Market Commentary

PORTLAND INVESTMENT COUNSEL™

January 18, 2010

Forthcoming Recirculation

We will early next month be looking to re-circulate some shares of Copernican British Banks (CBB) and on behalf of Manulife, some shares of Copernican World Financial Infrastructure (CIW).

News Highlights on Current Holdings

- The White House set forth their proposal for the "Financial Crisis Responsibility Fee" (FCRF), which aims to raise $90 billion over the next 10 years. Financial firms with more than $50 billion in consolidated assets will be covered by the fee. It is important to note that this is the administration's initial proposal and while sentiment in Washington is clearly "anti-bank" these days, it is a long way from finalized. While we expect the spirit of the proposal to make progress, changes are likely to come in any number of material sections, from the assessment fee to the definition of covered liabilities to the specific institutions affected.
- As presented by the administration, the fee would be 15 basis points on "covered liabilities," which are defined as total assets minus Tier 1 capital and FDIC insured deposits. As such, the formula favours core-funded firms with high levels of capital. The administration estimated that over 60% of the revenues would be paid by the 10 largest financial institutions.
- We project that large cap banks and brokers are most negatively impacted, with a more muted impact on insurers (other than AIG) and regional banks. On a median basis, we believe that the proposed fee would negatively impact 2011 Earnings per Share estimates by approximately 6% (less on normalized EPS). In general, its our view that this proposal is most punitive to the newly-minted bank holding companies. In the wake of the crisis, certain companies applied for bank holding company status and are now under the oversight of the Federal Reserve and subject to the fee. There is a more significant impact on the broker-dealers given their relatively smaller deposit bases, but we see more potential offsets (i.e., variable compensation, capital/liquidity levels, pricing). Specifically, given our current understanding of the proposal and based on 2011 consensus expectations, we expect the tax to reduce EPS by about 10% for Goldman Sachs and 19% for Morgan Stanley. Of the large banks, Citi (due to the size of its balance sheet and depressed earnings levels) is the most negatively impacted (roughly 21% of 2011 EPS).
- Rheinmetall and MAN have signed a military truck joint venture to combine their wheeled armoured vehicle operations. The new company will be called Rheinmetall MAN Military Vehicles, 51% controlled (and consolidated) by Rheinmetall. The JV will generate >€1.0bn sales, of which approximately €600-700m will come from MAN and therefore be incremental to Rheinmetall group sales in 2012 – the first year of full consolidation. Rheinmetall Defence has generated c€1.9bn sales in 2009. The MAN deal and organic growth will lift Defence revenues well above €3bn in 2012. This increases the likelihood for a break-up/sale of the Automotive division in our view. Management has consistently said in the past that gaining critical mass in Defence would be a necessary prerequisite to becoming a pure play Defence company.
- South Korea's POSCO, the world's 4th largest steel maker, reported solid results in Q4 and raised its guidance for 2010 in an environment of increasing iron ore prices. At the same time company guided for a 17% rise in steel production, to 34.4MT (million tons) and a 9% revenue growth over 2009, with most of the growth being supported by domestic demand as well as demand out of China. An approximately USD 8.3B ambitious investment program includes breaking ground to a 12 million ton per annum integrated steel plant in Indian and an integrated mill in Indonesia for 3 million ton per annum, as well as acquisition plans for Daewoo International and Daewoo Shipbuilding, non-steel companies which could potentially have significant synergies with its core steel business. POSCO expects to close a deal to buy the Thai stainless steel producer Thainox by the end of the month.
- MasterCard announced last week that SunTrust has agreed to convert its debit card programs to MasterCard, from Visa. Based on 2008 rankings from Nilson, SunTrust is the 9th largest debit card issuer in the US, so this is a significant win for MasterCard. The terms of the agreement were not disclosed, so it's not clear how much MasterCard is paying to get SunTrust to convert, and therefore, how profitable the business will be. Nevertheless, we believe the precedent for this is when MasterCard bought the Washington Mutual business away from Visa in 2005 (MasterCard paid Washington Mutual a fee and covered the conversion costs). Our view is that one of the primary reasons why MasterCard trades at a discounted multiple to Visa is MasterCard's considerably smaller market share in US debit cards, so this announcement should reduce concerns that MasterCard is falling further behind, and should ultimately benefit the multiple. It also helps support the case that, notwithstanding the duopoly, there is competition between Visa and MasterCard. SunTrust, which had $12.6B of debit purchase volume in 2008, will begin converting 5 million debit cards to MasterCard later this year.
- Barclays has last week announced the acquisition of the New York Stock Exchange Designated Market Maker

