Market Commentary

PORTLAND
INVESTMENT COUNSEL™

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In a widely anticipated speech, the US President Barack Obama tabled a $447bn economic stimulus plan in front of a joint session of Congress last week. The package includes tax cuts and new spending aimed at providing a 'jolt' to the lagging US economy.

$240mm, is set to be spent on tax relief, to both employees, by extending and deepening an existing payroll tax cut, and employers, by encouraging small businesses to increase their payroll through new hiring or wage increases. Other measures include aid to states, to support teachers, firefighters and police officers jobs, as well as to modernize schools, rehabilitate and refurbish vacant and foreclosed homes and support low income youth, all in, some $85mm. Further $50 mm would be spent on transportation infrastructure projects involving highways, transit, rail and aviation and which is expected to attract some of the underemployed construction workers, with an extra $10bn aimed at capitalizing an infrastructure bank. Existing unemployed would benefit from a $49bn one year extension of the long-term unemployment benefits, as well as $8bn of tax credits. $5bn would cover the extension of a tax break for companies investing in new plant and equipment.

Several economists estimate that the effect of the proposed package could include adding 1% to 3% of economic growth in 2012, 1mm job additions and a reduction in the unemployment rate of about 0.5%. However, to be put in practice, the package would have to be approved by the Congress, which has largely been seen as the key source of political uncertainty as the Democrats and Republicans are posturing for votes only 14 months ahead of the next presidential elections. The debt ceiling debate represented a prime example of the divisive attitudes of the American political class and was followed by a credit downgrade of the US as the entire world watched in horror. Although some of the measures, primarily tax cuts, seem acceptable to the Republicans, there is little expectation of the package passing through in its entirety.

News Highlights on Current Holdings

Financial Services Companies

Bank of America: CEO Moynihan announced a reorganization of the company's management that aligns the company's operating units with its three core customer groups: individuals, companies, and institutional investors. Moynihan appointed David Darnell and Tom Montag to the newly-created positions of co-chief operating officers, accountable for all of the company's operating units. This reorganization is effective immediately…and job losses are expected as a results of increasing efficiencies. Barbara Desoer continues as president of Bank of America Home Loans, reporting to Darnell. Joe Price, president of Global Consumer and Small Business Banking, and Sallie Krawcheck, president of Global Wealth and Investment Management, will leave the company.

HSBC - confirms that discussions continue regarding a possible sale of its Canadian full service investment advisory division of its retail brokerage business. According to the release, no decision has yet been made to proceed with any transaction.

JP Morgan: New international bank capital rules are anti-American and the US should consider pulling out of the Basel group of global regulators, says Jamie Dimon in an interview with the Financial Times. His contention is that whilst banks are being required to hold more capital the imposition of additional requirements on the largest global banks goes too far, particularly for US banks....which could be under threat of losing market share to Asian banks because of the combination of US domestic and global rules.

National Australia Bank / Lloyds Bank : NBNK, a vehicle set up by Lloyd's of London Chairman Peter Levene to buy UK banking assets, said trading in the company's shares will be suspended because the operations it is seeking to acquire would qualify the move as a reverse takeover. NBNK acknowledged "the level of on-going press speculation concerning possible acquisitions," and the Financial Times reports the company is discussing the takeover of NAB's Clydesdale Bank and Yorkshire Bank units. NBNK said there was no certainty a transaction would be agreed and that further announcements will be made in due course. Buying both NAB and the Lloyds branches would require NBNK to have a substantial war chest of available funds. The sale price for the Lloyds business is expected to be about £2bn, while the NAB franchises could fetch about £1.5bn.

Financial Infrastructure Companies

Deutsche Borse: It is expected that the European Commission will not impose serious anti-trust restrictions on the $9 billion merger between Deutsche Borse and NYSE Euronext and will instead use new regulations to force the exchanges to open up to competition.

