Market Commentary

PORTLAND INVESTMENT COUNSEL™

January 7, 2013

News Highlights on Current Holdings

Financial Services Companies

Aviva - CIMB and Aviva are to finalize buyers for their stakes in Malaysia's CIMB Aviva Assurance by end of this week, Business Times reports. CIMB expected to sell its entire 51% stake to Malaysia's state investment co. Khazanah Nasional for $500m, newspapers says. Manulife and Sun Life vying for Aviva's 49% stake, according to Business Times.

BBVA – last Thursday BBVA issued €1.5bn in senior bonds, the first corporate debt issuance of 2013. The bonds are due Jan 2018 with a 3.75% coupon and sold for 295bps above mid-swap, revised down from a guidance of midswaps plus 310bps and 85bps tighter than a 3yr bond issued in Sept.

Deutsche Bank - Italy's central bank has suspended all cash-machine and credit-card transactions in Vatican City on the grounds that the papal state hasn't fully complied with international rules on money-laundering, the Financial Times reports, citing a statement by Father Federico Lombardi, who heads press relations at the Holy See. Deutsche Bank's Italian unit, which runs a network of cash machines for the Vatican, was refused authorization to continue operating the service from the beginning of the month, Financial Times says.

Royal Bank of Scotland - The Financial Times says that the rundown of RBS's "non-core" business is among the most dramatic shrinkages of any bank in the world and is no less complicated. A quid pro quo for the UK government's 2008 bailout of what was then Britain's biggest bank was the creation of a £258bn non-core business that would be sold off and/or closed down. Four years into the five-year mission, Rory Cullinan, the man with the task of running RBS's non-core unit, is getting close to the end, with the portfolio shrunk to £65bn by the end of September. After cutting assets at a pace of about £50bn a year, there will only be about £20bn to shed this year. Of the remaining assets, the biggest subset remains corporate loans – £29bn now, compared with £112bn at inception. Another category, commercial property, has been trickier to cut – still £25bn today, compared with £63bn at the start of the project.

Royal Bank of Scotland/Lloyds - both banks are preparing to impose a 4th annual consecutive cap on cash bonuses, with a £2000 ceiling on cash payments, Sky News reports. Talks have begun between the banks and leading investors yet talks with the UKFI, the body that manages the government ownership, have not begun. Several bank executives speaking to Sky News have said a repeat of the £2000 cap was inevitable.

Santander/Banesto - Cinco Dias reports that Santander is seeking to cut 3,000 jobs at Banesto as part of its takeover plans. They hope to reach an agreement with unions by Jan 15. Santander aim to generate €520m synergies from the deal in the 3rd year.

UBS - The Financial Times reports that the record $1.5bn fine paid by UBS over Libor manipulation and other regulatory breaches was yet another public relations disaster for the company. But for CEO Sergio Ermotti, it marked a leap forward in his attempt to clean up the lender's many legacy issues. The Financial Times says however that the shrinking of the investment bank by winding down most of its fixed income business might continue to cause management headaches for several more years and investors and rival bankers are starting to assess the costs and risks of winding down a CHF560bn balance sheet.

European Investment Banks: Dealogic data data for 4th Quarter shows a strong finish to the year for Investment Banking primary businesses. Aggregate industry revenues totaled $18.7bn for the quarter, 14% higher than 3Q and the best 4Q since 2007. For all 2012 aggregate Investment Banking revenues totaled $67.4bn, 3% lower than 2011 and still 25% down on 2007 peak levels. The contrasting fortunes of debt versus equity remain stark with 2012 being a record year for Debt Capital Markets but the weakest year for Equity Capital Markets since 2003. Against a 14% quarter on quarter increase in industry Investment bank revenues, Barclays shows a 48% increase, Deutsche Bank a 24% increase and Bank of America Merrill Lynch a 20% increase. Equity houses fared less well with Goldman Sachs posting only an 11% increase, UBS 8% and Credit Suisse 6%.

Dividend Payers

Chemring – Appointed a new finance director to its management team last week, a move well received by the markets as a sign of reduced uncertainty for the British defence manufacturer. The company had employed an interim CFO since March of last year, when its former finance director stepped down. The new finance director is Steve Bowers, formerly Finance Director at Umeco, a firm that provides advanced composite materials mainly to the aerospace and defence industries and which was acquired by Cytec Industries last year.

POSCO – The South Korean steelmaker is part of a consortium that has agreed to buy a 15 percent stake in a Canadian iron ore mine operator controlled by ArcerlorMittal for $1.1Bn. A $540mm payment will be shared by POSCO and China Steel, while the remaining $560mm is expected to be paid by financial investors including the National Pension Service of South Korea. ArcelorMittal is divesting the stake in an effort to reduce its debt burden. It wrote down the value of its European business by $4.3Bn last month and has had its credit rating cut to non-investment grade by all credit rating agencies. ArcelorMittal Mines Canada operates two large open-pit mines in Quebec. As part of the deal announced on Wednesday, POSCO, China Steel and ArcelorMittal Mines Canada will enter into long-term iron ore supply agreements. We see the acquisition by POSCO as a step forward in securing raw materials as the company currently imports nearly all of its key raw materials. The group has been acquiring upstream assets, including a 12.5% stake in Australia's $10Bn Roy Hill project.

Toyota – managed to remove much of its litigation uncertainty by having its proposal to pay $1.1Bn in economic losses related to possible safety defects in Toyota vehicles approved by a US judged. The settlement amount was smaller than expected and is covering most of the litigation involving unintended acceleration. The group would take a one-time pretax charge of $1.1Bn to cover the costs. Toyota admitted no fault in proposing the settlement and a study by US safety regulator, the National Highway Traffic Safety Administration (NHTSA) and NASA found no link between the reports of unintended acceleration and Toyota's electronic throttle control system. The company may be able to offset the costs with a rise in profits as the yen weakens. The day prior Toyota guided for record-high groupwide global sales and production in calendar year 2012.

