# Market Commentary

PORTLAND INVESTMENT COUNSEL™

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## News Highlights on Current Holdings

### Financial Services Companies

Deutsche Bank - cut 10% of its staff in Asian equity sales and trading last week, around 50 jobs, saying they are part of a workforce reduction plan announced in July when Deutsche said they will eliminate 1900 jobs, including 1500 at the investment bank, as part of a €3bn cost cut plan

Hartford Financial Services announced the sale of its Retirement unit to MassMutual for $400mn (P/E of 12x annualized earnings). The deal is structured as a reinsurance transaction and could benefit The Hartford's net statutory capital by $600mn including the ceding commission and a reduction in required risk-based capital. This transaction is expected to close by end 2012 with no impact to Hartford's GAAP equity. This deal follows the sale of Hartford's Woodbury broker/dealer unit to AIG for up to $115mn. The Hartford also plans to sell its U.S. life insurance unit for perhaps $1bn ("Prudential Said to Be Lead Bidder for Hartford Life Unit", Bloomberg, 8/17/12.)

HSBC and BNP Paribas are among banks extending a US$1.5bn so-called profit participating loan to Dubai-based Drydocks World as it restructures debt, a person with knowledge of the talks said. It's understood the 15-year loan, part of a US$2.25bn debt restructuring for the Middle East's biggest shipyard, will pay creditors profit or cash from asset sales. Dubai World-controlled Drydocks is also understood to have agreed on a new US$800mn five-year term loan paying a market interest rate ( Source: Bloomberg)

ING is as expected, exiting the Capital One stake which was acquired as part of the ING Direct sale. 54mm shares (>9% stake) will be sold with bookrunners being Bank of America / Merrill Lynch , Morgan Stanley and Citigroup (Capital One will not participate). With Capital One shares closing at $56.49/share, assuming a $55/sh sale price would give ING +10% gain ($50/sh carrying cost), or $270mm (Eur ~215mm) pretax, Eur ~150mm aftertax (plus a guesttimated capital release of >200mm) and guesstimated >5bps core T1 increase. Although the transaction in isolation is immaterial, this is nevertheless positive as the market is now much more focused on the accelerating pace of the restructuring progress given the 2013 year-end deadline.

ING - Nikkei reports that ING is in late-stage talks to sell its Japanese life insurance business, exiting the market as part of a global reorganization. ING are looking to sell Japan's ING Life Insurance Co. to the Pacific Century Group headed by Richard Li, son of Hong Kong billionaire Li Ka-Shing. It is looking to complete the deal, likely worth tens of billions of yen, by the end of this month. The sale is not expected to affect ING's roughly 770,000 life insurance policies in Japan.

J.P. Morgan appointed a new executive to lead the unit that suffered at least US$5.8bn in trading losses tied to credit derivatives earlier this year, as it refocuses the division on "its core mandate of conservative investing," according to a memo announcing the appointment. Craig Delany, the new head of J.P. Morgan's CIO, most recently served as chief operating officer of the bank's mortgage banking unit. The appointment is effective immediately.

Nordea: Nordea's CFO Fredrik Rystedt presented at Handelsbanken's Nordic Large Cap seminar today. Nordea confirmed that credit quality is very good apart from in Denmark and the shipping portfolio. Although loan losses in Denmark are likely to stay elevated, the credit quality is actually gradually improving in Denmark helped partly by very low interest rates. In addition, the losses are largely unallocated general provisions and not specific provisions which suggest that there are buffers in place if credit quality deteriorates futher. Only <10% of Nordea's Danish impaired clients are actually non-performing. Shipping losses are likely to stay elevated as well but Nordea does not believe that losses would increase by up to 50% in 2013e from 2012e which DNB suggested at their CMD last week. This is mainly due to the fact that Nordea has previously booked more shipping related provisions than DNB. Unlike other Swedish banks, Nordea has not yet received approval from the Financial Services Authority to used Advanced IRB-models on its corporate book, and the expected benefits from the subsequent lower risk weights are expected to be reaped in 2nd half 2012 or early next year. The Danish and the Finnish FSAs appear to be moving towards the pan-European capitalisation regulation as opposed to the Swedish "finish" (with stricter requirements starting to be implemented as of Jan 1 2013). Nordea suggested that the final regulation might be a "blended" approach in which local capital requirements apply only to local operations. This would mean that the 12% Core Tier 1 ratio floor according to the Swedish finish (and the Nordea group given that the HQ is in Stockholm) would drop to 10.9% for Nordea. Regardless of what the final capitalisation regulation will look like we believe that Nordea will be able to distribute dividends in line with the payout ratio target of "above 40% of earnings" and build the Core Tier 1 ratio with the retained earnings. We see Nordea's Core Tier 1 ratio reaching about 13% by end 2014 (when full Swedish finish with a >12% floor is implemented).

