Market Commentary

PORTLAND INVESTMENT COUNSEL™

January 28, 2013

News Highlights on Current Holdings

Financial Services Companies

Barclays - 106 current and former employees have had their Libor anonymity request rejected by a High Court judge, the FT reports. The decision was made in in relation to the lawsuit brought by Guardian Care Homes against Barclays, which comes to trial in October. Lawyers representing Barclays asked for their names to not be published. Barclays is not planning any challenge as they see the situation as one for the individuals to challenge themselves.

Separately Andrew Tinney COO of Barclays Wealth Mgmt unit stepped down amid allegations he suppressed a critical report on the unit's culture in the US. His departure follows an independent report on cultural shortcomings at the unit.

Also, last Monday, Hector Sants, the former chief of the UK's Financial Services Authority , commenced his new job as Head of Compliance, Regulatory and Government affairs at Barclays.

Barclays has now also started the consultation process to slim down the Investment bank with the aim of shedding up to 2,000 jobs, or 9% of the Investment bank workforce. The cuts are part of the strategic overhaul by CEO Anthony Jenkins who is set to unveil a "blueprint for Barclays for at least the next decade" next month with annual results. The reduction of up to a tenth of the bank's 23,000 investment banking jobs 9,000 of which are based in London,is in keeping with Mr Jenkins' earlier remarks that the bank would not be split nor whole business lines exited.

Barclays/Credit Suisse – The Financial Times reports bankers in Europe are ready to test a new type of structured finance product that boomed pre-crisis, with Barclays and Credit Suisse both preparing collateralized loan obligations. The deals could come as early as next month. A successful launch would be further evidence in market sentiment towards riskier but high yielding assets. Separately, Barclays are considering issuing a $3bn contingent convertible bond issue immediately following the much awaited strategy day on February 12 according to the Sunday Times. The bank launched a similar issue late last year which was well oversubscribed. The move comes as UK banks await the findings of the inquiry into their capital positions ordered by Sir Mervyn King's new financial policy committee. Antony Jenkins, Barclays new chief executive, is said to be keen to remove any lingering doubts about the group's capital strength or accounting practices so it can move on.

Lloyds Banking Group is to shed 940 jobs across the UK, taking the total job losses announced by the state-backed lender this month to more than 1,300. Lloyds, which is 39% owned by the government, said on Wednesday that the reductions would take place across the group. Last week it announced 170 jobs cuts affecting staff working in its Halifax branches while on Monday it said 230 positions in HR would be lost. (Source Financial Times).

Santander, Spain's largest lender, is not in talks to buy Clydesdale and Yorkshire Bank from National Australia Bank. Santander is focused on organic growth in the UK, Andy Smith, a spokesman for the Spanish lender's UK unit stated in a telephone interview last week. The Sunday Times reported in the previous week that Santander has been considering a bid for NAB's Clydesdale and Yorkshire bank units since talks to buy 316 branches from RBS collapsed in October. (Source Bloomberg).

Wells Fargo announced that they are increasing their quarterly dividend to $0.25/sh, up 14% from $0.22/sh last quarter. The increase is consistent with the company's 2012 capital plan that was approved by the Federal Reserve last March. As a result of the increase, Wells Fargo's payout ratio increases to 27% from 23% of estimated 2003 earnings. Wells Fargo has also requested an increase in capital distribution in their 2013 Comprehensive Capital Analysis and Review (CCAR) submission which is currently under review

LTRO (Longer term refinancing operation) repayment: 3 year LTRO money issued last year is planning to be repaid by the sector. 278 financial institutions will repay €137bn on Jan. 30th – the first opportunity for early repayment, according to the ECB. Bloomberg consensus had suggested approximately €90bn would be repaid initially, rising to €150bn over the coming weeks out of the c€1trn total. The bank sector will probably be split between those that can repay from those that can't, like the small Spanish banks and with the market awash with central bank provided liquidity, there is still a considerable gap between sustainability and repaying LTRO. Conversely there is a risk that this will result in a temporary glut in Sovereign bonds. As banks repay their LTRO money, one easy way to finance it would be to sell the Sovereign bonds held as security. Lloyds will repay £8bn out of £11.4bn. Banks have said they were encouraged to take the LTRO funds by the ECB to de-stigmatize it and fears are that the stigma will return. Repayment of the funds does temporarily reduce liquidity and raises short term rates but we do not expect this to be a major event. Periphery banks will mostly retain LTRO funds as its cheap funding and banks

We recall that for the 3-year LTRO allotted on 21 December 2011, 523 banks had tapped EUR489bln, and these banks can start to repay the funds from January 30. They can make repayments from that day onwards on a weekly basis, just giving the central banks one week's notice. As for the repayment of the second 3-year LTRO, where 800 banks had tapped EUR529bln, banks can make repayments on a weekly basis from February 27 onwards.

