Market Commentary

PORTLAND
INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Australia & New Zealand Bank announced that its Chinese business is planning to issue its first debit card as part of a deal with UnionPay International, having signed a memorandum of understanding with China's only domestic bank card services provider that will allow ANZ China to issue debit cards and to open ANZ's network across the region to UnionPay customers. ANZ said this agreement, which is expected to be formalised later in 2013, would set the stage for the bank to issue its first solo card in the key market of China. Before now, it has only issued a co-branded Platinum and World Travel Card credit card with Shanghai Rural Commercial Bank. (Source : Dow Jones).

Bank of America has reported fourth-quarter earnings that were lower than the year-ago period but slightly above expectations as it worked to put the effects of the housing bust behind it. Bank of America said it had net earnings of $US367 million compared with $US1.6 billion in the previous calendar period. As expected, earnings were hit by a recently announced settlement with government-controlled mortgage giant Fannie Mae, which resulted in a charge of $US2.7 billion.

Barclays - NY Post says that Barclays new CEO Anthony Jenkins will outline a plan on Feb. 12 when the bank delivers its fourth-quarter results to cut between 5 and 10% of its global workforce. According to unnamed sources, the cuts will be concentrated in ancillary areas in Europe and Asia. In addition to the layoffs, the expectation is that Barclays will exit some businesses in its investment-banking arm to streamline operations and appease regulators. Separately, the Financial Times reports Barclays is weighing whether to recoup some or all of the £290mn Libor fine from the 2012 investment banking bonus pool. In an email to staff from CEO Anthony Jenkins on abiding by stringent ethical standards, he warned that performances and rewards would be judged on a set of core values including integrity, respect for others and quality of customer service.

Citigroup posted $2.32 billion of charges for layoffs and lawsuits in the first financial report under its new chief executive, Michael Corbat, who cautioned that the bank needs more time to deal with the problems it faces. Even with the charges, Citi reported a higher fourth-quarter profit as trading revenue rebounded. But the result was below Wall Street expectations. Citigroup reported 4Q12 GAAP EPS of $0.39. Excluding CVA/DVA (Counterpart and Debt Value Adjustments) of $485mn ($0.10) and $1.0bn ($0.21) of repositioning charges, EPS was $0.69 whereas market expectations was $0.98. Results in 4Q12 included only $0.02 of loan loss reserve release, down from $0.19 in 3Q12, which in the most part explains the miss. Relative to the 3rd Q 2012, results evidenced a relatively stable balance sheet with net interest margin expansion (+7bps), lower fee income (reduced trading), higher core expenses (+2%), and an increased loan loss provision (+$0.4bn) despite continued improvement in asset quality metrics. Balance sheet growth was sluggish in the quarter as slower growth in Citicorp loans was more than offset by a decline in balances in Citi Holdings due to continued runoff. Assets at Citi Holdings declined to $156.0 billion (8% of Citigroup's total assets). Capital ratios remained strong in 4th Q 2012, and at December 31, 2012, the company had an estimated Basel III Tier 1 common capital ratio of 8.7%. Over 2013, we expect Citi's legacy costs to decline and mortgage reserve releases to occur ($8.4bn reserve for $92bn of loans that are showing consistently improving metrics). In addition, Citicorp loans should continue to grow (in each of the past 8 quarters its grown loans y-o-y in every business), while it guided to a relatively stable NIM. While capital redeployment may be muted in 2013 (unlike expected buy backs by Wells Fargo and JP Morgan) we expect it to accelerate redeployment thereafter. It trading at about 80% of tangible book.

HSBC - agreed to pay US$249mn to end a case-by-case review of past home foreclosures in the US, bringing the total payout by banks to resolve related issues to US$9.3bn. London-based HSBC agreed to pay US$96mn to eligible borrowers who lost their homes to foreclosure in 2009 and 2010, and provide US$153mn in other assistance, including loan modifications and forgiveness. (Source :Reuters)

JPM reported 4Q12 Earnings Per Share of $1.39, beating expectations $1.21. Results included a $900mn (-$0.14) expenses for mortgage-related matters, $567mn (-$0.09) of Debt Value Adjusted losses, $620mn (+$0.16) tax benefit, $42mn (+$0.01) of net Mortgage Service Related hedging gains, and $102mn (+$0.02) of securities gains. Net, these cost the bank $0.04. Its loan loss provision was $972mn (+$0.17) less than Non Conforming Obligatiions, approximating the prior quarter's release, with $700mn ($0.11) tied to reduced mortgage loan losses. It expects further loan loss reserve reductions. Additionally, mortgage repurchase losses reflected a benefit of $53mn ($0.01) and included a $249mn reduction in the repurchase liability and lower realized repurchase losses driven by improved cure rates on agency repurchase demands. All of these items added $0.08 so adjusted earnings per share were $1.39 – still well ahead of expectations. Operating revenues rose 10% y-o-y and decreased 6% from 3rd Q 2012. Its Basel I Tier 1 capital common ratio was 11.0% (+60bps), while Basel III was 8.7% (+30bps). Its Return on tangible common equity was 15%.

