Market Commentary

PORTLAND INVESTMENT COUNSEL™

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Loan Growth

Last Thursday, the Fed released its data of consumer credit outstanding through the end of August. **Revolving (credit card) balances INCREASED $0.5B (0.7% annualized) in August on a NON-SEASONALLY adjusted basis,** which compares to a $1.5B drop in July. August is one of the stronger months for credit growth seasonally (13% avg annualized growth from 1996-2007), so this month's growth in balances isn't that surprising. Outstanding debt was revised downwards by $0.6B in July, meaning that loan balances contracted slightly more than previously thought. Year-over-year, August balances fell 9%, a slightly slower pace of decline than July (9.3%). Non-revolving consumer credit (mostly auto loans) increased $1.6B in August.

We believe that much of the decline in revolving debt outstanding has been due to charge-offs. Ultimately, we expect that the growth rate in credit card balances should follow card spend trends with a 1-2 year lag. We believe that loan balances might already have bottomed in 2Q10, and that balances could begin to show sustained growth (excluding purchased portfolios) in early-mid 2011.

News Highlights on Current Holdings

Financial Services Companies

Barclays: Nomura has sold 220M shares of Barclays 295p for hedging activities on behalf of PCP Gulf Invest 3 Ltd. the investment fund of Abu Dhabi's Sheikh Mansour bin Zayed al Nahyan (perhaps now better known as the owner of Manchester City football club). The hedge removes a large part of Sheikh Mansour's economic exposure to the Barclays stake bought in the complex recapitalisation of the bank by Middle Eastern investors in October 2008, and involves the conversion of PCP Gulf Invest 3's remaining 131.6m warrants in Barclays bringing their total holding to 758 million shares of which last week they disposed of 220m shares through Nomura. The warrant exercise by PCP adds 6.6bps to Core Tier 1 for Barclays. Coverage was 1.5x on the transaction. There are a couple of structures that Nomura could have used to hedge including a variable pre-paid forward (almost complete hedge on part of exposure) or a long-dated collar. The key question mark is whether Nomura needs to continually adjust this hedge which could result in some strong technical moves and high volatility….obviously the sale of 220 million shares has been a burden on the Barclays share price.

Barclays is understood to be planning to take a stake, valued at about $120mln in Intelenet an Indian company providing back-office services which is partly owned by Blackstone Group. Barclays will apparently award contracts for at least five years to Intelenet instead of paying cash for the stake.

Bank of America, the country's largest mortgage lender by assets, said last week that it was reviewing documents in all of its pending foreclosure cases to evaluate if there were errors made. It is the third major lender in the past two weeks to say it was freezing foreclosures in the 23 states where the process is controlled by courts.

Bank of America and Fidelity National have reached an agreement on foreclosure warranties to cover the title insurer's costs in the event of an error in the bank's processing of foreclosure documents, this is a step in lifting the overhang of the mortgage moratorium and concerns about mortgage volumes and the impact to title stocks.

Bank of America is stated to exit the wholesale mortgage-lending business, limiting its dealings with mortgage brokers as it focuses on loans made with consumers and large community banks.

Nomura Securities International last week opened its new equity-trading floor in New York and launched its U.S. stock-research coverage, continuing its push to gain market share in the Americas.

Lloyds, Royal Bank of Scotland, HSBC, Barclays, Santander UK and Standard Chartered are injecting £150m-£200m apiece over the course of a few years into a £1bln fund, designed to help recapitalise financially stretched smaller businesses bridge the "equity gap" in order to obtain credit more easily. This is an effort by the banks to improve their current public image whilst being seen as lending to SME's.

Royal Bank of Scotland has sold its North American gas and power trading book from a joint venture between itself and Sempra Energy to JPMorgan for $220m making the US bank one of North America's largest natural gas traders. JPMorgan completed the $1.7bln purchase of the metals, oil and European power and gas business from RBS and Sempra in July.

Deutsche Bank capital raise completed. 99.31% of subscription rights were exercised (=306.51m new shares). The remaining 2.13m new shares (0.2% of total) were sold on the stock exchange. Gross proceeds amounted to EUR 10.2bn as expected.