Dividend Payers

Chemring – The manufacturer of defence equipment, saw a significant rebound in its share price for the start of the year, hinged on expectations that its newly minted management team would better position the firm going forward. Some of the first measures targeted by the new management involve simplifying the management structure, integration of the operating units and prioritisation of cash and cost management. The full 2012 fiscal year results included a 42% fall in profit, on revenues 2% higher, of £740.2mm. The company reduced its final dividend to 4.2 pence, to enhance the firm's financial flexibility ahead of what is said it would be difficult market conditions in 2013. Total dividend for the year amounted to 9.5 pence per share, a 36% reduction compared to the year prior and roughly a 3.2% yield as of Friday's close. We continue to believe that the company is valued attractively and also believe that the relatively lower cost of its products, compared to the value of equipment and human lives they help protect, should provide it with a more solid footing even in a lower defence spending scenario.

Novartis – The company's fourth quarter and full year earnings announcement, broadly in-line with the expectations, was eclipsed by the unexpected announcement of Daniel Vasella's departure, the company's chairman, after 17 years of leading the Swiss drug company. He will be replaced by Joerg Reinhardt, who is returning from Bayer, having led that German firm's healthcare division. The markets received the management positively, as a sign of potential changes to the group's conglomerate structure.

Novartis' fourth quarter core earnings per share rose to $1.27, supported by better than expected sales of new products and a slower than forecasted sales erosion of its franchise drug Diovan, which went off patent last year. Although the group expects tough trading in 2013, and guides for a mid-single digit fall in profit in 2013, for the first time ever it also released a mid-term guidance which highlights increased confidence about its earnings prospects. The management said it expects to report sales growth of at least mid-single digits in 2014 and 2015, while core operating income is forecasted to grow ahead of sales.

The US Food and Drug Administration (FDA) approved Novartis' drug Exjade to remove excess iron in patients over the age of 10 who have a genetic blood disorder known as non-transfusion-dependent thalassemia (NTDT).

Novartis won EU approval for its first meningitis B vaccine, Bexsero. Previously there was no approved vaccine offering broad protection against meningitis B, a type of meningitis caused by bacteria that leads to inflammation of the lining around the brain and spinal cord. The challenge going forward is for the firm to persuade cash-poor governments to add it to routine vaccination programs.

Siemens – The group's first quarter net profit from continued operations reached €1.3Bn, as the company's focus remains on cost cuts to improve its operating profitability in-line with peers such as GE and ABB. Group level new orders retreated by 3% to €19.1Bn, affected by a slow-down of Chinese orders for drive technology and industrial automation as well as a decline in its home market orders. A €6Bn cost cutting programme was launched last year and is expected to reach its full potential over the next two years. The quarterly profit was affected by a charge related to a delayed high-speed train project. Outlook for the year includes an operating profit of €4.5Bn to €5Bn, largely affected by €1Bn in costs related to its savings programme. Longer term, the company's CEO, Peter Loescher aims to increase the margin of Siemens' core operating profit to at least 12% from 9.5% last year.

Toyota – announced it had returned in the top spot as the world's biggest automaker in 2012, posting record-high sales and ranking ahead of rivals General Motors and Volkswagen. Total tally was 9.75mm vehicles, including its various brands, a new record high in the company's 75 year history and up 22.6% compared to the prior year, heavily affected by the triple earthquake, tsunami and nuclear disaster. The company aims to increase its sales by 1.6% in 2013, to 9.91 vehicles.

Earlier in the week, the Canadian and Ontario government revealed that they would invest C$34mm to help retool a Toyota plant in Cambridge, Ontario, so it can produce a hybrid version of the Lexus sport utility vehicle, which would be the first hybrid vehicle to be built in Canada. The overall cost of the project is more than C$100mm. The upgrade will increase Lexus manufacturing capacity by 30,000 vehicles to 104,000 units, including 15,000 hybrids.

Economic Activity, Consumer and Business Conditions

US – The activity of the US goods producing sector, as measured by the US durable goods report, saw a strong resurgence in December, up by 4.6%, ahead of the expectations for a 1.8% advance. The improvement was driven by the volatile transportation sector, but, even when accounting for its effect, the core US durable goods orders were 1.3% higher, ahead of the forecasts for a 0.7% increase. Main drivers of the core orders were orders for communications equipment as well as orders for computers and electronics, which shows that, despite the uncertainty surrounding the US fiscal situation, US companies can't postpone their technological investment forever, if they are to maintain an edge in the world markets. Earlier in the week, the US leading economic indicator (LEI) surprised on the upside, moving 0.5% higher compared to expectations for a 0.3% improvement, after being unchanged for November. Higher stock prices and an improvement in the jobs outlook were key contributors to the composite index's advance, as five of the ten components indicated growth in the month.

