Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Barclays – Bob Diamond, Barclays CEO, last Monday accused the government of inflicting unnecessary damage on its reputation when it retrospectively outlawed a £300m tax deal earlier in the year. The Telegraph reported last week that Barclays has ended talks with potential buyers of French and Italian units. According to the article, Barclays was in advanced talks for several months with buyer of French business and Barclays is instead going to focus on boosting units profitability. Barclays declined to comment.

BBVA : Negative impact from telecoms' Telefonica's announced two thirds dividend cut. BBVA (according to BBG data) currently owns 6.2% of TEF. Dividend contributed c.EUR360m last year (c.6% adjusted net profit). Announced cut to dividend could cut as much as 3% off BBVA's consensus earnings for this year.

ING - The chief executive of ING Direct in Australia for the past three years is to take charge of ING's operations in Italy, the Dutch-owned lender said in a statement today.

Metlife : Major insurer MetLife has regained some traction in the Australian group insurance market after earlier this month picking up the mandate for the Nationwide Superannuation Fund (NSF). The NSF mandate represented a key step ahead for the company which had lost a number of mandates over the past two years as players such as TAL ramped up their presence in the group space.

Morgan Stanley has come a step closer to winning approval to enter India's commercial banking market, in a move that if granted will put the US bank in competition with the likes of Standard Chartered and Deutsche Bank, who already have commercial licences in Asia's third-largest economy. (Source Financial Times).

National Australia Bank : NAB CEO Cameron Clyne will personally oversee the restructure of the bank's under-pressure British arm after long-serving European chairman Malcolm Williamson outlined plans to step down from next month. Mr Clyne will step in as chairman of NAB Group Europe and Clydesdale Bank upon the retirement of Sir Malcolm Williamson.

Prudential PLC : Paul Manduca (age 60 and currently Chairman of Aon UK; founded Threadneedle Asset Management in 1994 and also served as CEO of both Rothschild Asset Management and Deutsche Asset Management) named Chairman effective July 2 and will succeed Harvey McGrath who is retiring after ~4 years. Manduca is viewed as a safe choice for Prudential which is now trying to address (along with other UK companies) growing shareholder concerns over corporate governance (eg. 30% voted against this year's proposed compensation for senior management, including double-digit increases for CEO/CFO and changing metrics for calculating bonuses for head of Asia ops).

Prudential PLC said last Thursday it will buy SRLC America Holding Corp. from Swiss Re AG in a £398 million ($616.1 million) cash deal, continuing its strategy of making bolt-on acquisitions. SRLC is a life insurance business that is part of the U.S. division of Swiss Re's Admin Re. Its primary operating subsidiary is Reassure America Life Insurance Company, which has a diverse portfolio of U.S. life insurance businesses.

Standard Chartered - named Carsten Stoehr, formerly of Credit Suisse, as Global Head of Capital Markets based in Hong Kong.

Dividend Paying Companies

BHP – Received the environmental approval for its outer harbour extension plans at Port Hedland in Western Australia, its key iron ore export hub. The project is still pending board approval later this year, yet it is crucial for the company's ability to double its annual iron ore production to 440mm tonnes. The expansion work should take about 8 years to complete. Upon completion, which is estimated to cost $20Bn, the outer harbour would be able to handle 240mm tonnes of iron ore a year, on top of an underway expansion of the inner harbour to 220mm tonnes. The new facility would include a four kilometre-long jetty, a four-berth wharf and a 32 kilometre-long shipping channel.

Carnival – Cruise Lines took delivery of the new 130,000 ton Carnival Breeze cruise ship at Fincantieri's shipyard in Monfalcone, Italy. The ship, the 24th vessel in the line's fleet will eventually become Carnival Cruise Lines' largest South Florida-based ship. Meanwhile, the ship is scheduled to run a number of 12 days Mediterranean cruises departing from Barcelona through October 25th of this year.

