Market Commentary

PORTLAND INVESTMENT COUNSEL™

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Bank of America : reported Q2/13 EPS of $0.32 compared to $0.10 last quarter and $0.19 a year ago. Earnings were well ahead of consensus of $0.25. Earnings included $0.02 per share comprising reserve releases of $900 million ($0.05/share) and Debt Value Adjusted gains of $38 million ($0.002 per share) partially offset by litigation fees of $471 million ($0.03/share), and representation and warranties provision of $197 million ($0.01 per share). Adjusting for the above noted items core operating EPS was $0.30 per share

- Consumer banking achieved record net income of $1.4 billion, up 15% YOY, driven by lower expenses and credit cost improvements.

- Mortgage banking revenue declined to $1.2 billion, down 7% QOQ and 29% YOY. The decline comes despite mortgage origination increasing 6% QOQ and 40% YOY. Volume growth was more than offset by industry-wide margin compression. Slowdown in the mortgage pipeline is expected as the mortgage pipeline came down 5% from Q1/13.

- Wealth management earnings were up 5% QOQ and 38% YOY. Earnings were driven by record revenues and strong pre-tax margins. Long-term AUM flows in Q2 doubled YOY to $7.7 billion

- Global banking net income was solid at $1.3 billion, up 1% QOQ but down 2% YOY. Earnings were driven by strong loan growth and near record investment banking fees. Sales and Trading revenue was weak at $3.5 billion (excl. DVA), down 22% from the previous quarter and up 3.5% from a year earlier (drag coming from lower fixed income, down 12% YOY). Total investment banking fees were $1.6 billion, up 1% from $1.5 billion last quarter and 36% from $1.1 billion a year earlier.

Net interest margin performance was solid at 2.44%, up 0.01% QoQ and 0.23% YOY. The NIM benefitted from a reduction in long-term debt, higher commercial loan balances, positive impacts from market-related premium amortization expense, and one additional interest accrual day in the quarter offset partially by lower consumer loan balances. Net charge-offs were $2.1 billion or 0.94% of loans compared to $2.5 billion or 1.14% of loans in the previous quarter and $3.6 billion or 1.64% of loans a year earlier. Reserve releases increased to $900 million from $804 million in the previous quarter and $1.9 billion a year ago.

Reported Return On Equity was 6.6% compared to 2.1% in the previous quarter and 3.9% a year ago. Core Equity Tier 1 Capital Ratio under Basel III was up to 9.60% compared to 9.5% at the end of the previous quarter, well above the Basel III minimum requirement of 8.5%. The bank estimates its bank holding company supplementary ratio to be approximately 4.9% to 5.0 at Q2/13% in line with Fed/OCC/FDIC proposed requirement 5.0%.

During the quarter Bank of America repurchased 80 million common shares or 0.7% of o/s at an average price of $12.59, below tangible book of $13.32. During the quarter BAC also repurchased $5.5 billion of preferred stock. The board authorized the bank to repurchase $5.0 billion of common equity and $5.5 billion of preferred stock until Q1/14.

Barclays: US regulators have fined Barclays $435m (£287m) for manipulating energy markets in California and other states from November 2006 to December 2008. Barclays intends to "vigorously defend the matter". Overall more unwelcome news for the bank, not helpful at a time when regulators looking at weak leverage but direct financial impact is small.

Barclays – Financial Times reports Abu Dhabi's Sheikh Mansour, who came to the rescue of Barclays Bank with a £3.5bn capital injection at the height of the financial crisis, has sold his 7% stake. The sale happened in the past few weeks but it's unclear what happened to the shares, although a 7% slump in Barclays' share price in the days running up to disclosure of the sale of the shareholding on June 26 suggests at least some of it may have been placed in the market. Sheikh Mansour, together with Qatari investors swept into the bank in 2008 as part of a £7.3bn deal that gave the two Middle Eastern investors a 30% stake.

BNP Paribas : French government has cut the interest rate on Livret A savings accounts to 1.25% from 1.75%, as recently recommended by the Bank of France. This is the second cut this year and is a clear positive for the banks in resetting lower what is an important benchmark rate for other savings products. Livret A balances have hit a record high this year on what the banks have criticized as overly generous rates. While the banks collect Livret A savings they are required to pass on the majority to state-owned Caisse des Depots. Les Echos reports French banks could get as much as €50bn ($66B) of savings regulated by Caisse des Depots et Consignations after executives met French President Francois Hollande on July 19. Finance ministry announced that €30bn of savings will be made available to the banks and this could increase to as much as $50bn if there is a recovery in the rate of lending to small and medium-sized businesses, Les Echos says.

