Market Commentary

PORTLAND INVESTMENT COUNSEL™

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US Mortgage foreclosures

It appears that the large banks may incur penalties from state Attorneys-General across the US for their lax foreclosure practices whereby mortgage documents were rubber-stamped without checking their accuracy. The mortgage-related issues are two-fold: (1) put-backs from the GSEs (government sponsored entities) and potentially the private label market, and (2) intensified concerns about the foreclosure process and title issues. Jamie Dimon (CEO JP Morgan) has indicated bank costs might rise as a result of the controversy but "we don't think there are cases where people have been evicted ..where they shouldn't have been".

JPMorgan has pledged to comprehensively review more than 115,000 loans that are in the foreclosure process and has legal reserves of $4.3 billion, Wells Fargo is expected to follow suit. Bank of America Corp Chief Executive Brian Moynihan is quoted by Reuters as saying he is "not so concerned" that an ongoing review of foreclosure documents will delay a rebound in the U.S. housing market. HSBC believe (i) they have been at the forefront of helping people manage their debt problems and avoiding foreclosure during the wind-down of their Household franchise and (ii) if they are stopped from foreclosing the impact is just a carry cost of the funding while they get the processes right before re-starting foreclosures. HSBC had $205mm reserve at H1 for broker-channel originated mortgages. Applying JPM's increase implies an additional $100mm charge (ie. not even a rounding error). Of course, public sentiment is hostile – fuelled by the press and a hedge-fund report which speculated Bank of America alone could face as much as $59 billion in losses (in lieu of its purchase of Countrywide, the former largest mortgage provider, as a going concern) – several analysts have since strongly refuted such numbers. Barclays Capital believe that the improper completion of paperwork might result in repurchase requests, industry-wide, that could cost of up to $22 billion – which suggests the reserves already taken by JP Morgan are sufficient. Furthermore, according to JPMorgan, realized losses related to repurchases appear to be peaking and it expects a 50% decline in 2011 (from an estimated $2.0 billion in 2010).

The originators of such mortgages do have fiduciary responsibilities which clearly have been treated too lightly – for which penalties will result – but a related issue concerns the inclusion of mortgages in securitization pools, despite rejections by independent appraisers, which could open those deals for repurchases and further delay the return of a properly functioning securitization market.

However, in our view, ultimately neither issue looks to have a material impact on the franchise strengths of the larger banks (although the 'tail' of this risk will likely last longest with Bank of America). Across JP Morgan, Wells Fargo and Bank of America the impact is expected to be probably no more than a 4%, 5% and 8% drag on respective earnings over the next 3-4 years. Some of these banks and title insurers may be guilty of sloppy paperwork but the spirit of the law is still strongly on the industry's side. If a homeowner is not making payments on his / her mortgage then they will be foreclosed upon. Therefore unless cases emerge of families being incorrectly evicted from homes, then it seems US politics will seek to re-engage foreclosures as quickly as possible as part of the remedial process necessary to ultimately return the housing market (and so new mortgage originations) to better health. We believe the issue could be defused over several weeks (rather than several quarters), and JPMorgan's 3Q10 conference call eased some of our concerns and comments from the other large players will be forthcoming this week.

News Highlights on Current Holdings

Financial Services Companies

Standard Chartered have confirmed they plan to raise £3.3bln through a rights issue to enable them to "seize opportunities" in Asia, Africa and the Middle East without being constrained by Basel III regulations (i.e. particularly pro-cyclical buffers and systemic capital surcharges). The bank said that Temasek (18% stakeholder, largest shareholder) will take up the rights. Standard Chartered will issue 1 new share for every 8 held at 1280p – which represents a discount of 33% to the closing price on Oct 12th when the rights issue was announced. The issue is fully underwritten by JPM Cazenove, UBS and Goldman. Theoretical Ex Rights Price would be 1839p based on Oct 12th close. Along with the issue they made some statements re their business :- Q3 income above H1 run rate; Capital ratios strong under Basel 2; Trade volumes almost back to pre-crisis levels; business activity levels rising although Mortgage income fell slightly in Q3.

