Market Commentary

PORTLAND INVESTMENT COUNSEL™

September 17, 2012

News Highlights on Current Holdings

Financial Services Companies

Axa - Axa Germany to focus on core business after CEO Thomas Bubert reorganises the unit, the Financial Times reported last Friday. The unit is to focus on the traditional business of insurance and health and retirement provisions.

Barclays - New Barclay's CEO, Antony Jenkins, said he will set a new profitability target in the 1Q next year following the conclusion of a review of the business. The bank had a cost of equity of 11.5% for 2011 and in February said it may fail to meet a 13% Return on equity target by 2013. A margin above the cost of equity "is exactly the right metric for us to use," said Jenkins. "I want to deliver sustainable returns."

Influential Barclays shareholders have rallied behind Sir John Sunderland as a prospective new head of the bank's remuneration committee last night — despite suggestions that his appointment could trigger a row. Barclays have been sounding out investors about appointing the former chairman and CEO of Cadbury's who has been on the board for seven years. There was speculation that his association with the old guard at Barclays could raise hackles among investors.

Barclays is set to sell all its stake in University Partnerships Programme, the UK's largest developer of university campuses, in a deal that is likely to net the bank £1bn. Barclays has agreed to sell a 60% stake in UPP, which has an enterprise value of £1.4bn, to PGGM, the Dutch pension fund that has been in talks about taking a stake in the student housing company for over a year. (Source : Financial Times).

Citigroup reached an agreement with Morgan Stanley to sell a 14% stake in its retail brokerage joint venture with Morgan Stanley, MSSB (Morgan Stanley Smith Barney) along with the transfer of $5.5 billion in bank deposits, valuing the brokerage JV at $13.5 billion. In addition, the companies set the price of the future sales of Citi's remaining 49% ownership in MSSB to Morgan Stanley at the same implied valuation, to be completed by June 2015. The figure comes in slightly lower than the consensus expectation, which was ~$15 billion. Earlier this summer, it became public that Morgan Stanley and Citi had been unable to reach a common price for the transaction. Morgan Stanley and Citi had valued the business at $9 billion and $22 billion, respectively. Thus two firms called in Perella Weinberg to settle the dispute to value the business which sells stocks and bonds to wealthy individuals – the agreed price means Citi have to write down the value of the current investment by US$2.9 bn.

Deutsche Bank signalled more jobs could be on the line after announcing plans to cut costs by €4.5bn a year and pledging to reduce bonuses to its most senior staff who will have to wait five years for any payouts. The bank, which employs more than 8,500 personnel in the UK, is also setting up a new compensation standards panel to review the way staff are paid as it attempts to tackle the reputational challenges facing the banking industry amid an ongoing investigation into Libor rigging that cost Barclays £290m in fines. (Source : The Guardian).

ING - KB Financial Chairman Euh Yoon-dae said talks with ING to buy their South Korean insurance unit are still ongoing. Negotiations are expected to continue until next week," Euh told reporters on Wednesday, in reply to a question about its bid to acquire the ING insurance unit. Euh said he hopes the deal will be concluded in two or three weeks but declined to give details of the negotiations. Separately, ING have said U.S. Chief Operating Officer Robert Leary has left the firm amid efforts to separate the company from its North American businesses. Alain Karaoglan, EVP of finance and strategy, will take on the COO role.

Standard Chartered : The New York times reported last week that lawyers within the Treasury Department recommend a preliminary settlement that could lead Standard Chartered to pay a final penalty to on illegal money transfers with Iran. The settlement will be much smaller than the $340m which the bank paid to the NY state regulator according to the NY times. This would be a positive because the market expects a fine between $700m to $1bn+ and it would remove a key uncertainty.

Dividend Paying Companies

ABB – revealed during its Capital Markets Day that it plans to improve competitiveness through cost-savings and productivity improvements while also looking at branching out into offering service and software packages rather than just standalone products to increase market share. The company said it plans to increase its service revenue by 20% to 25%. It also re-iterated its ambitions to build its position in the global industrial automation market, following its $3.9Bn acquisition of Thomas & Betts, earlier this year. ABB said that the global economy has developed in line with expectations when it announced its 2011-215 strategic and financial targets and, as a result, it reconfirmed all of the previously stated goals.

Chemring – announced it had granted Carlyle Group, a US private equity firm, an extension to the 'put up or shut up' deadline to make an offer for the British company. The deadline is now 1700 GMT on October 12, which is replacing the previous 1700GMT on September 14 time limit. The extension had been offered in order to 'enable the parties to continue their on-going discussions regarding a possible offer'. Chemring and its industry peers are facing lower defence spending in the US and Europe as governments are striving to reduce costs and this in turn has spurred consolidation in the sector. Last week BAE Systems and EADS, the Airbus parent, disclosed they were in advanced talks over a merger deal.

Vivendi – cleared the regulatory hurdles for its plans to establish a joint venture with TVN of Poland, which will try to challenge for a bigger slice of Poland's pay-television market, central Europe's biggest. Vivendi will have a 51% stake in the venture and will also acquire a 40% stake in N-Vision, TVN's controlling company. The consideration for the 40% share of N-Vision is €230mm.

Economic Activity, Consumer and Business Conditions

US – Macro-economic news over the last week painted an overall weaker than expected economic growth profile for the United States, providing credence for the Federal Reserve's unprecedented stimulative measures.