Toyota – registered a strong rebound in sales both in the home market, as well as in the key US market. The company reported May sales of 202,973 vehicles in the US, a 79.2% increase compared to last year's depressed sales affected by the earthquake and tsunami. Industry analysts report that Toyota and Honda made market share gains in the US as GM and Ford lost market share, same as Kia and Hyundai, which were affected by capacity constraints. In Japan, Toyota's sales more than doubled, as demand was also helped by government's subsidies on fuel-efficient cars.

Wesfarmers – hosted a Strategy Briefing Day in Sidney last week, which outlined the potential for network and supply chain improvement at Coles, the leading Australian grocery chain, as well as the expansion plans in the resource division. Expansion of coal production, supported by robust coal pricing, will be decided by the end of the year. The company's department store business, Target, is one of the divisions facing a more challenging outlook and is planning a strategic repositioning, which would see the chain occupy the space between department stores and discount department stores. The chain aims to offer customers style, quality and in-store experience at a reasonable price, similar to Zara's and H&M's business models. The repositioning exercise is estimated to cost some $40mm in the fiscal 2012.

Economic Activity, Consumer and Business Conditions

US – Not entirely surprising the macro-economic news out of US last week had a more down-beat tone, led by a sub-par set of numbers issued Friday in the employment report. The US economy managed to add only 69k non-farm payrolls in May, way short of the expectations calling for a 150k jobs addition, and below April's revised 77k. Private payrolls only added 82k positions, while the public sector in aggregate cut jobs. Manufacturing jobs grew 12k, short of the 15k expected, an acceleration though compared to April's 9k. The personal income report, issued the same day, revealed a below expectations growth in personal income, up 0.2% in April, down from 0.4% in March and short of the expected 0.3%. Personal consumption however, grew by 0.3%, as expected, arguably on the back of an improvement in the consumer credit. The core personal consumption expenditures (PCE) price index, US Fed's favourite inflation gage, remained flat at 1.9%, short of the now public 2.0% inflation target, providing room for further monetary easing if needed.

The business outlook continues to be uncertain at best, with the Institute for Supply Management's (ISM) Purchasing Managers Index falling short of the expectations for May, at 53.5 index points, versus 53.9 expected, and retreating from April's 54.8 level. The preliminary reading of the US Q1 GDP growth revealed an annualized economic growth rate of 1.9%, as expected, yet short of the advance reading of 2.2%. US pending home sales fell in April, down 5.5%, more than offsetting March's 3.8% gain. A deceleration in the rate of home prices decline, captured by the Case-Shiller index at 2.6% in year on year terms, did little to assuage worries. The consumer confidence, as measured by the Conference Board, dropped to a 64.9 level in May from 68.7 in April and fell short of expectations for a 70.0 index reading.

Canada – A drop in raw materials pricing, down 13.6% in April, on top of a 5.7% reduction in March, offers a much needed respite to the Canadian producers. The Canadian producer prices actually moved higher by 0.4% in the month, providing scope for margin improvement. The Canadian economy as a whole expanded at an annualized pace of 1.9% in the first quarter, in line with the economic rate growth South of the border and in line with the expectations, however the GDP by industry for March fell short of the expectations, up only 0.1%, against 0.4% expected. With weaker economy and less inflationary pressures Bank of Canada should wait a while longer before committing to monetary tightening.

Ireland voted “yes” to the EU fiscal compact

The European Commission challenged Germany’s remedies for the financial crisis, calling for direct euro-area aid for troubled banks and insisting on a “roadmap” for common bond issuance. The commission, the European Union’s central regulator, sided with Spain in proposing that the planned permanent rescue fund, the European Stability Mechanism, inject cash to banks instead of channelling the money via national governments.

