Market Commentary

April 15, 2013

News Highlights on Current Holdings

Financial Services Companies

BNP Paribas is set to open a new online bank targeting 500,000 customers in five years as it revamps its retail activities. Although France's biggest bank already offers online banking for its regular retail customers, the new project will be entirely digital. French daily Les Echos, which reported the plan, said the new brand might be called "Hello Bank". (Source : Reuters)

Credit Suisse - Outgoing Deutsche Bank finance expert Charlotte Jones will join Swiss bank Credit Suisse as head of group finance and investor relations in July, according to a memorandum seen by Reuters last Tuesday.

Deutsche Bank : Mitsubishi UFJ has acquired a US real estate loans business from Deutsche Bank, the latest in a series of acquisitions by the Japanese lender and a string of disposals by the German bank. UnionBanCal, the San Francisco-based subsidiary of MUFG, announced it was buying the US$3.7bn loan portfolio together with the loan origination platform. (Source Financial Times)

JPMorgan reported operating EPS of $1.41 slightly ahead of consensus of $1.39. JPM's Q1/13 reported EPS was $1.59, up 34% from $1.19 a year earlier. Reported earnings included reserve releases of $650 million ($0.10 per share after-tax) from mortgage Real Estate Portfolios, and $500 million reserve release ($0.08 per share after-tax) from credit card portfolio. Excluding these items operating EPS was $1.41.

JPMorgan increased its dividend 27% to $1.52 which would represent a 27% payout on Q1/13 operating earnings. JPMorgan also repurchased $2.6 billion of shares or 1.4% of market capitalization during the first quarter. The board also authorized JPMorgan to repurchase $6.0 billion of common equity or 3.2% of o/s until Q1/14.

Solid earnings were driven by strong performance across all business lines. Corporate & Investment Banking (CIB) earnings were strong. Sales and trading revenue (excl. Debt Value Adjusted) was strong, up 78% QoQ and up 8% YOY. Investment banking fees were also strong at $1.4 billion, up 4% YOY. Consumer & Community Banking (CCB) net income was down 12% YOY, although up 28% QoQ. Net interest income was down 2% YoY driven by lower deposit margins and lower loan balances due to portfolio runoff, largely offset by higher deposit balances. Non-interest revenue was down 11% YoY driven by lower mortgage fees and related income. Mortgage originations were up 37% YoY and 3% QoQ. Credit card sales volumes were up 9% YoY and down 7% QoQ. Auto originations were up 12% YoY and 18% QoQ. Asset Management net income was up 26% YoY and 1% QoQ driven by strong AUM net inflows. Net interest margin declined to 2.37% from 2.40% in the previous quarter and 2.61% a year earlier.

Net charge-offs totaled $1.7 billion or 0.97% of total loans compared to $1.6 billion or 0.90% of loans in the previous quarter and $2.4 billion or 1.35% of loans a year earlier. Total loans were $708 billion up 2% YOY and down 1% QOQ. Total deposits ended the quarter at $1.2 trillion, up 1% QOQ and 7% YOY. JPMorgan guided toward full-year 2013 expenses to be down ~$1bn YoY, excluding corporate litigation and foreclosure matters.

Reported ROE was 13.2%, compared to 11.4% in the previous quarter and 10.8% a year earlier. JPMorgan's Basel III Tier 1 Common Ratio at quarter end increased to 8.9% from 8.7% in the previous quarter.

Nordea - Polish press are indicating that Nordea could sell Polish subsidiary for between 2.3 billion zlotys and PLN3.7 billion ($0.73-$1.18 billion) with top Polish lender PKO the most likely acquirer.

UBS - Bloomberg reports that UBS plans to expands its Asia corporate advisory and capital markets team by 10% over three years to tap growth in the world's fastest-growing region. The bank may move some employees from Australia to faster-growing parts of Asia, Matthew Grounds, head of the Asia-Pacific corporate client solutions unit and chief executive officer for Australasia for UBS, said in an interview in Sydney last week. UBS doesn't plan to increase its headcount in Australia, he said.

Wells Fargo posted 1Q13 EPS of $0.92 (a record), ahead of consensus of $0.89, marking its 13th straight quarter of increased EPS (and 8th consecutive record quarter). Relative to expectations, a lower-than-forecast loan loss provision and higher-than-anticipated average loan balances were able to more than compensate for a modestly lower-than-anticipated net interest margin. Results included a $200mn loan loss reserve release ($250mn release in 4Q). It had $45mn in securities gains and $113mn in equity investment gains. Net MSR results were $129mn, down from $220mn in 4Q12, due primarily to MSR valuation adjustments made in 1Q13 for the impact of improving housing prices on estimated prepayment speeds. It provided $309mn for mortgage loan repurchase losses, down $70mn from 4Q12. Net, these added $0.02.