On the business activity front, the industrial production dropped by 1.2% in August, unexpectedly, as the consensus was factoring in a flat performance. While some of the decline was blamed on hurricane Isaac, the weakness was broad-spread, with manufacturing retreating by 0.7%, mining down 1.8% and utilities dropping 3.6%. Capacity utilization dropped a full percentage point over the same month, to 78.2%. Earlier in the day, the retail sales report showed a slightly better than expected performance, advancing 0.9%, ahead of the expected 0.7% improvement, in the month of August, on the back of strong auto sales and higher gasoline prices. Other retail categories, such as electronics, general merchandise and clothing actually retreated in the month. This relative weakness in the core retail categories could be explained in part by an unexpected drop in consumer credit in July, down $3.28Bn, against expectations for a $9.1Bn addition. This later development could turn out to be just temporary, in the light of the massive liquidity provided by the newly announced Federal Reserve actions and a significantly improved consumer sentiment. The University of Michigan consumer sentiment measure shot up to 79.2 index points in September, from 74.3 in August, led by a jump in the 'expectations' component of the index.

Meanwhile, inflation continues to remain low. The headline consumer price index (CPI) figure, moved off the relatively low 1.4% level in August, but was in-line with the expectations at 1.7% year on year level of change. The key driver was the energy prices, with gasoline alone up 9% in the month. The core level of inflation was tamer than expected, at 1.9% year on year change, short of the expected 2.0% level.

The US international trade balance moved deeper into deficit in July, to $42Bn, from $41.9 in June, as exports fell more than imports. We wouldn't be surprised to see an improvement in the US export metrics in the months to come, given the predictable and already observable weakness in the US dollar, as the Fed's printing press reaches record speeds.

Canada – The Canadian industrial capacity utilization managed to rise to an 81.0% level in the second quarter of the year, from a revised 80.5% level in the first quarter. The balance of visible goods trade reached an all time low in July, at $2.34Bn deficit, on broad-based export weakness, led by the energy exports. The main culprit for this situation is a deterioration of the trade balance with US, which is likely to continue given the above-mentioned expectations for a weaker US dollar.

On the Canadian housing front, a slow-down is less apparent than some would expect, as the house starts for August advanced at a 224,900 units annual rate, ahead of July's 208,000 units pace and contradicting the expectations, which were calling for a slow-down to a 200,000 units annual rate. New housing prices continued to grow in July, though the 0.1% advance was short of the expected 0.2% rise in prices.

The Federal Reserve said it would launch a major new round of bond-buying, extending the blitz of unconventional actions the central bank has unleashed since the financial crisis to support the precarious economic recovery. After months of careful signaling, the Fed's policy-making committee said last Thursday it would buy $US40bn each month of agency mortgage-backed securities on an open-ended basis, and said it would extend those purchases and buy additional assets if the jobs market doesn't improve. "Quantitative Easing 3" has therefore arrived with the additional intent to keep interest rates at rock bottom levels through to mid 2015 rather than late 2014 and that these stimulating measures are set to continue until the employment market improves 'substantially' .... which perhaps means an unemployment rate below 7.5% or below 7% ... no such materiality was given. At the same time we should expect such buying of mortgage-backed bonds will continue to keep mortgage rates down and provide further support to a recovering housing market ...to the evident benefit of mortgage providing banks, title insurers and house builders.

Financial Conditions

Europe's big banks could be forced to protect trading assets as the consensus recommendation of an European Union-wide review is due to be completed next month, the Financial Times reported. The Liikanen review was set up in November by Michel Barnier, the EU commissioner in charge of regulation, to review the structure of Europe's banks. The newspaper cited people close to the project as saying a clear majority was in favour of a combination of a ban on so-called proprietary trading and a ring-fence on retail banking activities.

Michel Barnier, the European Commissioner in charge of financial regulation, said that euro zone-wide banking supervision should be introduced by next January, despite German reservations. Barnier said the EU Commission's banking sector plan envisaged centralised supervision for all 6,000 euro zone lenders, large and small, though oversight of some day to day matters, such as elements of consumer protection, would remain with national authorities.

(Source : Reuters)

Banking Union - EC to unveil reforms to strengthen the EBA, with concerns in the UK that London could be overruled on supervision. EC President last week used his State of the Union speech to the European Parliament to unveil the EU's approval for banking union. In the first steps towards a banking union, the reforms give the ECB responsibility for supervising all eurozone banks by 2014. UK Chancellor Osbourne has called for clear safeguards for the UK single market. The UK back the plan for the ECB to have strong powers covering eurozone banks but it remains contentious that the EBA will be asked to adjudicate on cross border disputes and can over-rule one side. Under the plans, the ECB will become the top-level supervisor of every lender in the 17-nation currency region, but would still depend on national regulators for day-to-day supervision and ensuring that banks comply with European rules. Today's plans aim to phase in the new system by Jan. 1, 2014, and all 27 EU members will need to sign off.

Bank of England Governor Mervyn King said global central bankers agreed to set up an inquiry into Libor after confidence collapsed in the benchmark rate for more than $500 trillion of securities. The announcement follows a meeting yesterday of central bank governors led by King in his role as chairman of the Economic Consultative Committee at the BIS in Basel, Switzerland.

The inquiry will be led by "senior officials," and comes as Financial Services Authority Managing Director Martin Wheatley conducts a separate investigation into how the London interbank offered rate is set. (Source : Bloomberg)

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 1.59% and the U.K.'s 2 year/10 year treasury spread is 1.68% - 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 43 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 14.77 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.

Chris Wain-Lowe
Executive Vice President
Portland Investment Counsel Inc.
Phone: 905-331-4250 Ext. 4232
Fax: 905-331-4368
www.portlandic.com

Source: Thomson Reuters, Bloomberg, Company reports

Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

PIC12-0103-E(08/12)