Santander: Allied Irish Banks has launched the sale of its 22.4% stake in M&T Bank, valued at $2.2 billion, in a U.S. public offering. M&T Chief Executive Officer Robert Wilmers resigned from the board of Allied Irish yesterday ahead of the deal. The announcement would effectively be the last nail in the coffin for any Sovereign Bank (Santander's US unit) and M&T merger as Santander was originally expected to buy the stake. The Irish bank must dispose of the stake by the end of the year to comply with regulators. Morgan Stanley and Citigroup will underwrite the offering of notes, which will then be exchanged for M&T common stock following the requisite vote by AIB shareholders.

Sampo / Nordea: Press speculation that Sampo could buy 10% of the Swedish government's shareholding in Nordea. The Swedish government currently own 19.8% and hence this would represent a cost of c. SEK 5.6bn for Sampo and would take its stake to around 22%. This would be consistent with the company's strategy of wanting to increase its stake and is a transaction they could afford to do. It is also speculated that Mr. Wahlroos would like to become the Chairman of Nordea. He is already vice-Chairman. Concerns about a placing of the government stake in Nordea have weighed on the stock during and since the election.

Unicredit's new CEO Federico Ghizzoni confirmed the bank's plan to cut about 4,000 jobs in Italy over the next five years.

The major Australian banks are expected to increase their international expansion plans. The chairman of ANZ, John Morschel, and the chairman of National Australia Bank, Michael Chaney, last week stated that more Australian banks were likely to look offshore to develop growth plans.

BBVA is understood to be launching an aggressive bid to expand its investment banking in Latin America, Asia, and the US, with plans to hire about 1,000 in investment banking, sales, trading, and asset management over the next three years. It will also devote about Eur400m in building up its technology platform. The bank has already hired 300 bankers, including an M&A team in HK to focus on cross-border deals between China and Latin America through CITIC Bank, which it owns 15%.

TMX Group, operator of the Toronto stock exchange, is to launch an alternative trading system in Canada to attract high frequency traders and other new market entrants.

Visa / Mastercard announced last Monday settlement agreement with the Department of Justice.

In brief ….There is no monetary obligation associated with the settlement. Visa and MasterCard will now allow merchants to offer cardholders discounts when using a particular network card (Visa/MasterCard/Amex) or card product (rewards/non-rewards). American Express does not plan to settle the antitrust lawsuit on the premise that the rulings "would ultimately limit consumer choice, reduce competition, and curtail innovation." American Express are far more exposed to potential discount rate pressures as merchant fees account for nearly 60% of total revenues.

In more detail …Under the settlement, both companies are obligated to further relax their current discounting rules, this time allowing retailers to offer discounts that preference a particular card brand or even a particular card program. The new rules mean that in addition to current discounting practices, such as steering toward cash, merchants can promote different card networks by offering discounts (e.g., promote Discover over other networks, or preference non-rewards Visa-branded cards vs. Visa cards with rewards programs). We believe that discounting should have an only minor volume impact on Visa and MasterCard. Factors that should limit the impact of discounting include: higher likely adoption among smaller merchants that drive relatively little volume; the fact that current rules already allow discounting for check, cash and PIN debit on the Visa network but are not widely adopted; and potential consumer dissatisfaction with merchants who appear to be penalizing them for their choice of payment. American Express has decided to not settle the DOJ case, refusing to relax discounting rules…. It probably stands to lose the most if discounting across networks is allowed because its average credit interchange rate is potentially around 50-80 bps higher than that of Visa and MasterCard. Discounting could allow merchants to deter the usage of high interchange Amex cards.

Standard Chartered on Tuesday sought to take the moral high ground among the much maligned banking sector, launching the first of a series of reports on its social and economic impact around the world. The first report highlights Ghana – and the bank's estimated $400m positive impact on the Ghanaian economy, largely through corporate lending…. And there is also a section on what the bank could improve on, such as doing more to promote entrepreneurship and lending more widely across the small business part of the economy.
Dividend Paying Companies

BHP – A report commissioned by the province of Saskatchewan to Conference Board of Canada is favouring BHP's bid for Potash over a potential counterbid from a Chinese led consortium. The report however points out that a loss in revenue of C$2bn to

