Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Australian banks are the most profitable in the world among developed market economies, with rising pretax profits and increasing interest margins, the Bank of International Settlements (BIS) says. Confirming the strength of the banking system – and possibly highlighting a lack of competition – the BIS annual report shows Australia's banking system is more profitable than 10 other developed economies', including Canada, the United States, United Kingdom, Sweden and Germany.

Lloyds/Royal Bank of Scotland - Lloyds asked the European Commission for a 2-yr extension of deadline to complete sale of 631 branches, the Sunday Telegraph reports, without citing anyone. Royal Bank of Scotland also expected to ask for deadline extension, according to the article. Helen Kearns, spokeswoman for the European Commission in Brussels, declined to immediately comment on report.

Lloyds Banking Group is to receive a £1.6bn dividend from Scottish Widows. The bank said that the decision to make the payment was made at its regular board meeting. According to PRA, Lloyds's had the second largest overall shortfall of £8.6bn and before the exercise had plans in place to raise an additional £1.6bn of capital this year. In a statement the bank said had generated £5.8bn of additional capital this year and was about "three-quarters of the way towards" meetings its 2013 capital requirement. The Telegraph

Nordea : Swedish Government has confirmed it is to sell down its existing 13.5% stake in Nordea to 7.0% with a 90-day lockup.

UK Banks - the full report from the Parliamentary Commission on Banking Standards, a 571 page review into the UK banking system has finally been published, with Andrew Tyrie, the Commission Chair, insisting it "is not a bank bashing report" but it is "clearly not acceptable" the way the UK government has interfered in the running of the part nationalised banks, the Financial Times reports. Chancellor George Osbourne is due to welcome the review at his Mansion House speech this evening. The British Bankers Association described it as "the most significant report into banking for a generation", as the report calls for major changes to the way regulators approve the appointment of senior bankers and punish them for failure. The Commission wants personal accountability and create a new criminal offence, reckless misconduct in the management of a bank. The recommendations cover several main areas including: making senior bankers personally responsible, reforming bank governance, creating better functioning and more diverse markets, reinforcing the powers of regulators and making sure they do their job.

Britain's biggest banks said asset sales and funds generated from internal growth mean they won't need to sell shares to meet the Bank of England's £13.4bn in announced capital requirements outlined by the Prudential Regulatory Authority. (Source : Bloomberg)

Morgan Stanley is cutting jobs in its commodities business, one of the Wall Street's three biggest, after Chief Executive Officer James Gorman said revenue the past two quarters was among the unit's worst in 18 years. Bloomberg

Morgan Stanley/Citi announced last week that it received all regulatory approvals to acquire the remaining 35% interest in Morgan Stanley Smith Barney Holdings (MSSB) from Citi. Upon the close of the purchase, Morgan Stanley will own 100% of the business, which will operate under the name Morgan Stanley Wealth Management. Morgan Stanley said it will notify Citi that it intends to exercise its right to purchase the remaining interest at a previously established price of $4.7bn, payable in cash. The closing is expected to take place on or about June 28. Additionally, MSSB will redeem all of the Class A Preferred Interests in MSSB owned by Citi for a purchase price equal to their liquidation preference plus accrued and unpaid distributions ($2.0bn). This represents execution of its long term strategy of taking capital out of Fixed Income Currency and Commodities and putting capital into global wealth management. Morgan Stanley's Tangible Book Value will go down approximately $1.60 this quarter before earnings given the increased goodwill and one-time charges

Citi : The sale of Citi's remaining stake in MSSB JV will add to its capital base (+0.4% to Basel 3 Tier 1 Capital to 9.7%, above 9.5% 2019 requirement) and reduce the size/contribution of Citi Holdings (from 7.9% of 1Q assets to 7.5% pro forma), while only modestly reducing liquidity (-$10bn of net assets initially; ~$50bn overtime; ~5% of total deposits). Also, with Citi's carrying value capped at the agreed selling price of $4.7bn we do not expect any further write-down.

Dividend Payers

BHP Billiton - Japanese trading houses Itochu Corp 8001.T and Mitsui & Co Ltd 8031.T will invest a combined $1.5 billion in BHP Billiton's Jimblebar iron ore mining hub in Australia, the world's largest miner said on Thursday. Itochu and Mitsui will invest approximately $800 million and $700 million respectively in shares and loans, representing an 8% and a 7% interest in the mining hub and resource. The consideration includes a share of costs already incurred by the Jimblebar expansion project.

Itochu and Mitsui, already longstanding BHP partners, hold a combined 15% interest in BHP's current Western Australia Iron Ore mine, rail and port infrastructure. The new Jimblebar mine will have initial production capacity of 35 million tonnes per annum and could expand.

Chemring – British military equipment maker Chemring Group Plc said results for the year would likely be at the lower end of its expectations as it restructures its business to cope with the uncertainty around defence budget cuts in the United States. Chemring had in January said it expected difficult market conditions to persist in 2013. About $85 billion in across-the-board government cuts to both civilian and defence programmes, known as sequestration, kicked in in March after President Barack Obama and Congress failed to agree on a plan to bring down the United States' budget deficit. The budget reductions have weighed on military equipment makers such as Chemring and have made it difficult for them to predict exactly how much of an impact the cuts would have on their businesses.

