Market Commentary

PORTLAND INVESTMENT COUNSEL™

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Global Regulation: update

Canada's financial services regulator has opened the door for the country's big banks to pursue acquisitions and raise their dividends after a three-year hiatus. The Superintendent of Financial Institutions told the banks in a memo that in light of "greater certainty as to reform of capital rules" it was lifting restrictions on transactions that could impair their capital, which were imposed at the height of the financial crisis. Thus, we expect banks to proceed cautiously on all new capital actions such as dividend raises, share buybacks, and acquisitions.

The Financial Times wrote last Friday that the full impact of the new capital rules is likely to be 30% tougher than the headlines suggests due to the committee narrowing the definition of what can be called Core Tier 1. This is not 'news'. We had already understood that certain categories of capital (for instance deferred tax assets and mortgage service rights) were to be kept to a reduced percentage of permitted capital. Essentially, we have to remember that banks can control both the numerator (capital) and denominator (risk weighted assets) of the capital reserve ratios and have been given several years in which to implement. Crucially, they now have better clarity in how to manage their capital. For instance ……

JP Morgan : CEO Jamie Dimon at last week's Barclay's conference indicated JPM have continued with their share buyback this quarter. For their second quarter they cited they had bought almost $500mill worth of stock, but Jamie Dimon noted at the conference that they had continued with buybacks, buying in total $2.5bill worth of stock. It's not especially meaningful in terms of EPS, maybe only $.01 or $.02, but is is a strong signal that regulators are comfortable with their capital position.

Wholesale funding continues to improve:

Royal Bank of Scotland: plans to issue $7.2 billion of mortgage-backed securities in its first public sale of the debt since 2007. The sale highlights recovery in the asset-backed markets and marks a significant step for RBS as it seeks to rebalance funding sources in the wake of the credit crisis. …. similarly ….

Lloyds looking to issue 30yr bonds priced at about 250bps above gilts. Debt markets continue to open up for banks and Lloyds have recently been talking about opening up the RMBS market in the UK again. As funding concerns decline market continues to focus on the improving margins and potential capital return from Lloyds.

News Highlights on Current Holdings

Financial Services Companies

American Express and Discover Financial Services – last week both released August trust data that showed continued improvement in delinquencies consistent with our thesis that credit costs should steadily decline.

MasterCard authorized a share repurchase program of up to $1bn in its class A common stock in open market transactions.
MasterCard said an Memorandum of Understanding with China UnionPay may lead to future deals that improve merchant acceptance of MasterCard customers travelling to China and for UnionPay cardholders abroad. Visa recently clashed with UnionPay in June when it told banks and merchants to use its system to process China card transactions. UnionPay countered that Visa doesn't have the right to block dual-currency cards abroad.

AXA: National Australia Bank has confirmed the agreement for it to acquire the Australian and New Zealand businesses of AXA Asia Pacific has been terminated. This is not a surprise following the rejection of the NAB-AXA Asian Pacific deal from the Australian regulators. The Australian regulators rejected the deal for antitrust reasons. We now await a response from AMP the other bidder in the process.

Resolution has completed the £2.75bn acquisition (£2.25bn cash) of the AXA's UK life businesses comprising protection, corporate benefits and annuities.

AXA will extend their presence in Emerging markets according to CEO Henri De Castries in a Les Echoes interview "We won't target all markets and we are not limiting ourselves to Asia" he said.

Barclays Capital is acting as financial advisor to Discover Financial Services in their potential acquisition of The Student Loan Corp.

Barclays: is also understood to be looking at ways to ring-fence its deposits and is considering whether to put its investment banking arm Barclays Capital into a separate legal entity to try and head off more Government measures.

Royal Bank of Scotland Group has reached an agreement to form a Chinese securities firm, paving the way for the U.K.'s biggest state-owned bank to manage domestic share sales in China. RBS would hold 33% of the venture.

Bank of America CEO Moynihan told investors at the Barclays NY conference that the bank is aiming for more modest and less volatile profits as a smaller bank focused on returning profits to shareholders, instead of growth earnings and assets before the financial crisis. The bank is also aiming to increase cross-selling of Merrill Lynch investment products to existing bank customers. HSBC said it will sell 80.1% of HSBC Private Equity Asia (HPEA) to members of the firm's current management team HPEA is expected to have consolidated gross assets of about US$18.8 million at completion. HSBC will retain a 19.9% interest.

Credit Suisse announced that its Asset Management division has agreed to acquire a minority interest in New York-based York Capital Management for an initial CHF425m. There may be additional, unspecified earn-out payments depending on York's five-year financial performance of York. Credit Suisse argues to give its clients access to the independently managed products by York which focuses on event-driven and credit strategies. York has USDS14bn of assets under management. Closing depending on regulatory approval to be expected for 4Q10. With banks studying the new Dodd-Frank act prohibiting banks from contributing more than 3% of capital to a hedge fund, managing director Ravi Singh, said the bank's purchase works under the new rules as Credit Suisse are buying a non controlling stake.