Deutsche Bank plans to shrink its vast balance sheet by as much as a fifth in order to comply with incoming stricter rules for financial soundness. In a big strategic step by Germany's largest lender by assets, Deutsche is expected to tell investors that it aims to achieve a minimum 3% ratio of overall equity to loans by the end of 2015.

Nordea Bank: published Q2 results. Total Profit Before Tax Q213 €1,048m is +3% ahead of consensus €1,016m. Revenue and costs down 1% on Q1. Impairments down 6%, resulting in PBT +1%.

- Retail banking – Looks a little weak, with PBT +1% on Q1 as although Norway and Finland business both look strong, Denmark and Sweden both weak, with revenue down 7% and 8% on Q1 respectively.

- Wholesale Banking – Looks strong with PBT +8% on Q1, helped by Revenue +7% due to "higher demand for event-driven business and capital markets products".

Capital – Core tier 1 was strong, +0.8% over the quarter. Fully loaded Basel 3 Core Tier 1 estimated at 14.0% against 12.8% forecast

UBS surprisingly pre-released its results this morning. Net profit is estimated to be CHF690m (Q1 2013 CHF988 and consensus of CHF750m) while pre-tax profit is around CHF1090m (Q1 2013 1447m and consensus of CHF1235). UBS also announced pre-tax charges of CHF865m linked to a settlement on mortgage-backed securities and some other matters. We believe this is only partly reflected in the consensus, implying that underlying results were actually stronger than expected. UBS disclosed today that it has reached a settlement with the Federal Housing Finance Agency (FHFA) in respect of disputes over mortgage put back for US RMBS (residential backed mortgage securities) that UBS sponsored/underwrote from 2004 to 2007. FHFA was suing UBS for US$1.2bn plus interest on behalf of Fannie Mae and Freddie Mac for disputed mortgages in question of UBS sponsored RMBS c.$4.5bn and a further $1.8bn for third party RMBS. UBS/UBS subsidiaries sponsored c$80bn of RMBS and a further $19bn of loan pools originated by third party purchasers. Although this sorts out one of the bigger RMBS outstanding issues, the rate of put back claims accelerated through 2011 and 2012 and stood at $3.2bn as at Q113. We expect this settlement to increase the level of put back claims as other counterparties are buoyed by today's announcement. However, we note that, though the magnitude of the mortgage activity remains huge at c. $100bn, not all this would meet the criteria for put back.

Swedbank's Q2 net interest income (NII) beat consensus estimate by 2%. However, this included a positive one-off at SEK 37m for a stability fee refund and adjusted for that the NII beat was 1%. Commission income grew by 6% q-o-q on higher activity levels for finance solutions and corporate finance as well as card payments. Trading were clearly below consensus expectations but burdened by costs for repurchasing government guaranteed bonds of SEK 107m and other repurchases by SEK 103m. Total income was SEK 8,979m, broadly in line with consensus as NII and commissions came in slightly better than expected. Total costs came in line with expectations and credit losses remained very muted at 1bp. However, Swedbank also had tangible and intangible impairments at SEK 372m referring to writedowns in Ektornet and IT-systems, which drag down Earnings before taxes to SEK 4,393m, 5% below expectations. Swedbank had a ROE for continuing operations of 14.1% in the quarter.

Swedbank reports a core tier 1 (CT1) ratio (Basel III) of 17.2% and a Basel II CT1 ratio of 18.0%. This is up 0.8p.p. from Q1 2013, reflecting continued good earnings growth and includes a dividend from Swedbanks Baltic life insurance company at the amount of EURO 75m and lower risk-weighted assets following the exit from Ukraine. Swedbank reiterates its guidance to maintain total expenses at the same level in 2013 as in 2012.

Dividend Payers

Hutchison Whampoa: the decision by Hutchison to review strategic options for its supermarket business PARKnSHOP is a surprise to us, as a divestiture it may be slightly earnings dilutive in the current still low interest rate environment, and Hutchison has a goal of achieving HK$10/sh in EPS by 2015. Financially speaking, we regard the decision as a move to redeploy capital from a low-growth business in a saturated market to businesses with higher returns. ParknShop, with low margins, is also different from Watsons health & beauty business; the latter carries much higher margins and is the focus of Hutch's retail strategy.