Dividend Paying Companies

Bayer – a Food and Drug Administration (FDA) panel voted in favour to recommending the approval of Xarelto (rivaroxaban) for stroke prevention in patients suffering from atrial fibrillation (a heart condition which could lead to clot formation and which affects elderly people). The drug is competing with a number of other solutions, trying to replace the obsolete and deemed unsafe standard of care, "warfarin", for a market estimated at over $10bn. However the vote was not unanimous, with 9 panellists voting for and two against as a couple of concerns gain prominence during the review. Firstly, the panel was not entirely satisfied that the dosing of warfarin (the old drug) was properly managed in the control arm of the study, although some pointed out that such an inference is dependent on how the data is interpreted. Another concern had to do with a 'rebound effect' observed when the patients come of Xarelto and resumed warfarin at the end of the main clinical trial, increasing the risk of stroke. These expressed concerns lead to the risk that the agency may want additional studies, which would delay the launch of Xarelto in US for stroke prevention in atrial fibrillation (SPAF). The final FDA decision on Xarelto is expected before November 4th of this year. The impact of Xarelto SPAF sales in US is limited, as the US market only represents a fraction of the global potential and the US Xarelto sales rights are being held by Johnson&Johnson, with Bayer only receiving a royalty. Approval for Xarelto in SPAF in Europe is expected before the end of the year. Xarelto has already been approved in prevention of clotting in patients undergoing knee and hip replacement surgery in US and Europe.

Toyota – Recognizing the importance of the largest Southeast Asian economy, Indonesia, Toyota decided to invest close to $400mm in a new assembly plant, which should launch production in the first half of 2013. The production at the new plant would bring the overall Toyota production in Indonesia to about 200,000 vehicle per year. Sales of cars in Indonesia reached 750,000 units and are expected to exceed 1mm units in the coming years, with Toyota controlling about 60% of the market. The move is also set to improve the cost competitiveness of the manufacturer, which has traditionally had a strong Japanese production bias.

Economic Activity, Consumer and Business Conditions

US – Last week was a relatively light week in term macro-economic data-point releases, as President Obama's speech and action plan monopolized the attention of the markets. Within the releases, of note was a significant decrease in the net international trade deficit, from the $51.57bn in June to $44.81 in July, on the back of resurgence in exports and way ahead of the consensus expectations which were calling for a $51bn deficit. Meanwhile, the non-manufacturing purchasing managers index (PMI) beat consensus as well, moving to 53.3 in the month, ahead of consensus calling for a lowered 51.0 value and the prior's month reading of 52.7. The consumer credit south expanded by $12bn in July, in line with June, at $11.4bn, and significantly more than expectations for a $6bn increase, providing support for the all important US consumer sector.

Canada – The numbers that made the headlines on this side of the border were an unexpected drop in Canadian employment, down 5,500 in August, led by a loss of part-time jobs, as well as a retreat in private employment, as well as an upward move in the rate of unemployment, which reached 7.3% in the month.

The Canadian merchandise trade balance recorded a better than expected $750mm deficit in August, ahead of July's $1.37bn and expectations for a $1.22bn deficit, yet it is still disappointingly low when compared to a long run average of a $3bn to $4bn monthly surplus. Not surprisingly, yet still disappointing, the Canadian labour productivity in the second quarter retreated by 0.9%, more than erasing the previous quarter's advance of 0.4%.

USA: President Obama's $447bn package of payroll tax cuts and infrastructure expenditure was greater than the market was looking for however the reaction has been skeptical with concerns about implementation, cost and approval.

Greece will accelerate austerity measures pledged in return for international financing. Greek Finance Minister Venizelos said that he has received approval from the Cabinet to immediately transfer state assets to a special fund to be marked for sale, place civil servants in a "reserve" system to retrain them and cut expenses, and merge and shut down dozens of government agencies. According to the provisional national accounts provided by the Hellenic Statistical Authority, Greece's economy sank deeper into recession in 2Q11 as GDP was revised downwards compared to preliminary estimates from -6.9% (YoY) to -7.4% (YoY) due to the availability of new data, mainly on the turnover in the services sector (GDP contracted 8.1% in the first three months of the year). The unemployment rate stood at 16% in June compared to 11.6% in June 2010…and over the week-end Greek Prime Minister George Papandreou, vowed to avoid a default and keep the nation in the euro, by approving new measures to help plug a budget gap as resistance builds at home and in Europe to extending more aid to the European Union's most indebted nation. The Greek government announced that it would impose a two-year property tax to raise €2bn this year, levied through electricity bills to ensure rapid collection and to cut 1 month's wages from all elected officials. This will close a €1.7bn budget gap that the EU and IMF said must be resolved or they would stop making bail-out payments.