Santander values its UK business at about £20bn according to Expansion. An eventual sale of a 20% stake could raise 4Bn as the company finances acquisitions in the UK, Germany and Poland although we believe an IPO of the UK business is unlikely to happen earlier than Spring 2011.

Unicredit – will likely reduce the number of job cuts in its 2010 to 2013 restructuring plan to 3,000 from more than 4,000.

Royal Bank of Canada : Moody's placed the ratings on Royal Bank of Canada's Aaa rating on review for possible downgrade. The rating agency stated that the review will focus on the bank's commitment to capital markets and its growth plans for the business.

Macquarie has agreed to buy Presido Partners a New York-based real estate advisory (private capital raisings and advisory) for an undisclosed sum to stretch its reach in that sector to the US and Europe.

Scourge on short selling : It is reported by Bloomberg that naked short sales of shares and government bonds would be limited and some OTC derivates forced through clearing houses, under European Commission proposals.

Dividend Paying Companies

Posco – Posco has hired five foreign banks to manage and overseas bonds sale in order to finance its recent string of acquisitions and expansion plans. The five banks are Bank of America Merrill Lynch, BNP Paribas, Deutsche Bank, Morgan Stanley and Goldman Sachs. The timing and scale of the bond issuance has not been announced yet.

Steel Authority of India Ltd. (SAIL) announced that a deal to build a 1.5 million tonnes steel mill in India could be signed with Posco in a couple of months. Construction would start shortly after the contract is signed as land is already available in the state of Jharkhand, near SAIL's existing facility at Bokaro. This would provide Posco with direct exposure to the fast growing Indian steel market, estimated to rise at about 9% a year.

Posco announced it had started operations at its first auto sheet metal plant in United States located in Alabama and having a production capacity of 120,000 tonnes per year. The plant would supply a number of Japanese and Korean manufacturers including Toyota, Honda, Hyundai and Kia.

BHP – A decision regarding the proposed iron ore production joint venture between BHP Billiton and Rio Tinto by the Australian Competition and Consumer Commission (ACCC) has been further postponed, this time at the request of the companies.

BHP announced it will support the proposed Mining Resources Tax as per the bargaining agreement between the key iron ore and coal miners and the premier Gillard's Labor party. The tax, much diluted compared to its original design by the former premier Kevin Rudd, would in essence affect future projects by taxing at a 30% rate, the return in excess of a rate of return equal to the Australian 10 year treasury bond plus 7%, the equivalent of about 12-13%.

In relation to BHP's bid for Potash Corp's assets, Potash's management is in talks with a variety of investors to undertake a management buyout of the company, with the large support of Sinochem, the government backed Chinese chemical industry giant. The buyout would also involve a number of sovereign wealth funds and possibly some industry insiders such as Mosaic. Commentators see the tentative buyout proposal as a desperate attempt to determine BHP to raise its bid after a 'white knight' (competing bid from a reputable organization) has failed to come through. Needless to say, Canadian regulators, both at provincial and federal level, would not look favourably on a deal which would put a Chinese government backed organization in control of a key national resource.

Siemens – A venture of Siemens and GS Engineering and Construction of Korea received a $1.3bn order to build two 750 MW power plants in Oman.

Carrefour – Carrefour unveiled its plans to re-invent the hypermarket during an analyst presentation in Lyon, France, last week. The group had set up five pilot stores in France, Spain and Belgium and tested the new retail concepts for a few weeks before revealing its chain wide renewal plans. The new store concept aims to shifting the focus from the 'everything under the same roof' paradigm to a more nuanced retail approach where the hypermarket would become a destination for people looking for fresh and quality, good deals on packaged grocery, and more spacious user friendly specialist areas in key categories such as beauty, baby, fashion, home, multimedia and leisure. The offering would be overlaid with a wide array of services including nursery, cooking classes, snacking areas and events.

The group expects to convert or remodel a number of 500 stores in France, Spain, Italy, Belgium and Greece by 2013. The roll-out is expected to cost €1.5bn and is expected to lead to incremental sales growth of 18% over the 2010-2015 period and additional core earnings before interest and taxes (EBIT) of €315mm by 2013 and €650mm by 2015.The analyst community was pleased with the new concept and encouraged by the ambitious targets, the company's stock rallying on the event.

Economic Activity, Consumer and Business Conditions

US – The retail sales in US grew a 0.4% month on month, better than the expected 0.3%, helped by the back to school purchases in clothing, as well as an increased expenditure on groceries as food prices started picking up. The automotive sales dragged the headline figure lower, with retail sales excluding motor vehicles and parts being 0.6% higher month on month in August, double the expected rate of growth of 0.3%.