Operating revenues declined 1% on both a y-o-y and linked quarter basis. Relative to 4Q12, results reflected the absence of the higher than average equity gains, lower mortgage results, and two fewer days. It posted an ROA of 1.49% and an ROE of 13.59%. Its Basel I tier 1 common ratio was 10.38% (+26bps despite -25bps from Basel 2.5), while it was 8.39% under Basel III. It had net unrealized securities gains of $11.2bn at 1Q13, down $0.7bn. Dividend increased 20% to $1.20 per share, for a dividend payout ratio of 33% on Q1/13 earnings. Wells repurchased 17 million shares in Q1/13 or 0.3% of outstanding. The board previously authorized Wells to repurchase over $4.0 billion of common equity or 2% of o/s until Q1/14.

Net interest income declined 2% from 4Q12, with the company citing two fewer days as the main driver. Average earning assets rose 2% with loans up 1% and securities gaining 5%. Average deposits rose 1%, while period-end balances also increased 1%. Its net interest margin declined 0.08% to 3.48%. Approximately 0.03% of the decline was due to lower income from variable sources, including loan resolutions and periodic dividends.

Period-end loans were relatively stable as core loans increased 0.6% while its liquidating portfolios decreased 3.9% (to $91bn or 11% of total loans). Core commercial loans increased 0.3%, while core consumer gained 0.9%. The asset-backed finance, commercial banking, corporate banking, credit card, government and institutional banking, mortgage, retail brokerage, real estate capital markets, and retail sales finance portfolios all experienced year-over-year, double-digit growth.

Fee income was relatively stable with 4Q12. Gains in trading (+$295mn), other (+$90mn), and insurance (+$68mn; crop insurance seasonality) were offset by declines in mortgage (-$274mn, lower originations), other fees (-$159mn; lower CRE brokerage commissions), operating lease (-$40mn) and service charges (-$36mn; seasonality). Trust & investment fees (retail brokerage and asset-based fees up, investment banking down) and card fees were relatively stable. Results included $45mn in securities gains and $113mn in equity investment gains. Mortgage originations declined 13% sequentially to $109bn. Applications declined 8% to $140mn, while its pipeline decreased 9% to $74mn. Its gain on sale margin was relatively stable at 2.56% (though is expected to decline).

Expenses declined 2% y-o-y, and gained 4% from 4Q12 due to higher benefit costs. Its cost / income efficiency ratio was 58.3%, down from 58.8% in 4Q12 (55-59% target). Wells Fargo say it expects expenses to decline from 1Q13 to 2Q13, though its tax rate is expected to rise. Its effective income tax rate was 31.9% and included the benefit associated with the realization for tax purposes of a previously written-down investment. Absent additional discrete benefits in 2013, it expects the effective income tax rate for the full year to be higher than the effective income tax rate for 1Q13.

Non Performing Assets declined by $1.6bn, or 7%, to $22.9bn, with every major category stable to lower. Loans 90 days or more past due and still accruing (ex. government insured/guaranteed) totaled $1.4bn, in-line with 4Q12. Its Non Conforming Obligations ratio improved 33bps to 0.72% (lowest since 2Q06). Its loan loss provision was $1.2bn, down $612mn from 4Q12. Its reserve/loan ratio declined 4bps to 2.15%. It expects future reserve releases in 2013.

Dividend Payers

ABB – won a $150mm power order for world's highest capacity transmission link in China. Once completed in 2014, the 8,000 megawatt (MW) Xiluodu-Zhexi link will be capable of transmitting the energy equivalent of eight large power plants and supplying 40 billion kilowatt-hours of electricity per year – enough to meet the needs of over 11 million Chinese consumers.

Roche Holding – reported first quarter sales in London last week; at CHF11.59Bn sales were 5% higher than for the previous comparative period and ahead of the expected CHF11.45Bn level. Quarterly sales received a big boost from a spike in US demand for the flu drug Tamiflu. Sales of the mainstay cancer medicines were also strong in the quarter, with Avastin up 11% to CHF1.53Bn and the newly-approved Perjeta, a follow-on drug to company's leading breast cancer medicine Herceptin, reaching CHF50mm in the quarter. Sales in the smaller diagnostic business were up just 1%, as the diabetes care line of products saw a 5% decline in the quarter. Roche expects full-year sales to grow in line with 2012 when they rose 7% and core earnings to rise ahead of revenues. I said it expected to further increase its dividend in 2013.

Roche announced it had teamed up with emerging biotech firm Ascletis to develop and commercialise its investigational drug danoprevir in China for the treatment of the hepatitis C virus.

Roche denied rumours of it being interested in taking complete ownership over Chugai Pharmaceutical, of which currently controls 59.9%. Roche had already restructured its operations in Japan to remove duplication.

