued to weight during Q3. In addition, Aryzta was facing the pain of insourcing and low utilization rates in some factories. Aryzta guides 2018 EBITDA to be 9-12% lower than previous guidance of -20%. We understand that Aryzta is targeting EBITDA of between €295 million to €305 million, respectively a drop of around 30%. Aryzta has initiated a cost reduction plan of €200 million over three years. Implementation to start immediately with the aim of: 1) restore financing flexibility; 2) improve asset and cost base to its current revenue run rate.

Roche Holdings AG forwarded after Swiss market closure a press release issued by AbbVie Inc. reporting that the Phase 3 iLLUMINATE (PCYC-1130) trial met its primary endpoint of improvement in progression-free survival (PFS): The study evaluated

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

IMBRUVICA (ibrutinib) in combination with Roche's GAZYVA (obinutuzumab) in previously untreated chronic lymphocytic leukaemia or small lymphocytic lymphoma (CLL/SLL) patients, the most common adult leukaemia. Specifically, the study met its primary endpoint for a clinically and statistically significant difference in PFS for patients treated with IMBRUVICA plus GAZYVA versus those who received chlorambucil plus GAZYVA, as assessed by an Independent Review Committee (IRC). Pharmacyclics and Janssen are sharing the primary analysis data from the study with regulatory authorities and plan to present the data in a future publication or medical congress. We expect that these results will support Roche's sales of GAZYVA in CLL, all the more as the study results reported here by Abbvie promise that, if approved by U.S. Food & Drug Administration, IMBRUVICA plus GAZYVA could be the first chemotherapy-free CD20 combination in first-line CLL treatment (in second line, already Roche's MURANO study results indicated that Venclexta/Venclyxto (venetoclax) plus MabThera/Rituxan has the potential to provide an important new chemotherapy-free option for people with previously treated chronic lymphocytic leukaemia). We expect that key data will be reported by AbbVie at this year's ASH conference.

Economic Conditions

U.S. durable goods orders were down 1.7% in April, exceeding the expected 1.4% pull-back. The drop was chiefly driven by the notoriously bulky orders in aircraft production. The core figure, which excludes orders in the defence industry as well as orders in the transportation sector, was actually up 1.0%, ahead of the expectations for a 0.7% advance. Computer related orders were up 5.3% in the month, followed by orders for electrical equipment and appliances, at 2.6% and communications at 1.6%. General machinery orders, on the other hand, were down 0.8% in April.

U.S. existing home sales fell 2.5% in April to 5.46 million units annualized. That's the first decline in three months and the lowest since January. The drop spanned nearly all regions of the country (the Midwest was flat). Singles fell for the first time in three months (down 3%) while condos increased (+1.6%) but obviously not enough. More homes were put on the market in April …. the number of homes available to be bought jumped 9.8% but that series is not seasonally adjusted and it is the spring selling season. That helped alleviate some of the strains on the market but they're still down 6.8% from a year ago. The **months' supply** rose to 4.0, the highest since September 2017 but still below normal. In other words, inventories are still lean but not as mean as they once were. First-timers stepped in, pushing their share of sales to 33%, the highest since May 2017.

Italian financial markets are not taking the possibility of yet another election in Italy before the end of the year very well this Monday morning. It is not a done deal but it is possible after President Mattarella, over the weekend, couldn't bring himself to accept PM Giuseppe/the coalition's recommendation for the all-important Economy Minister role. He rejected Paolo Savona for the job, despite his previous experience with the Bank of Italy. Rather, it was due to his well-documented anti-euro views (referring to the euro as a "German cage" and a "flawed project"). Indeed, it was the prospect of Mr. Savona having such a powerful role in Italy that saw Italian bond yields march higher, particularly on Friday. Today, yields for 10-years surged 20 bps to as high as 2.68%, the highest since August 2014 (and are 222 bps above German bonds, the widest since January 2014), while 2-years jumped over 30 bps, and are hovering around 0.8%. PM Giuseppe, after spending a week as Italy's leader, resigned yesterday as he was unable to fulfill his mandate of putting a government together. So, for the first time in history, another person has been brought in—former IMF official Carlo Cottarelli—to form a government. First, he needs to pass a confidence vote and if he fails (a strong likelihood), then he has to carry the 'government' through to the next election in the fall of 2018 or in early 2019. Clearly, the two populist parties are livid: the Five Star Movement and the Brothers of Italy are calling for President Mattarella's impeachment under Article 90 while the Northern League wants another election.

Spain's parliament is currently having a **no-confidence vote**. The main opposition party, the Socialists, with support from the centrist Ciudadanos, are pushing for new elections following scandals involving members of PM Rajoy's party, the People's Party. (Note that Spain is 4th largest in the Euro Area, after Italy.)

Financial Conditions

Italy - Moody's, the rating agency, is putting Italy's Baa2 rating on review for downgrade which may have served as a wakeup call for the government over the week-end, with the message being that they should stick to the EU budgetary rules. Or, at least, not stray too far from them, or risk being punished by global investors.

The U.S. 2 year/10 year treasury spread is now .46% and the U.K.'s 2 year/10 year treasury spread is .63% - 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.

Influenced by the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.66% (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 4.0 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

Phone: 1-888-710-4242
Web: www.portlandic.com
Email: info@portlandic.com

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 13.22 (compares to a post-recession low of 9.52 achieved in early November) 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:

- Bay & Scollard Development Trust
- Portland Advantage Plus - Everest and McKinley Funds
- Portland Focused Plus Fund LP
- Portland Focused Plus Fund
- Portland Global Aristocrats Plus Fund
- Portland Global Energy Efficiency and Renewable Energy Fund LP
- Portland Global Sustainable Evergreen Fund
- Portland Global Sustainable Evergreen LP
- Portland Private Growth Fund
- Portland Private Income Fund
- Portland Special Opportunities Fund
- Portland Value Plus Fund

Individual Discretionary Managed Account Models - SMA

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

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.

Portland Investment Counsel Inc. portlandinvestmentcounsel Portland Investment Counsel Inc. @PortlandCounsel

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, 'ROE' return on equity, 'ROTE' return on common equity.

Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

PIC18-039-E(05/18)