Eurozone - PM Rajoy said European leaders should reinforce efforts to protect euro area banks, adding his voice for calls for a robust ‘banking union’, a more centralised system to recap lenders, in Europe. Merkel toughened her stance on opposition to euro-area debt sharing when speaking to members of her party in Berlin saying that “under no circumstances” would she agree to German backed eurobonds. Merkel’s isolation was underlined as French Finance Minister Pierre Moscovici said that aid for troubled banks should come through the ESM rather than through governments. In a sharp contrast, the Wall Street Journal last night suggested “Germany signals crisis shift” that is would be willing to lift its objections to ideas such as common euro-zone bonds or mutual support for European banks if other European governments were to agree to transfer further powers to Europe.

Financial Conditions

Greece - The Hellenic Financial Stability Fund disbursed the €18bn to Greece’s four biggest banks last week. The banks will receive bonds issued by the European Financial Stability Facility, which approved the transfer last week. National Bank will receive the largest capital injection of about €7bn, followed by Piraeus, which will get about €4.7bn, Thomopoulos, head of the HFSF said. Separately, Greece may access €3bn left over from 1st bailout if attempts to revive tax revenue fail, Reuters said last Monday.

Long Term Refinancing Operation - LTRO loans of €21.4bn were “repaid before maturity,” the ECB said in a statement last Tuesday, reducing the total outstanding amount to €1.061tn. The ECB lent euro-area banks about €1tn in two three-year LTROs in December and February. At the same time it looks like the Emergency Liquidity Assistance decreased this week – the line that ELA sits in (“Other claims on euro area credit institutions denominated in euro”) increased by €34.0bn. This could be related to the Greek banks, remember they were temporarily suspended from access to the ECB and moved to ELA. According to Greek press they received the €18bn recap from the HFSF and should comply again with legally minimum Basel capital ratio of 8%.

Federal Reserve policymakers appear determined to flatten the yield curve as much as possible, having indicated they expect ‘exceptionally low levels’ of interest rates “at least through late 2014”. which is still an “exceptionally low level” in the grand scheme of things. Fed Reserve Chairman Ben Bernanke has indicated 1% or less would be considered exceptionally low. The advent of the US ‘twist’ (whereby the Federal Reserve is selling 3 year and less maturities to buy 6 years and longer) means all parts of the yield curve will benefit from a near-zero anchor until mid to late 2014. The U.S. 2 year/10 year treasury spread is now 1.26% and the U.K.’s 2 year/10 year treasury spread is 1.27% - meaning investment banks can no longer profit from a steep yield curve and instead are seeking operational efficiencies, including job cuts and lower compensation, to maintain acceptable levels of profit, i.e. above their costs of capital. It seems the top tier 8-10 investment banks will continue to command their market and possibly increase their share – as barriers to entry for newcomers have in our view been raised.

Influenced by the US ‘twist’, the U.S. 30 year mortgage market remains very low at 3.75% - (the lowest rate since the Federal Reserve began tracking rates in 1971), as the Federal Reserve effectively continues to give priority to incentivising home ownership. Existing U.S. housing inventory improved to 6.6 months supply of existing houses. So the combined effects of record low mortgage rates, near record high affordability, a more promising economic recovery, job creation, and low prices are finally supporting the housing market with housing inventory well off its peak of 9.4 months and we believe now in a more normal range of 4-7 months. While we still believe it remains premature to consider a recovery in house prices prospects of a measure of stability are likely to increases as a result of the Fed actions – which is 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 and whether bank’s have mis-represented the quality of those assets sold to Freddie Mac and Fannie Mae. Such legal debates are likely to drag on for years but from recent bank investor relations presentations it does seem the rate of “put backs” are now beginning to decline and that litigation reserves have been increased suggesting overall current levels of total provisions should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 2 years by when we expect more normalized earnings power to have returned. 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.

As concerns have swung from commercial real estate and unsecured consumer loans/credit card loans to European sovereign debts the number of small U.S. banks failing continues to grow, albeit at a more moderate pace with 25 in 2012 (compared to 95 in 2011 and 157 in 2010 which was the highest annual tally since 1992). 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 VIX (volatility index) is 26.91 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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