Market Commentary

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Financial Services Companies

Bank of New York and National Australia Bank (largest custodian in the Australian market) announced last week they are expanding their relationship. For the past 20 years, Bank of New York has been National Australia Bank's primary global custodian for offshore assets and NAB is Bank of New York's primary sub custodian for Australian and New Zealand assets. The new alliance will offer additional support to customers of both firms, as well as the opportunity to introduce an expanded suite of asset servicing products and services to Australian institutional investors.

Citigroup and HSBC have won approval to sell local mutual funds within China, a breakthrough for foreign banks largely locked out of the domestic retail investment market.

Citigroup has agreed to pay $US968mn to Fannie Mae to resolve potential future repurchase claims on residential mortgage loans originated between 2000 and 2012. A sizable group of the loans were originated during the US housing boom. Mortgage giants Fannie Mae and Freddie Mac bought mortgage loans from banks like Citigroup in the run-up to the financial crisis. Fannie and Freddie teetered as the loans went bad, and they were effectively nationalised in 2008. The government has spent billions to keep Fannie and Freddie afloat.

Credit Suisse : Jo Oechslin, widely regarded as one of the top Chief Risk Officers in the insurance industry has announced he is leaving Munich Re to join the Executive Board of Credit Suisse - a replacement is yet to be found. Widely regarded as a very sensible and smart guy - definitely a loss to Munich Re's management board, positive for Credit Suisse.

The Prudential Regulatory Authority (PRA) has added bank-specific detail to the previously disclosed aggregate capital data. As at end-2012, after adjusting for conduct costs/future expected losses and additional Risk Weighted Assets, the eight banks and building societies examined had an aggregate £27.1bn capital shortfall, of which £13.7bn was already expected to be filled by end-2013. The remaining £13.4bn shortfall will be filled via disposals/restructurings, some of which has already been completed. These shortfalls were measured against a 7% Basel 3 Core Equity Tier 1 ratio post-adjustments. The PRA additionally expects the banks to have a Core Equity Tier 1 leverage ratio of not less than 3% post-adjustments, with Barclays (2.5%) and Nationwide (2.0%) currently below that threshold and expected to comply by end 2015. We believe Barclays via ongoing capital generation (c0.3% pa leverage ratio increase via retentions) should comfortably exceed 3% Core Equity Tier 1 leverage by 2015.

Lloyds. A shortfall of £8.6bn was identified, with £7.0bn additional measures (on top of agreed capital plans) required. Of that £7.0bn, Lloyds has already raised £5.1bn via disposals and other measures, leaving a total of £1.9bn. It expects to meet the additional requirement via core earnings and non-core disposals. In part reflecting the Scottish Widows dividend, it raised its fully loaded Core Equity Tier 1 target to >9% by end-1stHalf 2013 and c10% by end-2013. These ratios already deduct insurance capital above the threshold allowances as confirmed by the PRA.

Last Wednesday, the Wall Street Journal reported that Royal Bank of Canada is close to placing a bid for Scottish Widows Investment Partnership, the asset management arm of insurance group Scottish Widows (SWIP), owned by Lloyds Banking Group, according to three sources familiar with the situation. According to the report, RBC's bid would likely be below Lloyds' target price of between GBP400 million-GBP500 million for the business. Other potential bidders mentioned in the article include French corporate and investment bank Natixis, and Australian banking group Macquarie. The report notes that RBC has been looking for a UK acquisition for some time, after buying U.K. fixed-income specialist BlueBay for $1.51 billion in October 2010. Further, the article states that Natixis Asset Management has $785 billion under management, with a large business in France and a U.S.-led multi-affiliate operation, and is making a big push into the UK defined contribution market, where SWIP has expertise.

Lloyds is to rebrand 631 branches across the UK using the name of TSB, a bank that merged with Lloyds in 1995. The TSB name will appear on Sept. 9, before the branches are ultimately spun off into an independent business.

Royal Bank of Scotland. The PRA discloses a £13.6bn deficit (to 7% CET1) after £7.1bn conduct/expected loss deductions and £56bn additional Risk Weighted Assets. Of that, £10.4bn was agreed in capital plans with £3.2bn outstanding, which RBS targets to reduce to £0.4bn by YE 2013 via Markets downsizing, divestments and LME gains.