StanChart specifically highlighted that the capital was to take advantage of organic growth opportunities in its key markets without the overhanging risk of needing to slow growth due to insufficient capital, presumably triggered by concerns that the local regulators may impose a buffer in excess of the minimum capital requirements recently announced by the Basel Committee. Standard Chart's core tier 1 capital ratio was 9% at the end of Jun-10 and based on the recently announced new capital requirements, the bank's fully loaded Basel 3 core tier 1 is ~8%.

Therefore, post the rights issue, Standard Chart's core tier 1 should be ~11% pre-Basel 3 adjustments - ~10% post adjustments, ranking it among the best capitalized international banks and so at a capital advantage over most of its competitors. In our view, Standard Chart's move is all about growth. While banks in many developed markets are struggling to grow their balance sheets as corporates & consumers de-lever, Standard Chart's key markets are experiencing a broad based recovery in credit demand - the additional buffer puts Standard Chart in a strong position and competitive advantage, to maintain momentum.

J.P. Morgan Chase & Co.'s 3Q10 profit rose 23% from a year ago. The investment-banking arm saw profit drop by one-third as revenue slid 29% from a year ago, and the bank disclosed that it cut compensation in that unit by 31% (from the prior quarter). JPMorgan reported 3Q10 EPS of $1.01, beating consensus by $0.11. The beat was driven by improved credit quality and lower than expected provision expense of $3.2 billion from $3.4 billion in 2Q10. The company released about $1.5 billion ($0.22 per share) in credit card reserves but added $1.3 billion ($0.18 per share) to litigation reserves, and $1.0 billion ($0.15 per share) to mortgage repurchase reserves. Principal transactions increased to $2.3 billion in 3Q10, mortgage loan originations were strong (up 27% from last quarter) and commercial banking reported record revenue in 3Q10.

Highlights for the quarter included: a 14% decrease last quarter in net charge-offs (NCOs) to $4.9 billion from $5.7 billion in 2Q10; a $1.7 billion reserve release primarily due to improvements in the credit card portfolio; a 16% decrease in credit card NCOs; continued improvement in early-stage delinquencies; loan loss coverage remains very strong at 5.1% of total loans; a smaller-than-expected decrease in the NIM to 3.01% from 3.06% in 2Q10 (although a net benefit on Fed Funds borrowings due to favorable market conditions for dollar-roll financings helped support borrowing costs at low levels in the quarter which may not be sustained); a 4% increase in investment banking fees; an improved outlook for middle-market commercial banking; and a 2% increase in wholesale loans due to the purchase of a $3.5 billion multifamily portfolio. Additionally, the company addressed foreclosure affidavit issues indicating that it believes underlying foreclosure decisions were justified. It expects to take several weeks to review about 115,000 loans and will re-file affidavits where appropriate.

Lowlights for the quarter included: a 5% decrease in total revenue; a 20% decrease in mortgage banking income to $707 million due to mortgage repurchase expense of $1.5 billion (up from $667 million in 3Q10); and a 15% increase in wholesale net charge offs to 0.49% of average loans from 0.44% in 2Q10.
Overall, results indicated the firm continues to produce solid results from its diversified franchise, allowing it to cope with the continuing fallout of the mortgage meltdown while still producing acceptable earnings. On the other hand, the material increase in Repurchase Reserves signals ongoing uncertainty although foreclosure halt is thought temporary, and JPM believes its basis for foreclosures is solid.