Italian budget - PM Berlusconi's revised €54bn austerity plan was backed by the Senate in a confidence vote last Wednesday after the government beefed up the package the previous day with an increase in sales tax and changes to pension rules. The plan now faces final passage in the Chamber of Deputies in a vote that could come as soon as this week. Silvio Berlusconi's centre right Government had earlier announced a U turn to strengthen Italy's austerity package. The earlier proposed budget bill had been criticised by the European Commission and the ECB. The highest value added tax band is proposed to be increased to 21% from 20%, a 3% wealth tax is to be imposed to incomes over €300,000 from a previously communicated €500,000 and later retirement for women is to be introduced.

UK House Prices: Halifax house price index - "On a monthly basis, house prices fell by 1.2% in August. This was the first fall since April and follows three successive monthly rises." "The underlying trend, as measured by the latest three months compared with the preceding three months, showed a modest improvement in house prices for the second consecutive month in August.

Financial Conditions

The UK Independent Commission on Banking ('ICB') released its final report this morning recommending UK banks be ringfenced, saying ringfencing would get the benefits of full separation. The ICB sees implementation costs of €4bn-£7bn with the banks getting until 2019 to complete the plans… this timeframe is longer than previously expected and allows banks time to adjust. According to the report investment banking should be outside the fence with banking services to individuals and small and medium enterprises inside. The ICB will permit lending to non-finance companies inside the ringfence with ICB said to recommend separate board for retail operations as if independently listed and firewalls around retail operations. The ICB recommends loss absorbing capacity of 17-20% and the ICB see 1/6 to 1/3 of UK bank balance sheets within the ringfence. On Lloyds, "The Commission confirms its view that the prospects for competition in U.K. retail banking would be much improved by the creation of a strong and effective new challenger by way of the Lloyds divestiture," the commission said in the report today. The Commission therefore recommends that the Government seek agreement with Lloyds to ensure that the divestiture leads to the emergence of a strong challenger bank…this is entirely in line with earlier expectations and what Lloyds have already begun implementing.

Policymakers continue to accommodate a recovery in bank profits, albeit less than 12 months ago. The U.S. 2 year/10 year treasury spread is 1.74% and the U.K.'s 2 year/10 year treasury spread is 1.67% - enabling financial services companies' assets booked at these levels, to be profitable.

Later cycle issues continue to challenge 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 – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow, albeit at a more moderate pace (74 in 2011) compared to 157 in 2010 which was the highest annual tally since 1992 (140 in 2009). 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 U.S. 30 year mortgage market has remained low at 4.12 % - (the lowest rate since the Federal Reserve began tracking rates in 1971 was 4.17% on Nov. 11, 2010), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 9.5 months supply of existing houses – a 7 month high and much higher than what we believe is a more normal range of 4-7 months. We believe it remains premature to consider a recovery in house prices but a measure of stability would be welcomed….particularly for those financial services companies holding such assets in their portfolios.

A concern which remains is the extent to which mortgage foreclosures have been properly documented, thereby enabling mortgages to be "put back" to the originating bank. However, from recent bank investor relations presentations it does seem the rate of "put backs" are now expected to decline, suggesting current levels of provisions should suffice. 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 38.52 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

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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Sources: Credit Suisse - MONEY NEVER SLEEPS, KBW - EuroAsian Daily, Global Financials Daily (Sovereign, Liquidity, SNB, JPM, BAC, WFC, C, Indian Banks, CWB, TD, Aussie Banks, Global Financials Daily (EU IB's, BK, ASIA Banks, UK IBC, GLE USD, SAN, BPM, Italian Insurers, HL, BAC, US MI's, GS, NTRS, CIBC, Korea Insurance),

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