Chemring supplies equipment such as flares and pyrotechnics for ejection seats in aircraft, and minefield breaching systems to the U.S. military. Europe's largest defence contractor, BAE Systems BAES.L, last month left its outlook for the year unchanged, saying its 2013 forecast does not reflect the impact of U.S. defence spending cuts because it does not have sufficient detail.

The company has embarked on a restructuring under Chief Executive Mark Papworth, who took over last November and was assigned to turn around the business. Chemring said it would operate its businesses under four units. The company also decided to close its administrative offices at Pall Mall and Derby in the UK and in Washington and Philadelphia in the United States. The restructuring, expected to reduce head office headcount by 40%, or 20 jobs, would cost Chemring £15 million and is expected to help the company save about £10 million a year, mostly from 2014. The company has also revised its financial covenants with lenders and cut its interim dividend to 3.4 pence per share from 5.3 pence last year.

GlaxoSmithKline's (GSK) - experimental once-weekly diabetes drug albiglutide was effective in late-stage clinical trials, but the medicine is likely to face challenges in an increasingly competitive market. Albiglutide belongs to the same class of injectable GLP-1 drugs as Victoza, from Novo Nordisk, and Byetta and Bydureon, from Bristol-Myers Squibb and AstraZeneca. GSK said in a statement on Monday that its treatment had lowered glycated haemoglobin, an indicator of blood glucose levels, more than placebo and some other treatments in the series of trials. Consensus forecasts for albiglutide currently point to annual sales of around $440 million by 2018, according to Thomson Reuters Pharma.

GSK is discussing the sale of its thrombosis drug brands Arixtra and Fraxiparine, along with a related French factory, to Aspen Pharmacare in a deal that could be worth some $1 billion. Britain's biggest drugmaker said on Tuesday that Aspen had offered to buy the medicines, sales of which are in decline, and it was now in exclusive talks with the South African company about a deal, which is subject to consultation with employees. Neither company put a value on the proposed deal but assuming Aspen pays twice this year's anticipated sales, it could be worth around £700 million - after stripping out sales in China, India and Pakistan, which GSK will retain. About 1,000 GSK employees would transfer to Aspen, if the deal goes through, the majority of whom work at the Notre Dame de Bondeville production site in France. GSK said the proposed disposal fitted with its strategy of focusing on products with the most growth potential and delivering its new-drug pipeline. Declining products such as Arixtra and Fraxiparine are seen as a drag on GSK's growth at a time when new drugs are set to reach the market, and the company said in April it was bundling many of its older medicines into a new established products unit. That decision prompted speculation that more old drugs might be sold off to generate windfall gains, which could be returned to shareholders. GSK is also divesting its energy and fruit drinks Lucozade and Ribena in an auction that is expected to get under way later this summer. Aspen and GSK have a long history of doing deals together. Last year, the British group sold 25 older brands marketed in Australia to Aspen for £172 million in another clear-out of non-core drugs.

Hutchison Whampoa – Telefonica has agreed to sell its O2 Ireland mobile business for at least €780 million ($1 billion) in cash to Hutchison Whampoa's local unit 3 Ireland, it was announced on Monday. The deal, which is subject to regulatory approval, would quadruple 3 Ireland's market share to 37.5% and follows Hutchison's failed bid last year for Eircom, which owns the country's third-biggest mobile operator Meteor. In the past decade Hutchison has built a presence in six European markets, including Britain and Italy, but has struggled to make a profit as it remains smaller than domestic rivals. Last year its Austrian unit bought Orange Austria from France Telecom and more recently has been in talks with Telecom Italia about merging with its local unit 3 Italia.

A €2 billion offer from Hutchison Whampoa for Meteor parent Eircom was rejected last year in favour of a debt-restructuring deal that put the group's most senior lenders in control. The terms of the Telefonica sale include an additional deferred payment of €70 million if certain financial targets are achieved and the phasing out of the O2 brand, Hutchison said. The combined firm will have 120 stores in Ireland, whose domestic economy continues to stagnate, five years after the economy collapsed when a housing bubble burst. The two companies had combined revenues of €803 million in 2012.

Siemens - German industrial conglomerate Siemens is reportedly seeking offers from private equity firms to buy its stake in its telecoms equipment joint venture Nokia Siemens Networks. Siemens, together with its partner Nokia is reviving efforts to find a buyer and has approached private equity companies TPG, KKR and Blackstone, the sources said. NSN has shown signs of a turnaround in recent quarters, helped by a massive restructuring drive last year that cut around 20,500 out of 74,000 jobs.

Economic Activity, Consumer and Business Conditions

United States – A good week for news out of the US housing sector, started off with a 52 index points reading for the National Association of Home Builders' (NAHB) Housing Market Index, for the first time in over seven years that the indicator jumped over the 50 points threshold. A reading above 50 index points indicates that on balance, more home builders are optimistic regarding activity in the sector than there are homebuilders with pessimistic views. US housing starts moved higher, to a 910,000 units annualized level in May, up from an 860,000 units annualized level in April, albeit short of the expected jump to a 950,000 units annualized level. The building permits missed the expectation at the margin, suffering a mild retreat in May to a 970,000 units annualized level. Also, the US existing home sales saw a 4.2% jump in May, to a 5,180,000 units annualized level, ahead of the expected 5,000,000 units annualized reading.