(DMM) business of LaBranche & Co. for $25m in cash. The acquisition will enhance Barclays Capital's position as the leading DMM at the NYSE, and follows the firm's acquisition in March 2009 of the DMM rights of Bear Wagner Specialists. Note that currently Barclays Capital is responsible for approximately 900 NYSE-listed securities. LaBranche is responsible for approximately 700 NYSE-listed securities, making it the no.3 DMM by number of securities traded. On the NYSE, a DMM has certain responsibilities to ensure that trading in its clients' securities remains orderly and liquid. Completion of the transaction is expected in 1Q 2010.

- Morgan Stanley is set to form a new private banking operation that will serve wealthy customers of its brokerage division. The new operation, which will provide banking products and services to customers already receiving investment services from Morgan Stanley Smith Barney's financial advisors, will be headquartered in Charlotte and New York.
- UK Financial Investments (UKFI), the body managing the UK Government's shareholdings in the banks owns 43.5% of Lloyds Banking Group with average cost of 74p/sh, or £20.4bn cost. It is now anticipated that UKFI will move into divestment mode – probably starting by reducing its stake in Lloyds – a sale process expected to begin with 3-5% stake sale, or £1.1-1.8bn with remainder of stake sales to be arranged over the next 2 years in 4 or 5 transactions. Optically, the UKFI could initiate the first sale at current market prices and claim that the price achieved is better than the cost incurred in the more recent lower cost tranches – politically important for the incumbent Labour Government.

  The breakdown of the government's Lloyds Banking Group stake is as follows:

£20.4bn Stake	**Cost/Sh**
8.5bn (HBOS)	113.6p/sh
4.5bn (LTSB)	173.3p/sh
1.5bn (Pref Exchge)	38.4p/sh
5.9bn (Rts Offering)	37.0p/sh

Economic Activity, Consumer and Business Conditions

The fragile nature of the current recovery process in the US has been reiterated by the latest economic numbers issued last week statewide. The University of Michigan's consumer confidence index moved up to 72.8, a 0.3 increase versus the previous reading but, below the expectations of 73.9. Moreover, the increase was driven by the current conditions index, while the expectations index fell for the third time in the last four months. The retail sales, which were expected to edge higher, decreased by 0.3% in December, a significant change of pace and direction after the 1.8% growth for November, with the core retail spending, which excludes sales of automobiles, gasoline and building materials, decreasing as well. The consumer price index (CPI) reading indicated a modest increase in both the headline and core values, a reflection of the considerable slack in the economy as measured by both the output gap and the unemployment numbers.

However, better news came last week from the industrial production reading, indicating a growth of 0.6% for the month of December, the sixth monthly improvement in a row, as the inventory re-stocking process continues.

Financial Conditions

Worldwide, the improvements in financial conditions are providing support for a rebound in the economic activity and an upgrade in the business conditions.

The People's Bank of China last week raised the reserve requirement for local banks by 0.5% to 15% of their deposits, only hours after raising interest rates on its one-year bills after an apparent surge in lending since the turn of the year. The aim is to slow spending amid worries that the economy is overheating. The increase in reserve requirements, which comes earlier than most economists had expected, is thought likely to be followed by an increase in the country's benchmark interest rates.