Santander has launched a listing of its Mexican subsidiary, valuing the business at up to US$17.23bn in what the Spanish bank hopes will be the world's second largest IPO this year. As Santander seeks shelter from the eurozone crisis by raising cash from overseas operations, the bank on Tuesday filed a prospectus for the sale of 24.9% of Santander Mexico with the Mexican stock exchange. A $4.3bn raise would increase the bank group's core capital by about 0.5% ( Source: Financial Times)

Dividend Paying Companies

Bayer – announced its development partner Johnson&Johnson filed a response to US regulator's concerns regarding a new use of their anti-clotting pill, Xarleto, to prevent heart attacks and strokes in patients with acute coronary syndrome (ACS). It also revealed that it had renewed its application for the combined use of Xarelto with standard antiplatelet therapy to reduce the risk of stent thrombosis in patients with ACS. Xarelto, the most promising new Bayer drug, was approved in the US last year to prevent strokes among patients with an irregular heart beat condition called atrial fibrillation, which most commonly impacts the elderly. The pill was also approved to reduce risk of blood clots in the legs and lungs of people who have had knee or hip replacement surgery.

Siemens – is rumoured to be exploring the sale of the business support systems (BSS) of its Nokia Siemens Networks (NSN) telecom division. The US telecoms equipment maker Amdocs as well as Ericsson, the world's top mobile network infrastructure supplier, are reportedly interested. Ericsson had acquired Telcordia, in the US, for $1.1Bn in order to expand in the BSS area. BSS industry is in business of providing billing and charging systems for telecom operators. NSN is in the middle of a restructuring programme, that will also see a 17,000 jobs cut of its workforce, almost a quarter of the total, as it is trying to improve its operating metrics.

Toyota –revealed plans to double its sales of vehicles in China to 1.8 million by 2015, about 15% of its global sales at that time. Toyota sold 0.9 million cars in China in 2011 and is expecting to reach 1 million units sold this year. The company recorded a pull-back in sales in China in the month of August as it cycled through a tough comparative period. At the same time, sales of vehicles in the US moved 46% higher in the month, to 188,520 vehicles, and the company reported 'strong opening' for September with 'excellent labor day weekend results'.

Vivendi – EU Commission's decision in the $1.9Bn purchase of EMI by Vivendi's music unit Universal Music Group is due on September 27, yet sources indicate it will likely be an approval, after Universal tabled a series of concessions. One of the most important concessions is selling the bulk of Parlophone, which includes Coldplay and Queen rights, while keeping the rights to The Beatles. The package of concessions also include the divestment of Mute, Ensign and Chrysalis labels, as well as EMI Classics, Virgin Classics and EMI units in France, Belgium, the Czech Republic, Poland, Portugal, Sweden and Norway. The concessions are pertaining to European rights, as the European Commission warned Universal that the combined group needs to cut its market share to below 40%. The US Federal Trade Commission is also examining the deal, while regulators in Canada, Japan and New Zealand have cleared the takeover. Interested buyers of EMI assets may include BMG, a joint venture between the German media group Bertelsmann and private equity group KKR, as well as Virgin Records and Sony Music.

BHP Billiton has completed the sale of its 37% non-operated interest in Richards Bay Minerals (RBM) to Rio Tinto. As part of the restructuring of RBM in 2009, BHP Billiton and Rio Tinto concluded an option agreement that made provision for BHP Billiton to sell its interest in RBM to Rio Tinto pursuant to an agreed valuation process. BHP Billiton and Rio Tinto announced on 1 February 2012 that this option had been exercised and that completion of the transaction was conditional upon the fulfilment of customary regulatory approvals, all of which have now been met. Pursuant to the prescribed valuation process, BHP Billiton has sold its entire interest in RBM for US$1.91 billion before adjustments. The divestment reflects the company's commitment to a simpler, more scalable upstream portfolio. RBM is a South African mineral sands mining and smelting operation and the leading producer of chloride titanium dioxide feedstock. Prior to completion of the sale, BHP Billiton held a 37% equity stake in RBM with equity partners Rio Tinto (37%), Black Economic Empowerment (BEE) parties (24%) and employees (2%). Rio Tinto manages the operation and is responsible for the marketing of RBM's products.

## Economic Activity, Consumer and Business Conditions

US – The macro-economic highlight of last week was the US unemployment report, which at only 96,000 non-farm payroll additions failed to assuage concerns of a jobless recovery. The consensus expectations were calling for 125,000 jobs additions in the month of August, yet a surprising 15,000 manufacturing jobs loss (expectations were for a 10,000 jobs additions), as well as weakness in trade and temporary employment, caused the labour market to sag. July's numbers were also revised downwards, from 163,000 to 141,000. However, the headline unemployment rate improved from 8.3% to 8.1%, albeit due to students returning to study and the result of a dismal labour force participation rate, the lowest in more than 30 years, as discouraged workers, some of them out of work for more than a year, are quitting. Part of the same report, the average earnings were flat in nominal terms, short of expectations for a 0.2% improvement, undoubtedly a brake on consumer's spending intentions.