Net interest income declined 8% y-o-y but rose 1% sequentially. Relative to 3Q12, average earning assets increased 2% with loans stable and securities up 5%. Its net interest margin declined 3bps to 2.40%. Its core Net Interest Margin decreased 7bps to 2.85%. Results reflected lower loan yields, lower yields on investment securities (yield down 7bps), limited reinvestment opportunities, and higher balances in Fed funds, partially offset by lower long-term debt costs (-34bps).

Fee income declined 2%. Overall trading revenues declined 15%, the lower end of its 15-20% guidance. Fixed Income, Currency and Commodities (FICC) decreased 15% (-$549mn) to $3.2bn, while equity markets decreased 13% (-$149mn) to $895mn. The portion of the synthetic credit portfolio transferred from CIO experienced a modest loss. Investment banking fees rose 20% to $1.7bn (record debt underwriting fees). Core expenses looked rose about 6% year on year and increased 2% from 3Q12.

Non Performing Assets (NPAs) were $11.7bn, down from $12.5bn in 3Q12. Before the impact of the reporting changes, NPAs would have been $8.7bn, down from $9.5bn. Its reported Non Conforming Obligation ratio declined from 1.53% in 3Q12 (1.05% adj) to 0.90%. The credit card net charge-off rate was 3.50%, down 7bps and its 30+ day delinquency rate was 2.10%, down 5bps. Its loan loss provision of $656mn was down from $1.8bn in 3Q12 and was $972mn less than NCOs. Its reserve/ loan ratio declined 16bps to 2.99%.

Morgan Stanley reported adjusted earnings for the fourth quarter on Friday that beat analyst estimates, driven by gains in wealth management and investment banking. Including charges, the firm had a 4Q profit of $US481mn, or US25cps per share. That compares with a per-share loss of US15cps in the year-ago period. The group plans to trim about 15% of its investment banking positions in Asia. The job cuts in Asia investment banking are expected to be deeper than the 6% reduction to be made across the broader institutional securities group, which includes fixed-income and equity sales and trading, research and investment banking.

Nordea - CFO Fredrik Rystedt was sacked yesterday and replaced by Torsten Joergensen. The head of IR said it is about differing views especially on how to reduce costs further in central functions and how to do the reorganisation (for which he deemed Torsten more appropriate). The new plan should be ready by summer (3Q announcement most likely). Nothing to do with 4Q no's. CEO seems clearly not happy with NDA execution especially given the poor relative share performance and multiple differential to Swedish peers.

Royal Bank of Scotland - The Sunday Times reports that RBS will break its investment bank into two divisions in the wake of an estimated £500m fine for its role in global interest rate rigging of LIBOR (London Interbank Offered Rates). John Hourican, head of the RBS investment bank, is expected to leave within the next 2 weeks after being forced to take responsibility for the bank's involvement in manipulating Libor rates. Hourican is not expected to be replaced, with the Investment Bank then expected to be split into a markets business and an international banking arm. Trading and traditional investment banking would then be expected to be housed in the markets division. The international banking arm will handle lending and trade finance for large and multinational corporate clients.

Santander - The Sunday Times reported, citing unnamed sources, that Santander is considering making a £2bn bid for National Australia Bank's UK 'Clydesdale' business to accelerate its British expansion. According to the article, executives in London and Madrid have been looking at a deal since the collapse of talks to buy a network of 316 branches from RBS last October. Santander declined to comment on the report. Note, National Australia Bank scrapped plans to sell 337 Clydesdale and Yorkshire bank branches last April, having struggled to attract a buyer, and instead announced plans to shrink the business, cutting 1,400 jobs.

Britain's banking industry and financial regulator are in talks to establish a cut-off date to end the costly stream of claims from the public relating to banks' mis-selling of payment protection insurance (PPI). The banks are facing a huge back-log of claims from the mis-selling scandal and the bill is likely to exceed the £12bn they have already put aside. The British Bankers' Association has suggested a deadline of summer for claims to be made, in return for the banks agreeing to finance an advertising campaign warning people of the new cut-off date. (Source : Reuters)

Dividend Payers

Barry Callebaut – the leading global cocoa processor and chocolate maker, reported first quarter sales which were marginally lower, down 0.6% to CHF1.25Bn, affected by pricing pressure in its ingredients business, affected by global oversupply. However, Barry Callebaut's sales volume beat expectations with an 8.3% increase to 388,160 tonnes, driven mostly by rising emerging market demand. Barry Callebaut's sales revenue grew by 1.6% in Europe, 6.3% in the Americas and 8% in the Asia-Pacific, as the global chocolate market grew by only 1.1%. Growth in chocolate sales was offset by a drop in coco processing business. Part of the decrease was the result of the fact that internal demand for cocoa powder to feed the business making chocolate for other firms, limited sales of cocoa intermediates to other firms.