Beijing's move to reinstate a higher Reserve Requirement ratio (RRR) was predictably taken to mean that it is seeking to curb growth and thus hit global markets – particularly commodities and, in China, banks. However, the move needs to be put into context; first, the requirement for big Chinese banks was cut at the start of the global crisis from 17.5% in October 2008 to 16% in November 2008 and 15.5% in December 2008. It is now being raised to 16.0%. (The comparable numbers for the smaller banks were 17.5% (in June/08), 16.5% (September/08), 16.0% (October/08), 14% (November/08), 13.5% (December/08) and is now being moved back to 14%). Second, the big Chinese banks have existing RRRs at an average of 180bps above the old rate, or 130bps above the new. The smaller banks' average ratio is 200bps above the old rate and 150bps above the new. Suggestions that this move will freeze RMB250bn of liquidity are in our view therefore misleading: the banks will not (yet) need to move any additional deposits or funds to the central bank, nor will loan/deposit ratios be affected. As far as we can recall all the banks have historically had RRRs above the requirement at every quarterly reporting (which does not mean that they might not dip below during a quarter).

The move was in our view a signal (arguably a symbolic one) specifically aimed at ensuring the banks stick to 2010 lending targets (rumored to be about RMB7.5 trillion after 2009's original target of RMB5 trillion was exceeded by almost RMB5 trillion) and not a precursor of higher interest rates (which we don't think will be seen until the second half of the year. That said, markets around the world have perhaps taken it as a reminder that the next move by all central banks will be up, the only question of course being when and in our view an anticipated rise in rates should be interpreted as further evidence that economies are recovering.

Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.81% and the U.K.'s 2 year/10 year treasury spread is 2.71% - enabling financial services companies' assets booked at these levels, to be very profitable, so enabling them to accelerate the absorption of anticipated consumer credit losses.

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 regional banks – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (140 in 2009) but their 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.

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.

JPMorgan's CEO Jamie Dimon said commercial real estate is a "train wreck" during a speech Monday, but noted that many of the problems in the sector have already happened and won't affect the economy too much. Dimon also said financial regulation is needed, but described the return of the Glass-Steagall Act, which separated commercial and investment banks, as a "quaint notion" and expressed frustration about recent criticism of the banking industry. "Commercial real estate is a train wreck, but it's already happened," Dimon said. Investors specializing in distressed debt and foreign buyers have been attracted by the lower prices, which has helped refinancing activity. Deals often take the form of a recapitalization, in which the lenders become the equity holders, Dimon added. Such transactions have less of an economic impact, Dimon said, noting that when the owners of an office building change, that doesn't necessarily trigger layoffs. Meanwhile, the worst of the residential real estate crisis may have passed, Dimon said. Prices have "leveled off" in many parts of the US during the past six months and affordability has improved, he added. Dimon predicted more foreclosures, but described them as a "constant flow," rather than a "wave."

The VIX (volatility index) is 17.9, substantially below the levels experienced last August/September (and well off the highs of 70-80 witnessed late September/October). While, by its characteristics, the VIX will remain volatile, it is we believe further evidence of markets reacclimatizing to risk – typically we believe a VIX level below 25 augurs well for quality equities. And credit default swaps across most leading financial companies are trading in a gradually improving range of 1%-2% (compared to 5%-7% late September/early October).

Cash on Sidelines – we understand that US money market funds as % of market cap are currently 25% versus 18% long-term average.

We believe the largest impediment to a sustainable rally remains government intervention, not the global economy.

We believe the next few years will highlight the growing polarization between strong and weak institutions. Financial services 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. Financial services companies that have breached client trust will keep losing business to those reputations that have been enhanced by the crisis. We believe all the Funds are extremely well positioned to benefit from the strength of their portfolios of strong, dominant, attractively priced financial services companies.

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Closed-End Funds

Spreads on the closed-end funds are narrowing but remain wide and so in our view are very attractively priced to purchase. We will early next month be looking to re-circulate some shares of Copernican British Banks (CBB) and on behalf of Manulife, some shares of Copernican World Financial Infrastructure (CIW).

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.

The details published last Friday are replicated here below from which you can see we also highlight whether the funds share prices are trading at a premium or discount to their respective Net Asset Value.

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