C$5.7bn over the next 10 years to the province of Saskatchewan is possible if BHP offer succeeds and the company ends up running existing Potash assets at full capacity while at the same time it continues developing its Jansen project, estimated to produce 8 million tonnes of potash annually. The report also cautions the province on opposing the BHP bid as a failed deal would depress Potash Corp's share price and hurt investment in the province. Later in the week BHP issued an update on the development of its own Jansen project and while it welcomed Conference Board of Canada's position, it added that the full extent of the benefits to the province was not captured. Some 2,900 full time jobs are expected to be created in the construction phase of the Jansen project, leading to about C$280mm in federal in provincial taxes, while the royalty streams over the life of the project are estimated to amount to about C$90bn, out of which 65% payable to the province of Saskatchewan. BHP letter ended by ironically pointing out that the transfer of a large number of highly paid management jobs out of Chicago to Saskatchewan is also likely to contribute to the province treasury.
The prospect of a competing Potash bid by Sinochem is getting dimmer, as the Chinese government revealed it would not provide financial backing for a potential deal.

The roughly A$116bn iron ore joint venture between BHP and Rio Tinto announced last December and which is still waiting for a number of regulatory approvals, seems to be unravelling as both parties found the process to be seriously interfering with their client relationships. Rio Tinto in particular is coming to realization that the initial joint venture framework could put the company at disadvantage as the roughly A$6bn equalization payments by BHP are seen as insufficient to balance the excess mining and transportation infrastructure Rio is bringing into the deal. A much improved financial position, boosted by high iron ore prices, compared to last year is also making the deal less compelling for Rio.

Seven&i – The Japanese retail giant reported Q2 and H1 results which showed good momentum, supported by a pick-up in the core convenience business. The second quarter, which ended in August, operating profit rose by 12%. The general merchandise and department stores are continuing to struggle as the Japanese consumer copes with the effects of a slow economic growth. The group kept its full year results guidance, an improvement of 5.9% over last year. The restructuring in the general merchandise and department stores is continuing and the company is shifting the focus abroad, with its bid for America's Casey's General Stores continuing.

Tesco – Tesco's first half results beat expectations by a large margin as the international businesses delivered robust sales and operating margin improvement, while the core UK business is showing signs of improvement. The group also announced it expects the troublesome US division to break even in the 2012/2013 fiscal year, much sooner than most analysts expected. In fact the company is re-iterating its commitment for the US business by stepping up its 'Fresh and Easy' store roll-out to about 2 openings a week, especially across California where the results have been most encouraging. Asia businesses were a major contributor to the company's profitability in the period, which was rounded up by property deals and decreased borrowing costs. The management also pointed out its sees a robust global recovery and is discounting fears of double dip. Food price inflation has picked-up globally and Tesco is guiding for a 3-4% increase in food pricing in UK.

Siemens – Siemens has emerged as the winner of the bid to supply 10 high speed trains to Eurostar, the operator of the Channel Tunnel, replacing the French champion Alstom, which has traditionally been the supplier of trains for the Tunnel. The contract is worth roughly $1bn and its award raised vehement protests from the French government who argued that Siemens trains are not up to the safety standards required by the operation of the Channel Tunnel.

Economic Activity, Consumer and Business Conditions

US – At the forefront of the economic news last week in US was the employment situation, with the key unemployment rate sticking to the 9.6% figure, as the nonfarm payroll employment came short 95,000 jobs on expectations of a slight 5,000 jobs gain. Most of the job cuts came from the public sector, yet the private sector disappointed as well, as the 64,000 jobs created in September were well below the average for the year. Key job detractors were manufacturing and construction, while jobs were added in the services sector, in particular education and food services. Part of the same report, the average weekly hours remained flat at 33.5, despite expectations of an increase to 34.2, while the average weekly earnings were flat as well with the consensus calling for a 0.2% monthly improvement. As such the report delivered mostly bad news regarding the US employment situation, with the only bright spot being the weekly initial jobless claims, retreating 10,000 persons, to 455,000 continuing an encouraging trend that seems to have taken hold over the last couple of months.