Capital Ratios: JPM repurchased $2.2B of stock in 3Q (at an average price of $38.52 and comprised 56.5 million shares = 1.46% of market cap) , versus $0.4B in 1st Half; Tier-1 Common ratio ticked down to 9.5% from 9.6% as a result. Buyback is an important signal of JPM's intent to restore dividend, and was likely accretive as stock has traded below BVPS of late….and Jamie Dimon hinted the dividend could rise in first quarter 2011. Tier 1 capital ratio 11.9% vs. 12.1% in 2Q 2010. Tangible Common Equity ratio of 5.54% in 3Q10 vs. 5.76% in 2Q10. Tangible Book Value was $29.54 in 3Q 2010 vs. $28.44 in 2Q10 and Book Value was $42.29 in 3Q vs $40.99 in 2Q 2010. Dimon indicated JP Morgan "Could be an aggressive buyer of its own stock" especially when the new capital rules are clarified.

HSBC: has decided not buy Nedbank, at least not yet – as its period of exclusivity ends. As far as Old Mutual are aware this was nothing to do with any adverse findings during due diligence although HSBC are reported as saying due diligence on the South African bank's operations had proved more complex than expected. The belief is that there may have been some political issues surrounding the transaction. Immaterial for valuation but should be seen as a positive message re: financial discipline at HSBC.

Lloyds Banking Group is to axe 4,500 jobs – predominantly IT roles in the UK and India – as bank (still 42% owned by UK Govt.) takes another step in its integration of HBOS.

Barclays' CEO John Varley said credit supply shouldn't be affected by Basle 3 rules in an FT interview. Varley commends the "substance and timetable" of the proposals and said that the plan is "very clearly sensitized to the obligation that the banks have over the course of the coming years to facilitate economic growth."

UK banks will be banned from selling most types of credit insurance at the same time they sell the underlying financial products, an antitrust regulator said. The decision last week comes a year after Barclays and Lloyds won an appeal blocking the first effort by Britain's Competition Commission to change the sales process for payment-protection insurance, known as PPI, to ensure it isn't pushed on consumers.

BNP Paribas will look to hire an additional 200 bankers over the next 3 to 5 years to expand its cash equities platform in its joint venture with Exane in the UK. In the opinion of the Financial Times, the plan is a signal that London continues to be central to the global plans of banks like BNP.

Royal Bank of Canada announced today an agreement to acquire BlueBay Asset Management a U.K. based wealth management firm for £963 million representing a 58% premium to the 90-day average. The deal is expected to close by the end of December 2010. The transaction will be funded using RY's existing cash resources and is not expected to have a material impact on earnings in the near term with a reduction in Tier 1 Capital of 55 bps. BlueBay, with over US$40 billion in AUM, is one of Europe's largest independent managers of fixed income debt funds and products for institutional and high net worth investors in the U.K., Europe, the U.S., the Middle East, Asia, and Australasia (60% Institutional/40% High Net Worth). Retention of BlueBay talent will be crucial in our view.

Swiss Private Banking withstood assaults on client secrecy by the U.S., France and Germany to attract more than 50 billion francs ($53 billion) of assets since the end of 2007. While UBS AG customers withdrew 248 billion francs during the past two and a half years, those redemptions were exceeded by net flows into the nation's 19 other biggest banks by client assets with Credit Suisse Group AG, Pictet & Cie. and Bank Sarasin & Cie. winning the most funds, bringing in almost 196 billion francs between them.

Australian Stock Exchange: The Australian government has confirmed it will allow rival stock exchanges to move into Australia however the timing is uncertain with Assistant Treasurer Bill Shorten declaring the government would push ahead only once the appropriate regulatory checks were in place.

Axa and AMP are making good progress on their talks to jointly bid for AXA APH according to the Australian press. AMP would take the Australasian units whilst Axa would take the Asian units if the companies did bid. NAB and Axa's joint bid was rejected by regulators in September.