Siemens – The German engineering group signed an option with Denmark's DONG Energy to supply 154 offshore wind turbines for a total capacity of 924MW. The 6MW-each turbines may be installed from 2015 at the Gode Wind projects in Germany, which DONG acquired in 2012.

A Munich court on Wednesday ruled to allow Siemens' plans to spin-off lighting unit Osram to go forward, despite legal action taken by a handful of investors. The group is selling off Osram as part of a restructuring, which includes shedding less profitable businesses and seeking €6Bn of savings.

Toyota – recalled 1.73mm vehicles worldwide due to an airbag problem; the airbags had been supplied by Takata Corp and other Japanese manufacturers are also affected: Honda recalled 1.14mm vehicles, Mazda recalled 45k vehicles and Nissan recalled 480k vehicles.

Veolia Environement – QGC, a subsidiary of BG Group, signed a 20-year contract with Veolia Water to manage the three water treatment plants at its coal gas production sites in the Surat Basin, southeast Queensland (Australia). The contract is expected to generate an estimated cumulated total turnover of €650mm.

Veolia Environement and Total inaugurated the Osilub recycling plant in Normandy, which recycles used oil into high-grade lubricants. The treatment capacity is of 120k metric tons of oil a year or nearly 50% of the volume of used oil generated each year in France. The plant is expected to provide a recycling yield of around 75%, the best rate achieved anywhere in the world, as per company reports.

Economic Activity, Consumer and Business Conditions

US – Macro-economic news out of US for the last week centred on the US consumer and reports were underwhelming. The US retail sales for the month of March unexpectedly dropped by 0.4%, reversing partly the 1% gain in February and falling short of the consensus expectations which were calling for a flat reading. Sales of vehicles and parts retreated 0.6% in the month, while the core retail sales, which exclude the above-mentioned auto-related sales, were also down 0.4%. Weakness in the sector was relatively broad based, with many categories being impacted, including electronics and appliances, sporting goods and general merchandise. The outlook for the sector is not a lot rosier as the US consumer sentiment for April, measured by the University of Michigan, showed a drop in consumer confidence, to 72.3 index points from 78.6 index points in March, significantly under-shooting the expectations for a 78.5 index points level. Both the 'current conditions' and the 'expectations' components of this composite index dropped in the month.

It would also appear that the US housing sector is taking a bit of a 'breather' after recent signs of improvement. In a report released earlier today, The National Association of Home Builder's housing market index retreated 2 index points to 42, surprising the market watchers, who were pencilling in an improvement to a 45 index points level.

Canada – Macro-economic news out of Canada for the last week were mainly about housing and data seems to help alleviate worries for a hard landing. The housing starts in Canada picked-up in March, to a 184k annualized level, contrary to the expectations, which were factoring in a slow down to a 176.5k annualized level. The building permits for the month of February, though up 1.7%, fell short of the expected 4.3% advance. The New Housing Price Index for February moved 0.2% higher, in line with the expectations and topping January's 0.1% improvement.

Hurricane Season: With less than two months until the official start of the hurricane season, (re)insurers have been warned to expect another active tropical season of wind activity. Weather Services International (WSI) has predicted 2013 will contain 16 named storms, nine hurricanes and five intense hurricanes, adding that this estimate may prove "a bit conservative". This compares to an average since 1950 of 12 named storms, seven hurricanes and three intense hurricanes. (Source: Insurance insider)

US Federal Housing Finance Agency (FHFA): announced last week the extension of the Home Affordability Refinance Program (HARP) until 12/31/15 (vs 12/31/13). While not entirely unexpected, today's announcement is a positive surprise for mortgage originators that have used HARP to help qualify high Loan To Value borrowers for refinancing opportunities at currently low market rates. More than 2.2 million homeowners took advantage of the program to date, with about half of them in 2012 alone. At present, it is estimated there may be as many as 2.5-3 million more eligible borrowers outstanding (~$600 billion-$1 trillion in volume), who haven't yet taken advantage of HARP, which was likely a key driver behind the extension. Further, HARP activity now accounts for nearly a third of all refi applications

UK House Prices: Property sales website Rightmove highlighted that UK property sellers asking a healthy 2.1% more for UK Residential property in April than March. Likely to partially reflect start of spring sales round, but encouraging suggestion that property initiatives are starting to feed through.

Financial Conditions

Banking Union - Reuters reported Germany said European banking union will require changes to EU law, a call that could slow the plan's completion. Finance Minister Wolfgang Schaeuble said the EU's Lisbon treaty had to be changed to allow common rules on shutting troubled banks, which is a key part of the banking union. Schaeuble said Europe would need to strengthen the network of national restructuring funds and authorities, which will require treaty change.

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% (March 7.6%) 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 1.49% and the U.K.'s 2 year/10 year treasury spread is 1.50 % - 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 3.43% - (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 4.7 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 14 – 20 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 5 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 12.06 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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