The US leading economic indicators (LEI) index moved up modestly, by 0.1%, in the month of May, a significant deceleration from the 0.85% improvement in April, and short of the expected 0.2% advance. The negative surprise was provided by the initial jobless claims, new orders, non-defence capital expenditure ex-aircraft and the building permits components of this composite index.

On the US inflation front, the headline consumer price index (CPI) jumped to a 1.36% year on year rate in May from a 1.06% rate in April, driven by a jump in energy prices. The core reading, which strips the effects of volatile prices, such as energy and food, showed a 1.68% year on year rate of price change, broadly in-line with the expectations for a 1.70% rate and April's 1.72% read.

Canada – Retail sales in Canada continued its series of underwhelming readings, with a muted 0.08% improvement in April, which barely offset the 0.05% retreat in March and fell short of the expected 0.30% advance. The improvement was driven by a 1.4% gain in auto sales and as such, the core retail sales, which strips off sales of autos, where actually 0.30% lower in April than for the month prior, which were, in turn 0.28% lower than February's. Some retail categories managed to grow in the month though, including electronics and appliances, health care and sporting goods. Meanwhile, the Canadian headline consumer prices moved off the 0.41% low year on year rate to a 0.74% rate for the month of May. The core reading was almost identical to April's, indicating a 1.09% year on year advance in prices, still meaningfully below the Bank of Canada's 2% inflation target.

The New Housing Price Index surprised on the upside in April, with a 0.2% advance, which, together with earlier very strong housing starts and building permits reports does little in the way of underlying a much desired cooling off of the Canadian housing market.

On the Canadian business activity front, the April manufacturing sales dropped an unexpected -2.4% (expectations had been for a 0.3% improvement). Sales of autos and petroleum products were to blame for the retreat. Canadian capacity utilization improved to 81.1% for the first quarter of the year, from 80.5% in the last quarter of 2012, albeit short of the expected 81.5% level.

China : China markets fell-5% today, dragged by banking stocks, on official news reports Beijing will not change its tightening policy as it looks to crack down on shadow banking, which is blamed for a cash crunch on the mainland.

Financial Conditions

Euro zone finance ministers agreed that the bailout fund will be able to spend a maximum of €60bn on buying shares in banks, but the limit may be raised if necessary. A government would first have to recapitalise the bank to make sure it meets the minimum common equity Tier 1 ratio of 4.5%, before the bailout fund could become a shareholder. If a bank already meets the minimum ratio, the government would have to provide 20% of the necessary capital injection alongside the bailout fund's 80% during the first two years after the law comes into force in autumn 2014. After the two years, the government contribution to the necessary capital increase would fall to 10%. (Source : Reuters).

EU regulation: Bloomberg reports that revised EU proposals on bail-in debt contain specific target levels that banks will have to meet. The measures were discussed at an EU finance ministers' meeting on Friday with the UK, Finland and the Netherlands pushing for EU-wide minimum requirements that would require systemically important banks to hold bail-in debt equivalent to 15% of risk-weighted assets or 10% of total capital and liabilities. Smaller banks would have their requirements set by national regulators. There remain significant differences of opinion on the degree of discretion that should be left to national regulators. If passed, the rules are likely to be incrementally negative for those banks with the largest nominal balance sheets, including the French and Deutsche Bank.

European Banks: The Bank of International Settlements (BIS) has used the occasion of its annual report to wade deep into the debate on QE, warning that "central banks cannot do more without compounding the risks they have already created". Monetary stimulus has already led to "aggressive risk taking, the buildup of financial imbalances and misallocation of capital". The report also questions the ability of authorities to manage the rate tightening cycle without causing huge losses to the banking system, putting the cost of a 3% upward move in US treasury yields at more than $1tn or 8% of US GDP and 15-35% of GDP in France, Italy, Japan and the UK. "As foreign and domestic banks would be among those experiencing the losses, interest rate increases pose risks to the stability of the financial system".

UK - The UK has reached an agreement with European Union member states that will potentially limit Brussels' influence on the way the City of London regulates trading on its financial markets. A deal between the countries reviewing the EU's key markets legislation, known as the Markets in Financial Instruments Directive (Mifid), represents a significant step forward after 30 months of fierce negotiations between the UK, France and Germany, as well as banks and exchanges. It stipulates that no proposal or policy from any regulator, or from the European Securities and Markets Authority (Esma), should "directly or indirectly, discriminate against any member state or group of member states as a venue for the provision of investment services and activities in any currency".

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% (May 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 2.21% and the U.K.'s 2 year/10 year treasury spread is 1.98 % - 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 possibility of the withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has recently increased although remains very low at 3.93% - (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 16 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 18.90 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Source: Thomson Reuters, Bloomberg, Company reports

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