Vivendi – is rumoured to be interested in a deal merging its mobile telecom unit, SFR, the group's largest division with Iliad the French market newest (and recently most successful) operator. The French regulator, Autorite de la Concurence, is said to oppose a merger because it would create a duopoly in the French broadband internet market, along with France Telecom's Orange. Vivendi's chief executive predicted the group's future would lie in its content and media business and we share its preference for content related assets. The group has been shopping its Brazil and Morocco telecom assets.

Economic Activity, Consumer and Business Conditions

US – The highlight of last week's US macroeconomic releases was the December employment report, which surprised marginally on the upside, with a headline non-farm payroll job increase of 155,000 positions, ahead of the consensus expectations of 150,000 positions and on top of November 161,000 positions added. The growth was driven by a 168,000 private payrolls addition in the month, offset by a 13,000 pull-back in government positions. Manufacturing added 25,000 jobs in December, which was 25,000 more than expected. The headline unemployment rate was 7.8%, on par with the upwardly revised November rate, as a 150,000 jobs improvement is seen as consistent with steady unemployment. Good news also transpired on the income side of the report, with the average weekly earnings advancing 0.3% in the month, ahead of the 0.2% expected improvement.

US business trends, as gauged by the twin leading indicators for the manufacturing and services sectors issued by the Institute for Supply Management at the beginning of each month, show a mild improvement, with the PMI (Purchasing Managers Index) advancing to 50.7, back into expansionary territory, while the NMI (the Non-Manufacturing PMI) moved to 56.1 from 54.7 in November, contrary to the expectations calling for a retreat to a 54.2 level.

In the midst of the political brinkmanship surrounding the fiscal cliff negotiations (see below), the US consumer confidence suffered. The Conference Board's consumer confidence index dropped to 65.1 in December, from 71.5, way short of an expected 70.0 level.

News from the housing sector continue to be positive with readings over the last couple of weeks improving sequentially. The Case-Shiller housing price index for the 20 US metropolitan areas moved higher at a 4.3% year on year pace in October, ahead of the expected 4.0% and an acceleration from September's 3.0% rate. New home sales improved in November as well, even though, at 377,000 units annualizes, a whisker short of the expectations. Lastly the US pending home sales for November, a good leading indicator of existing home sales in the following couple of months, also improved, by 1.7%.

Canada – The Canadian economy surprised with another strong employment report in December. Employment improved by 39,800 positions, adding to a 59,300 jobs increase in the month prior and significantly beating the consensus expectations which were calling for a 5,000 positions improvement. The growth was broad based, with many sectors, including construction, manufacturing and transportation contributing to the improvement. The unemployment rate retreated one tenth to 7.1% from 7.2% in November.

Financial Conditions

Fiscal Cliff

As some had anticipated, at the very last moment, Democrats and Republicans in the US Congress managed to pass a compromise bill, limited in scope, as it only deals with the revenue side of the US budget problem, and which is designed to increase tax revenues by about $620Bn over the next ten years.

The bill avoided an increase in income taxes for most Americans, by making the Bush era tax cuts 'permanent' and imposed increased taxes on those making more than $400,000 individually or more than $450,000 as a household in taxable income. Given that taxable income is arrived at after applying a number of deductions to one's revenues, the tax is only expected to affect some 0.7% of the Americans. The top marginal tax rate was raised to 39.6%, up from 35%, coupled with increased taxes for dividends and capital gains for the same Americans. Those making more than $2.7 million will pay in average $443,910 more in 2013, while households with income between $500,000 and $1 million will pay an average of $14,812 more.

A payroll tax cut was allowed to expire in effect triggering a 2% increase in taxes for employees, potentially removing more than $100Bn out of the economy in 2013. The bill also extends expanded unemployment benefits and continues refundable tax credits for low-income families and college students and also extends miscellaneous tax breaks through 2013, including the production tax credit for wind energy and the tax credit for corporate research. Automatic tax cuts scheduled to start this month were also delayed, at a $24Bn cost, which is set to be offset by a blend of additional revenue and spending deductions spread over a number of years.

The 'bipartisan' bill did, in fact, meet limited Republican acceptance, with 85 of the 236 House Republicans voting in favour, which it anticipates means further brinkmanship and protracted uncertainty as the US is approaching other substantive milestones: the sequester at the end of February, which, if unaddressed will trigger a number of automatic spending cuts agreed during the 2011 debt ceiling negotiations; the debt ceiling limit, which is likely to be reached by early March; and the expiration of a temporary budget on March 27.

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 until the unemployment rate falls below 6.5% (December 7.8%) which is likely to be through 2014. Fed Reserve Chairman, Ben Bernanke has indicated 1% or less would be considered exceptionally low. In September 2012, the Fed announced it would buy $40 bn per month of agency mortgage-backed securities and in December 2012 that it would also buy $45 bn per month of treasuries (4 year maturity and above) which means all parts of the yield curve will benefit from a near-zero anchor until late 2014. The U.S. 2 year/10 year treasury spread is now 1.64% and the U.K.'s 2 year/10 year treasury spread is 1.65% - 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 3.34% - (3.31%, end of November 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 4.8 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. A recovery in house prices appears increasingly sustainable 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 is easing 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 should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 18 – 24 months 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 0 in 2013 (compared to 49 in 2012, 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..

The VIX (volatility index) is 17.84 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

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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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