The US non-manufacturing sector is showing signs of strengthening after characteristically lagging the manufacturing sector throughout most of the early recovery. The Institute for Supply Management (ISM) non-manufacturing index moved higher to 53.2 in September, from 51.5 in August and higher compared to the expected 52.0 level. Numbers were improving in most services industries as well as in the new orders and the employment components.

The pending home sales index improved to 82.3 in August, better than expected, providing a breath of fresh air for the battered sector.

Canada – The Canadian housing and construction activity is weakening as the economic and regulatory environment is becoming less supportive. The housing starts retreated to the 186,400 units level in September, lead by a slowdown in Ontario's construction activity, while the building permits are down a whopping 9.2% in August compared to expectations of a less severe drop by only 2%.

Germany – Robust new orders growth in Germany, up by 3.4% in August, far exceeded the expectations of only a 0.8% monthly gain and helped alleviate some of the worries regarding global industrial production slow-down.

Financial Conditions

Funding: JPMorgan is understood to be ready to sell the largest Commercial Mortgage Backed Security offering this year. The top-ranked 10yr portion may yield 155bps above benchmark swaps rate, compared to 305bps on comparable bonds issued before 2008. The deal is the 7th this year and signals improving confidence in underlying quality in the commercial real estate market.

Financial Activity: Dealogic figures for the first nine months this year showed M&A activity was down 31% to $US75.3bn and that number is inflated by the $US58bn BHP-RIO joint venture, which is unlikely to happen. Equity capital market activity is down 70% to $US13.6bn, making it the quietest period since 2003. Debt capital market activity was down some 16%, but at US$96.6bn at least ranks as the second busiest period with 424 deals.

US TARP (Troubled asset relief program): Tim Geitner, US Treasury Secretary, says that the TARP – originally to cost $700 billion may in fact now cost less than $30 billion … with increasing expectations that the US taxpayer will break even or may even do better. However, the stimulus has yet to work through to rejuvenating homeowners (a clear goal was to preserve home ownership) – with house prices having stabilized at best – for now. And although bank lending is now expected to increase – the overall process will take time to deliver tangible results towards decreasing unemployment.

Ireland: Anglo Irish Bank has now accounted for 90% of Ireland's E 40 billion taxpayer-funded bail-out. However by putting a figure on the losses of Anglo Irish, the Irish Government is seeking to drawn a line under the banking crisis…. and so price its way back into the debt market.

Bank of Japan: the BOJ announced an array of small policy measures after its latest meeting, lowering the overnight call rate from 0.1% to 0.0-0.1%, and a mild commitment that the current policy will persist until the BOJ is forecasting price stability (i.e. deflation is defeated) as well as signalling a downgrade in its economic forecasts. Also, by buying up to Y5,000 billion ($60 bn) in financial assets this should help push down longer-term interest rates. The overall policy shift should be seen as an indirect attempt to support the government's fight against further yen strength. Part of the BOJ's problem is that it is doing things that it had previously said were undesirable, unnecessary or ineffective. Moreover, the BOJ is apparently acting reluctantly and emphasising the temporary nature of the measures, which may limit the impact. There is a stark contrast with the Fed's "whatever is necessary" approach.

The Reserve Bank of Australia surprised the markets last week and left rates unchanged at 4.5%. Although the market was pricing in a high chance of a hike going into the meeting, the RBA said that keeping the 4.5% policy was appropriate "for the time being" but higher rates will be required at some point.

UK Banking compensation - Barclays Chairman Marcus Agius, CEO John Varley, RBS Chairman Philip Hampton, Chancellor George Osbourne and FSA Head Hector Sants have met to discuss an international bonus standard to prevent the UK from being put at a disadvantage on compensation according to The Sunday Telegraph. This follows EU Bank regulators laying out tough and far-reaching curbs on bonuses, prompting speculation that financial firms are more likely to leave Europe in favour of less onerous countries. The main rule is that no bonus will be able to be pay more than 10% up front and in cash, there are also claw backs and ratios implemented between salary and bonus. Most press articles speculate that banks will either increase salaries to get round the curbs or simply move their operations out of Europe.

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 2.02% and the U.K.'s 2 year/10 year treasury spread is 2.21% - 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 (129 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 4.27% - (the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 11.6 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 20.00, which is below the levels experienced prior to the ECB bailout 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.

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