Standard Chartered : Standard Chartered's Q1 2013 Interim Management Statement stated that group income grew by a mid-single digit in 1st Half 2013 (vs 1st Half 2012) with stronger volumes offsetting margin pressure in credit cards, cash (down 15bps) and trade finance (down 25bps). Group Net Interest Margin is expected to be lower by some 0.2%. The gap between operating income and operating costs was broadly neutral and is expected to be so for the year. Impairments picked up by $120m over 2nd half 2012 in the Consumer Bank as the unsecured book seasoned, while in Wholesale asset quality was guided to be good with low signs of stress. On the conference call management said it was comfortable it would hit the lower Profit Before Tax consensus of $8.07bn (it was $8.2bn at the time of the Q1 2013 IMS conf call). Headwinds to the group from Korea remain strong, which contributed around 40% of the consumer impairment number. The $1.9bn of current goodwill attributed to Korea is likely to be reviewed for impairment at 1st Half 2013 we assume in the range of a $500m/$600m charge.

Swedbank - Dagens Industri reported today, citing an interview with CEO Michael Wolf, that Swedbank plans to slowly and safely increase home mortgage market share. The bank says margins on future deals may decline as competition for wealthier customers remains tough. Swedbank is the most geared to mortgage spreads from a profitability point of view. We do not expect to see mortgage spread pressure in 2Q though new business margins remain below back book and should this persist already 3Q could see an impact.

Dividend Payers

Barry Callebaut AG, the world's leading manufacturer of high-quality cocoa and chocolate products, last week officially inaugurated its expanded state-of-the art chocolate factory located in Toluca, 65 km southwest from Mexico City. As announced in June 2011, Barry Callebaut acquired the industrial chocolate and compound production facility in Toluca from Chocolates Turin to further strengthen the company's presence in fast-growing emerging markets. Together with its chocolate factory in Monterrey (Mexico), the extension of the factory in Toluca marks an important cornerstone in Barry Callebaut's strategy to expand into emerging markets that offer above-average growth opportunities. For Barry Callebaut, it makes Mexico the fourth biggest country in terms of liquid chocolate production capacity worldwide. With an annual production capacity of around 65,000 tonnes, Toluca will be among the largest factories within Barry Callebaut's global network. Barry Callebaut established operations in Mexico in 2009 when it opened its first chocolate factory in Monterrey, Nuevo Leon. After four years of actively being present in the domestic market, the company became the largest manufacturer of chocolate on an industrial scale in Mexico, providing more than 300 jobs and manufacturing chocolate products for small to large food manufacturers in its two local factories. Barry Callebaut operates ten chocolate, two cocoa and one combined (cocoa and chocolate) factories in the Americas. Barry Callebaut, successfully closed the acquisition of the Cocoa Ingredients Division from Singapore-based Petra Foods Ltd. as planned on June 30, 2013, following approval from the regulatory authorities. The combination of the two businesses makes Barry Callebaut the world's largest cocoa and chocolate manufacturer, fully integrated from bean sourcing to the manufacture of the finest chocolate products. It creates an organization with over 8,000 employees, an estimated annual sales volume of 1.6 million tonnes and CHF 6 billion (EUR 4.9 billion / USD 6.4 billion) in sales revenue, as well as further diversifying Barry Callebaut's global footprint to 50 factories on four continents.

Carnival : Carnival announced that Micky Arison will split his Chairman and CEO duties, as Arnold Donald, a 12-year board member will take the helm. Mr. Donald has an impressive resume (founder of sweetener company Merisant and management roles at Mondalez) as well as a board position at Bank of America. Carnival reported adjusted EPS of $0.09 versus consensus of $0.06 and guidance of $0.04-$0.08. Net yields declined 1.9% versus guidance of -0.5% to -1.5%. Carnival benefited from the timing of certain SG&A expenses as well as a $15m gain from the sale of Holland America Line's former Noordam. Carnival noted cumulative advance bookings for the remainder of 2013 are behind the prior year at prices below the prior year levels. Carnival also indicated that net cruise costs will increase 8.5%-9.5% in 3Q12 largely due to vessel enhancement initiatives and increased marketing following earlier brand damage to Carnival.

Siemens has announced that Nokia is to buy out Siemens' 50% stake in the Nokia Siemens Networks (NSN) joint venture for Eur1.7bn. This will include a cash payment Eur1.2m, together with a 12 month vendor loan (or bridge loan) of Eur500m. This is slightly higher than a sum of parts estimate for NSN of about Eur1.4-1.5bn, which its estimated was the approximate book value.