The US industrial production was virtually flat, up only 0.1% month on month in August, with auto and furniture/appliances production components underperforming, being offset by good performance in the business equipment manufacturing. The capacity utilization is virtually flat at 74.7% up from the revised July figure of 74.6%, still way of from its normal low to mid 80% level.

The US headline Consumer Price Index (CPI) had a 0.3% higher reading in August versus July, mainly as a result of higher gasoline and food prices. Year on year headline inflation moved lower to 1.1%. The core CPI, which removes the effects of energy and food prices, was flat in August compared to July and kept the yearly rate at a worryingly low 0.9% level. The next few months will be key for determining whether the deflationary trends will continue to impede a normalization of US monetary policy.

The US Consumer Sentiment preliminary reading for September revealed an unexpectedly low level of confidence at 66.6, just as the consensus was calling for an improvement to 70.0. While the current conditions reading kept steady, the expectations component actually retreated, suggesting tough times for the retail environment in the short term. The National Association of Home Builders (NAHB) Housing Market Index's reading for September stayed flat at the very depressed level of 13, while the traffic of prospective buyers component inched lower to the 9 level and is dangerously close to its historical low.

Canada – A mixed bag of economic indicators was revealed last week in Canada. The labour productivity has returned to its proverbial poor performance with a 0.8% (or 3% annual rate) retreat in the second quarter, beating even the gloomy consensus of a 0.5% retreat. The manufacturing sector however is continuing its recovery process, with Canadian capacity utilization at 76% in the second quarter, considerably higher than the 74.2% figure in the first quarter of the year, yet still considerably lower than its about 85% historical average.

Financial Conditions

Policymakers continue to accommodate a recovery in bank profits, albeit less than 6 months ago. The U.S. 2 year/10 year treasury spread is 2.25% and the U.K.'s 2 year/10 year treasury spread is 2.42% - enabling financial services companies' assets booked at these levels, to be profitable.

Our concerns are mostly focused around the later cycle issues facing financial services companies – particularly commercial real estate and unsecured consumer loans/credit card loans. However, commercial real estate exposure is more acutely held by US, Spanish and German regional banks (as identified in the European stress tests) – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (125 to-date in 2010) and we expect will exceed last year's 140 which was the highest annual tally since 1992. This supports our view that franchises are being acquired/absorbed as convergence of the financial services industry accelerates – favouring we believe the stronger, better managed banks. Typically banks acquiring collapsed bank franchises from the Federal Deposit Insurance Corporation (FDIC) are paying little or no premium for deposits, assets are purchased at a discount and are covered by loss sharing agreements – so that such deals can be expected to be immediately accretive to earnings per share. The FDIC changed the loss share arrangement on assisted deals from absorbing 95% of losses down to absorbing 80% although this is still attractive to acquiring banks it does probably lower the Internal Rate of Return.

The U.S. 30 year mortgage market has remained low and has now fallen back to 4.37% - (the lowest rate since the Federal Reserve began tracking rates in 1971 was in August at 4.32%), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 12.5 months supply of existing houses – much higher than what we believe is a more normal range of 4-6 months. We believe it remains premature to consider a recovery in house prices but a measure of stability from which to build is welcomed…. particularly for those financial services companies holding such assets in their portfolios.
A concern which remains is the extent to which loan modifications are an exercise in loss deferral but for the larger franchises the quantum of proactive provisioning continues to act as a differentiator of quality which we believe has still to be fully appreciated.

The VIX (volatility index) is 22.01, which is below the levels experienced prior to the ECB bail out and substantially lower than last August/September. While, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

We believe the next few years will highlight the growing polarization between strong and weak institutions. Companies that have capital strength will buy assets from those required to divest. Companies that have a strong presence in emerging markets will likely grow quicker than those that do not. Banks that have strong retail deposit franchises will take market share from those that rely on wholesale markets to fund loan growth at attractive margins. We believe the Funds we manage are extremely well positioned to benefit from the strength of their portfolios of strong, dominant, attractively priced financial services companies.

Closed-End Funds

Spreads on the closed-end funds are narrowing but remain, in our view, very attractively priced to purchase.

The Portland Investment Counsel Inc. 2009 Closed End Annual Reports are now available on the web site. Below you can find the link to access the closed end annual report.
http://www.portlandic.com/Info.aspx?disp=Financial_Reports

At the close of business on Fridays and at the end of each month we publish the Net Asset Values (NAV) of our funds onto our Portland website at http://www.portlandic.com/Funds/WeeklyPricing.aspx. The NAV for the AIC Global Financial Split Corp. can be found on the AIC/Manulife website at http://www.aic.com/EN/PricePerformance/AICClosedEndFunds/Pages/Price.aspx and the Copernican World Financial Infrastructure Trust, Copernican World Banks Split Inc. and the Copernican International Financial Split Corp. can be found on the Copernican website at http://www.copernicancapital.com/Funds/WeeklyPricing.aspx.

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