The company's recent acquisition of Petra Foods, a major cocoa processor, should alleviate this type of problem in the future. The firm confirmed its medium-term growth targets, which include average volume growth of 6% to 8% and growth in earnings before interest and tax (EBIT) in local currencies at least in line with the growth in volume through to its 2014/2015 financial year.

Separately, the company announced the acquisition of a chocolate factory in Sweden as well as the signing of an outsourcing agreement in Denmark. Barry Callebaut bought ASM Foods AB, the Swedish chocolate factory, from Denmark's Carletti A/S, which will add 35,000 tonnes of production capacity. At the same time the firm signed an outsourcing agreement to produce industrial chocolate and compounds in Denmark for Carletti. Lastly, Barry Callebaut announced it would sell its frozen pastry business in Alicante, Spain, to a holding company of Carletti and ASM Foods. The total cash-out resulting from the three transactions will be CHF33mm.

Carnival Corporation – re-established a $1Bn share repurchase program and declared a quarterly dividend last week. The repurchase authorization covers the common stock of both Carnival Corporation, trading on NYSE, and Carnival Plc, trading on LSE.

Underlying the attractiveness of the vacation cruise industry, Norwegian Cruise stock rose 32% to $25.10 in the first trading session post its initial public offering, which was priced at $19, above the expected $16 to $18 price range.

Vivendi – Etisalat, the Gulf area's second largest telecom operator, is reported to be interested in Vivendi's 53% stake in Morocco's top telecom operator. The stake is worth around $5.8Bn at the current market price and Vivendi is hoping to secure a $7.3Bn from a potential purchaser. Other bidders rumoured to be interested are Qatar Telecom and South Korea's KT Corp.

Economic Activity, Consumer and Business Conditions

US – Retail sales in the US exceeded expectations for the month of December, rising 0.5%, ahead of the 0.2% consensus call and on top of a robust 0.4% advance in November. Sales of auto vehicles were a big part of the story, but other retail categories, such as furniture and apparel, contributed as well. The core retail sales figure, which excludes sales of automobiles and parts, was up 0.3% also ahead of the expectations, which were pencilling in a 0.2% improvement.

The US consumer price index (CPI) data for December, released last week, give no reason for concern for the time being, as the headline rate actually cooled-off to a benign 1.7% year on year level, from November's 1.8% level, while the core reading, which excludes food and energy prices, was, at 1.9% year on year, in-line with the expectations and the prior month's level.

Industrial production improved, as expected, in December, up by 0.3%, driven by manufacturing and offset by a relatively slow month for utilities, courtesy of warmer than usual weather. Capacity utilization saw a marginal improvement, to 78.8%, still significantly below a meaningful inflationary level.

News out of the housing level mostly met the expectations over the last week, as the National Association of Home Builder housing index inched lower to a 47 level from 48, the housing starts advanced to 954,000 units annualized and the building permits were an exact match of the expectations, at 903,000 units annualized.

The one particularly disappointing data point last week was the Michigan consumer sentiment reading for January, which showed a drop to a 71.3 level, from 72.9 in November and below the expected 75.0 index points reading. Both the 'current conditions' and the 'expectations' components of this index 'contributed' to the poor reading, which paints a rather depressed consumer, affected by still sluggish revenue growth and protracted political bickering around the fiscal cliff, debt ceiling and the US budget.

The World Bank has sharply downgrading its growth forecasts, warning that both Europe and the US could pitch the world into recession this year. Global growth is expected to reach only 2.4% this year, up from just 2.3% last year, with the bank expecting Europe to endure a second year of recession and growth falling in the US and Japan. (Source: The Australian)

Germany's economy is estimated to have contracted by 0.5% in the 4th Quarter 2012, slowing the annual rate of growth to 0.7% for 2012, down from 3% in 2011, according to Germany's Federal Statistics Office. This weakness is expected to be relatively short lived, reflecting more the worst of last year's crisis rather than fresh concerns.

Financial Conditions

Investment banks are cutting jobs in equities faster than any other division as revenue recovers at a slower pace than the rest of their businesses and more trading is automated. Employees on stocks desks fell by 8.5% globally in the first nine months of last year, according to a survey by Coalition Ltd., an industry analytics firm. That compares with a 6.6% drop in fixed-income workers and a 5.8% decrease for origination and advisory functions, the data show. Bloomberg

UK banks: The Bank of England last week published a Draft Policy Statement on "Powers to supplement capital requirements". Highlighted two aspects – (i) Countercyclical capital buffers as per Basel 3, but also (ii) Sectoral Capital requirements, where the Financial Policy Committee will be able to require additional capital to be put aside to cover exposure to specific sectors where there is evidence of over-heating. They specifically highlight three; (i) residential property; (ii) commercial property; and (iii) other parts of the financial sector. Would appear that the additional capital will be expressed as a buffer rather than higher risk weighting.

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 1.59% and the U.K.'s 2 year/10 year treasury spread is 1.64% - 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 3.38% - (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 2 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 12.46 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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