The planned deal is likely to be EPS dilutive by a c.3% subject to any reinvestment. The important aspect however is the ongoing process of Siemens focusing on its core operations. The deal should close in calendar Q3 (Siemens financial Q4) and looks to represent a 'clean exit' from NSN ie with no residual recourse to Siemens. Following a significant restructuring program cutting about a quarter of the workforce since 2011, NSN looks to be performing well at present, following many years of losses and charges. We think Siemens takes the view that this represents an opportunity to exit a non-core business and sell to the entity in the best position to manage it (ie Nokia).

Vivendi and Universal Music Group announced today the completion of the sale of Parlophone Label Group to Warner Music Group. The transaction amounts to £487 million in cash. This sale represents the final significant divestment requested by the European Commission for the EMI

Recorded Music acquisition, bringing today the sale proceeds to a total net amount of £562 million in cash (approximately €700 millions) for Vivendi. Vivendi is one of the few multimedia groups in the world to operate across the entire digital value chain. It creates and publishes content for which it develops broadcast networks and distribution platforms.

Economic Activity, Consumer and Business Conditions

U.S. durable goods orders handily beat expectations in May, rising 3.6% for the second month in a row. Nondefense aircraft and parts increased 51%. Excluding transportation, orders were a more modest but still an above-expected +0.7%, also the second consecutive gain. Aside from auto parts orders (down 1.2%....likely temporary), the rest of the major components that make up durable goods orders increased…machinery, computers, communications, metals, etc. Most importantly, nondefense capital goods orders excluding aircraft picked up for the third straight month (longest rise since 2011), up 1.1%, which is very encouraging as this component is a key gauge of future business investment. So we believe this points to a pickup in capital expenditure in coming months. Nondefense capital goods shipments, a measure of current business investment, were no slouch either in May, jumping 6%, which hints at upside risk for capital expenditure in Q2.

U.S. consumer confidence surpassed expectations in June, according to the latest Conference Board's findings. The headline index of consumer confidence rose for the 3rd month in a row, jumping 7.1 pts in June to 81.4, the highest since January 2008. That's pretty impressive considering the volatility in financial markets over the past while. The continued improvement in confidence was spread between the 'present situation' (highest since May 2008) and the future (highest since July 2007). And zeroing in on the jobs measure…….. it improved in June, which is the 2nd such move in a row. The "net jobs hard to get" component slipped again, pointing to a potential slide in the jobless rate in June (the official report is out July 5th).

Housing : It likely helped that home values continued to grow for the 15th consecutive month. The S&P Case-Schiller house price index beat expectations with a 1.7% jump in April, which follows March's upwardly revised gain of 1.9% (was pegged at 1.1%). From a year ago, prices in the 20 largest metropolitan areas in the U.S. of A. grew 11.6%....that's the 2nd monthly double-digit increase in a row and now, the fastest gain since March 2006. For the 5th straight time, each of the 20 metropolitan areas rose from the prior month…we haven't seen that since late 2004/early 2005. Prices in Denver and Dallas have retraced all of their losses, and are now at their highest levels on record (or since their data series began). The energy sector likely is a big factor here. Coming up next would be Charlotte, NC, although prices are still 9.7% from prior peaks. And although areas such as Vegas, Phoenix, Miami and Los Angeles, which were crunched during the housing collapse, have made big strides since bottoming, they're still roughly 30%-to-50% below their peaks. Overall, this is great news for the housing market. And while investors and 'flippers' are playing some role in boosting house values, the majority of buyers are still repeat homebuyers (54%, according to the NAR).

U.S. pending home sales jumped 6.7% in May, perhaps reflecting a move by homebuyers to jump in before mortgage rates climbed further (which they did in June). The 6.7% surge left the index at its highest level since 2006 (or 12.1% y/y), with great strides made in all corners of the country except the Northeast. But mortgage rates have hit near 2-year highs lately. The 3-year FRM (Freddie Mac survey) reached 4.46% in the week of June 27, up from 3.93% in the prior week and up a full percentage point from the end of May. The higher borrowing costs go, they will start to nip housing demand. But stepping back to look at rates, these are still near the lowest in decades and so even in the face of somewhat higher mortgage rates, home prices can continue their recovery, and the positive spinoffs into homebuilding, consumer confidence and consumer spending should support U.S. economic growth.