Following a long string of better than expected numbers out of the US housing, last week's announcement related to the sector seem to indicate a pause in the advance. The US existing home sales for December retreated to a 4.94mm units annualized, from November 4.99mm units annualized and short of the expectations for an improvement to a 5.10mm units annualized. The new home sales report that followed also showed a retreat, to a 369,000 units annualized level, which was short of the expectations for a milder pull-back, to a 385,000 units annualized level. Lastly, the US pending home sales, a good indicator of future US existing home sales, reported earlier today, unexpectedly dropped by 4.3% , compared to expectations for a 0.3% improvement.

Canada – Retail sales in Canada delivered yet another positive surprise, moving 0.2% higher in November, compared to an expected flat reading, chiefly driven by sales of auto vehicles. Core retail sales, which exclude sales of auto vehicles, were disappointing, down 0.3% in the month, compared to expectations for a 0.1% rise, with advance in some of the categories, such as electronics and home furnishing being offset by drops in sales of gasoline, clothing and general merchandisers.

Unexpectedly low levels of inflation were observed in the month of December in Canada, were the annual rate of change of the headline consumer price index (CPI) was 0.8%, in line with November's rate and lower than the expected 1.2% rate. The core rate, which excludes the eight most volatile price categories, was 1.1% in the month, again milder than the expected 1.4% rate. Such low rates of inflation should temper Bank of Canada's intentions to raise rates.

Japan - the Bank of Japan has moved to unlimited asset purchases and a 2% inflation target. The Bank of Jamaica is adopting a 2% inflation 'target', in contrast to the previous 1% price 'goal', and from January 2014, when its current Y101 trillion round of asset-purchases had been set to expire, it will begin buying Y13 trillion ($146bn) of mostly short-term government debt each month until that inflation target is met.

Spain's regional government of Madrid yesterday sold €1bn of 5 year bonds attracting €1.9bn of demand and at 1.9% above the equivalent Spanish government debt. The sale is the largest single debt auction by a Spanish region ever and is a sign of increasing confidence in Spain, it follows the successful sale Tuesday of Eur 7bn in 10 year Spanish government debt in a deal that attracted almost €23bn of orders, the most in Spain's history, the Financial Times reports. This was the first sale of regional debt since March last year when Madrid sold €665mn of 3 year debt and followed the regions of Catalonia and Valencia requesting a bailout from central government. The Madrid Community also managed to place €1bn of bonds maturing in 2026 in a private placement, a development hailed by local politicians as a sign that international confidence was returning to Spain.

Portugal returned to the long term debt market since the 2011 bailout. Bankers said demand for Portugal's "syndicated tap", increasing the size of an existing €6bn bond maturing in 2017, was in excess of €12bn. Overseas demand led the government to increase the offer size by a quarter to €2.5bn and lower the cost of borrowing to less than 5%.

Financial Conditions

Basel III Capital Rules for Banks - Bundesbank board member Andreas Dombret says so-called Basel III capital rules will go into effect in the EU in early 2014 at the latest, WirtschaftsWoche reports. Dombret has "no doubt" the U.S. will introduce the Basel III rules as well. Lenders that combine "traditional banking business and investment banking" aren't necessarily a threat to the stability of the financial system, WiWo cites Dombret as saying.

Investment banks must take further actions to improve returns and more will follow firms like UBS and RBS that have exited businesses, McKinsey said. Only five or six companies will remain "bulge bracket" firms that offer all investment banking and trading products worldwide, the consulting firm said today in a report titled "After the Reckoning." Others will step back from some businesses to focus on areas where they have a competitive advantage, according to the report (source : Bloomberg).

The UK's financial industry will lose 43,000 jobs in six months, according to a forecast from the Confederation of British Industry, as companies shrink and reduce costs. Banks, insurers, asset managers and other finance firms probably cut 25,000 positions in the last three months of 2012 and may eliminate 18,000 jobs in the first quarter of this year, according to a study by Britain's biggest business lobby group and PwC. (Source : Bloomberg).

Financial Transaction Tax - Germany, France and nine other euro zone countries will get the go-ahead on Tuesday to start work on a financial transactions tax, a measure likely to unsettle banks and trading houses but which will please voters and could raise much-needed revenue. European Union finance ministers are expected to give their approval at a meeting in Brussels, allowing 11 states - Germany, France, Italy, Spain, Austria, Portugal, Belgium, Estonia, Greece, Slovakia and Slovenia - to start preparations for imposing a tax on all financial market transactions. "There is sufficient support from ministers ... and it looks likely they will allow the 11 to go ahead with enhanced cooperation on a financial transactions tax," said one diplomat. Under EU rules, a minimum of nine countries can cooperate on legislation without all member states using a process called enhanced cooperation, as long as a weighted majority of the EU's 27 countries give their permission.

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 1.71% and the U.K.'s 2 year/10 year treasury spread is 1.73% - 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 3.42% - (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 12.89 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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