Dividend Paying Companies

Posco – Posco's Q3 profit missed consensus expectations as steel demand in China slowed down following effort by the Asian superpower to cool down the fast growth in the property market and as the South Korean steelmaker could not pass through significant raw materials price increases for inventories acquired in the previous quarters. The outlook for the global steel demand growth is relatively weak for 2011, as demand in developed countries is lagging. Posco's profitability however is likely to be helped by a weaker US dollar, as the company imports all its raw materials and its exports account for roughly 30% of its revenues. Posco, the second largest steel maker worldwide, is also in a better position to weather a slowdown in growth, compared to other key producers, as it possesses the more modern and efficient steel mills.

Syngenta – Syngenta's third quarter sales exceeded expectations by a large margin as the strong growth in volume in crop protection, the company's core business, up 18% year on year, more than offset a relative weakness in pricing, down 5% ex-glyphosate. Of note though, pricing has strengthened sequentially and the management indicated that selective price increases are being targeted for the next quarter and for the next fiscal year. Business environment is expected to improve as strong agricultural commodities pricing is driving improved farm economies all over the globe. Seeds revenues were also up, helped by a 4% improvement in volume and an 8% improvement in pricing. The outlook in the key corn and soybean markets has improved recently, as Monsanto's SmartStaxx recent set-back is providing opportunities in the lucrative US market. The Latin American season is off to a good start, with sales in Argentina up 40%.

Carrefour – Carrefour's sales for the third quarter came ahead of the forecasts helped by good performance in the key emerging markets in Latin America, as well as a significant improvement in China. The management pointed out that encouraging signs of recovery are also seen in Belgium, Poland and Taiwan. Like for like for like sales excluding petrol in the key market of France were up by 0.2% in the quarter, driven mainly by good performance in the supermarkets business, while the hypermarket business seems to be stabilizing, with an improved traffic trend being noticed. Carrefour lowered the guidance for the operating profit for the full year to £3bn from £3.1bn as a previously announced charge in the hypermarkets business in Brazil was increased by £100mm in the quarter.

BHP – Sinochem of China is reported to have abandoned its plans to put together a bid for Potash Corp of Saskatchewan to block BHP's $40bn all cash bid for the fertilizer giant. Sinochem, at the request of the Chinese authorities, tried to spearhead a deal to counterbalance the influence BHP is threatening to gain in the crop nutrients market. However, it failed to gain political acceptance from the Canadian authorities and it failed to attract partners in a potential consortium as it could not muster the financing needed to pay for Potash's assets by itself.

Economic Activity, Consumer and Business Conditions

US – More signs of US manufacturing sector slowdown as the industrial production indicator moved 0.2% lower in September, offsetting the 0.2% increase in August. The main drags were the consumer goods manufacturing and the construction sectors, while the business equipment production edged higher. The capacity utilization state-side also moved marginally lower and is sitting at 74.7% in September compared to the 74.8% figure in August.

The US consumer, on the other hand, seems to be alive and well with the September retail sales up 0.6% month on month, beyond the expectations. The sales improvement was relatively broad, with only the clothing sales suffering a set-back in month. The Consumer Sentiment index's preliminary reading issued by the University of Michigan is showing a more temperate attitude, with the current situation component worsening, while the expectations component is indicating an improvement of the consumer attitudes in the near future. The index was down to 67.9 for October from 68.2 the month before and well below the expectations of 69.0.

The rate of price increases in US continues to be weak with the headline consumer price index reading for September holding steady at a 1.1% yearly rate of growth, while the core prices (excluding food and energy) inched lower to 0.8% yearly rate, the lowest rate since 1961.

Canada – Canada's trade balance deficit shrunk to C$1.3bn in August from the revised C$2.6bn in July, chiefly due to an increase in exports by more than 3%. However, the result is still in stark contrast with the pre-recession average of over C$4bn trade balance surplus.

Financial Conditions

Chinese currency : In the latest sign that the Chinese could be keeping the yuan artificially undervalued, China's currency reserves jumped in the third quarter, to one of the highest levels on record.

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 2.17% and the U.K.'s 2 year/10 year treasury spread is 2.29% - 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 (132 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 4.19% - (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 19.75, 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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