U.S. manufacturing sector resumed growing again last month. The U.S. manufacturing ISM rose (snapping three consecutive declines) to a marginally above-expected 50.9 in June from 49.0 in the prior month. As for the details….they were almost all encouraging. ALMOST. New orders rose over 3 pts to 51.8 (demand is being maintained…good news for future production), current production was up nearly 5 pts to 53.4, supplier deliveries slowed (this is good news for the survey), and inventories grew for the first time since February. But the bad news was employment, which fell 1.4 pts to below 50, the first time this key component contracted since September 2009. The official factory payroll figures have shown that manufacturers have been cutting back jobs for three straight months (March, April and May), even when the ISM manufacturing employment component remained above 50, so it could be a lagged response. But the key takeaway in this report is all of the encouraging indicators of future and current activity and they are pointing in the right direction….UP. Also, new export orders grew for the first time in three months.

GDP : The final correction of the quarterly U.S. GDP data came up with a significant revision……a size that is usually associated with the 2nd round, not the third. The U.S. economy grew at a slower than expected pace in the first three months of the year. The first release had the economy growing 2.5% annualized, then it was trimmed to 2.4% last month, and now, the final tally is showing a 1.8% pace, up from Q4's weak 0.4% rate but obviously disappointing. The biggest downward surprise came from business investment in structures (non-housing), which contracted 8.3% not 3.5%. But as far as weighting is concerned, the downward revision to consumer spending had the biggest impact. The private side of the economy (final sales) is still up a decent 2.7% annualized, but that is slower than initially estimated. We don't expect much of a pickup in the second quarter due to oft-mentioned sequestration although, more recently, the signs of a pickup in the summer have sprung up. Depending how Q2 comes in …..if we end up with three consecutive quarters of sub 2% growth, we believe the Federal Reserve won't taper under those conditions. They need convincing signs of a pickup before they start turning off the taps.

Personal income growth doubled expectations in May, rising 0.5% in the month while April's flat reading is now showing up as +0.1%. This contributed to a boost in the savings rate to 3.2% from 3.0% in the prior month and the highest so far in 2013. Disposable incomes were also up 0.5%. And on the inflation front, prices are muted…..the core PCE deflator inched up 0.1% and is up just 1.1% from a year ago, the slowest increase in a long, long, long time. Personal spending grew 0.3%, which matched expectations but not enough to erase the prior month's drop. In real terms, that May increase is 0.2% but there were downward revisions to the prior few months and all in, Q2 consumer spending is coming in at just 1.2% annualized, the slowest since mid-2011. This is very disappointing, and comes even as incomes pick up.

Ireland is back in recession for the first time since its 2010 bailout, official figures have confirmed. Irish GDP shrank 0.6% in the first quarter of 2013, but the recession was confirmed when official data revised down the economy's performance in the final three months of 2012 to a decline of 0.2%.

Financial Conditions

Mergers & Acquisitions around the world slowed to their most sluggish pace since 2009 in the first half of 2013, Thomson Reuters data shows, as recession-hit European companies put the brakes on transactions and their healthier US counterparts took a cautious approach amid market uncertainty

US Rates on 30-year, fixed-rate home loans spiked 0.53% to an average of 4.46% this week -- the largest weekly increase in more than 26 years, according to Freddie Mac.

A People's Bank of China official said the central bank will guide interest rates to a "reasonable range," suggesting a potential end to a cash crunch that has gripped the country's financial system this month. Ling Tao, a deputy director of the Shanghai branch of the People's Bank of China, also said recent interest rate volatility in the nation's money market is temporary. Interbank liquidity overall is abundant and risk is largely under control, he added. On Monday, the overnight rate at which banks borrow from one another eased by more than two percentage points to 6.64%, though it remains high compared with its typical range of 2% to 3%. (Source : Wall Street Journal)

Global regulators are pressing ahead with plans to limit overall bank borrowing and make it easier for investors to compare institutions by announcing that banks will from 2015 have to calculate and disclose their 'leverage ratios' with plans to impose a 3% ratio from 2018 (i.e. banks to hold equity equal to 3% of total assets, regardless of risk weightings....and the fact that such a measure penalises lower risk activities such as first mortgage lending and trade finance).

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 2.13% and the U.K.'s 2 year/10 year treasury spread is 2.01 % - 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 at 4.46% - (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.

The VIX (volatility index) is 16.01 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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