Last week, the Institute for Supply Management's (ISM) indicators for manufacturing (PMI) and services (NMI) provided a mixed bag of results, as the PMI reading worsened in August to 49.6 from 49.8, further indicating contraction in the sector, while the NMI unexpectedly improved in the month, to a 53.7 level from July's 52.6 level.

Second quarter productivity improved in the second quarter in the US by 2.2%, ahead of the expected 1.8% and reversing some of the 0.5% retreat in the first quarter, consistent with recent labour force market weakness as companies postponed their hiring plans faced with economic uncertainty. Labour costs came in as expected, higher by 1.5%, a significant cool-off from the first quarter's 6.4% spike.

Canada – The Canadian employment report was upbeat, as 34,300 jobs were added in August, way ahead of the expected 8,500 jobs additions, more than reversing the 30,400 jobs lost in the prior month. Details though were less impressive, as the growth was driven by a strong pick-up in part-time hirings, which added 46,700 positions. Jobs were lost in construction, manufacturing and finance, more than offset by increases in transportation, professional, management and administration. The unemployment rate held steady, as expected, at 7.3%. Labour productivity, however, disappointed in the second quarter, falling a larger than expected 0.4%.

Building permits in Canada, much as expected, retreated in July by 2.3%, hopefully a sign of a much needed real estate cool-down.

## Financial Conditions

European Central Bank: The ECB held rates steady at 0.75% last week, as expected. As widely anticipated, and largely leaked to the media, ECB President Draghi announced that the Bank stands ready to intervene in secondary bond markets in order to “safeguard the monetary transmission mechanism” by lessening the distortions due in part to euro break-up fears. The program has been dubbed “Outright Monetary Transactions” or OMT. Purchases will be focused on the short end of the yield curve (up to three-year maturities) and be as large as necessary (i.e. unlimited) and ECB will be ranked pari passu. Draghi asserted that the OMT is within the ECB’s mandate and again said the euro is “irreversible”. In order to qualify for ECB purchases, a country would first have to apply to the EFSF/ESM for a bailout (either a full program or precautionary program). The conditions attached to ECB action would be the same as those in an EFSF/ESM bailout.

The ECB’s so-called “big bazooka” against Europe’s debt crisis, via a massive sovereign debt buy up is designed to bring down the soaring borrowing costs that crisis-wracked countries say prevent them from getting back on their feet. In effect, the ECB will buy the debt - or bonds - of struggling governments, helping to keep their borrowing costs at manageable levels while giving them the funds they need to operate.

This a major shift in policy which should finally enable peripheral eurozone governments to implement fiscal and structural reforms, while enjoying less punitive financing costs as the market stops fretting about sovereign defaults and euro membership.

In addition, the ECB has also relaxed the criteria for eligible collateral. Given it was estimated that Spain and Italy would run dry of collateral within the next two months, these changes are a relief for their banking systems.

1. The ECB will accept marketable debt instruments issued in USD, GBP and JPY issued in the Euro area with an additional uniform haircut of 8%. Previously the ECB only accepted very minimal amounts of non EUR denominated debt in specific countries. The total value of USD, GBP and JPY debt instruments issued in the Euro area is estimated to be EUR 1.4 trillion ( see chart below). Some of this will not be eligible; some will already be encumbered; a small proportion is already accepted; and some will not be held by Euro area banks. But assuming an average haircut of 25% it represents a maximum potential liquidity injection of just over EUR 1000 bn. a potentially significant increase in Euro area liquidity. It is arguably more effective than the OMT because liquidity can be provided to banks now without conditionality. Of course such an injection should only be seen as granting respite for markets to normalise and that the need is for these traumatised sovereigns to be able to return to the market in their own name, raising money at lower and sustainable costs.

Potential maximum size of collateral and liquidity injection

Source: Dealogic, RBC Capital Markets

2. The ECB will also accept marketable debt instruments issued or guaranteed by the central government and credit claims granted to or guaranteed by the central government irrespective of credit rating if that country is eligible for OMTs or under programme and conforming with conditionality. This will be applied to outstanding and new assets. This effectively removes the issue of ratings downgrades if a country enters the programme. It also is suggestive that banks in a country under the programme will be able to use self issued government guaranteed debt as collateral, which was limited earlier this year. Effectively we believe this is a small additional encouragement and promise of liquidity if a country is to enter the programme, and so should be of interest to the Spanish banking system which has recently created significant amounts of collateral through lending to its regional governments.

The Bank of England has kept interest rates at 0.5% and held off from more stimulus measures. Its rate-setting Monetary Policy Committee has voted to maintain rates at this historic low for three years

US – UK: US Federal Reserve policymakers remain 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 extension 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 1.42% and the U.K.'s 2 year/10 year treasury spread is 1.58% - 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 3.55% - (3.49% end of July was 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 is at 6.5 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 42 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 14.25 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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