While the revenue impact may be large, we do not expect a sale of ParknShop, if undertaken, would have significant impact on earnings or Net Asset Value given its low margins. Other large divestiture also seems unlikely, unless Hutchison has a clear acquisition target in mind to offset any potential earnings dilution. Hutchison's most-recently announced acquisition of O2 Ireland was for €780mn, while its discussions with Telecom Italia (TI) seem to have cooled off.

Novartis reported Q2 sales of $14.49bn up 3% at constant currencies (cc), beating consensus expectations by a little over 1%. Core operating income at $3.76bn rose 2% at cc in-line with forecasts , declining 2% in IFRS terms on a 4pt currency swing on the weakening Yen. Core operating margins declined by 0.9% to 25.9%, 0.6% of which was on currency movements, but this was anticipated in forecasts. Earnings per share of $1.30 missed consensus by 4cents. Results were in-line with expectations down to the Net Income line, core EPS missing forecasts on a 49m increase in the number out shares out and so the EPS miss does not arise from a weaker than expected operating performance. All operating divisions met or beat our forecasts.

- Pharma sales +1% (at cc) beat by $160m. Excluding the negative impact of generic competition, underlying sales grew 8% at cc and core operating profit grew 18%. Highlight was a 13% increase in sales of growth products Gilenya (+66%), Afinitor (+77%), Tasigna (+38%), Galvus (+37%), Xolair (+20%), Exforge (+11%) Onbrez/Seebri and Jakavi, which continue on a strong growth trajectory. Together growth products contributed $4.5bn in sales equivalent to 31% of Group net sales and 37% of Pharma division sales. Pharma sales continue to benefit from the delayed entry of generic competition for Diovan monotherapy in the US. Alcon sales were up 6%. Sandoz sales rose 3%, despite some price erosion.

- Consumer Health sales rose 12% on product re-launches in OTC and Animal Health. Vaccines and Diagnostics sales rose 18%, comfortably beating expectations. A particular positive for investors was the strong performance of Gilenya, in Multiple Sclerosis. It suggests the competitive pressure is more than offset by the expansion of the market for oral MS treatments.

The company upped full year guidance to low-single digit sales growth versus year ago (cc, from flat); core operating income to a low-single digit decline (cc, from mid-single). This implies full year sales of $56.7bn to $57.23bn and core operating profit of $14.6bn to $14.9bn. Implicit in guidance, is a marked deterioration in performance in the second half. Guidance anticipates a 6 percentage point decline in core operating income on flat sales.

Vodafone announced Q1 2013/2014 key performance indicators that were marginally ahead of expectations. Group service revenue growth has inflected (Q3: -2.6%, Q4: -4.2%, Q1: -3.5% … Page 3). Q1 consensus was -3.8%. This is the first improvement in top-line growth rates, for some five quarters. The Emerging Market portfolio continues to register strong turnover. Vodafone India has seen accelerating revenue growth (Q4: +7.8%, Q1: +13.8%), driven by price rises and better net adds. Vodafone Turkey (Q4: +14.5%, Q1: +15.5%) top-line growth remains strong, although this business now faces a c8ppt termination headwind. Vodacom (Q4: -0.7%, Q1: +3.2%) has seen considerably better trends in S Africa. Vodafone UK (Q4: -6.6%, Q1: -4.5%) and Spain (Q4: -12.7%, Q1: -10.6%) have seen top-line growth trends bottom out, which we believe is positive news after several difficult quarters. On the downside, Vodafone Italy (Q4: -17.0%, Q1: -17.6%) continues to struggle, dragged down by a weakening macro backdrop. Vodafone Germany (Q4: -3.5%, Q1: -5.1%) has been negatively impacted by Deutsche Telecom's subsidy policy and E-Plus price competition. The results conference call heard Vodafone's CEO suggest that high-end handsets are seeing some price pressure (mirroring Asia where Samsung has cut S4 prices by €150/unit), good news for operators. Vodafone believes its European network quality remains higher than peers, and does not see the need to raise capex.

Economic Activity, Consumer and Business Conditions

U.S. industrial production mildly beat expectations in June, rising 0.3% following May's flat performance. Business equipment is one area of good news, as the 0.5% rise was the first of its kind since February. Production of consumer goods was also up for the first time since March (up 0.5%), which includes cars (+1.4%) and computers/tech goods (+2.3%). Nondurable consumer goods were also higher. Manufacturing advanced for the second consecutive month. And it was interesting that motor vehicles and parts jumped 1.2% despite a drop in auto production. Bottom line here is positive but too soon to call a positive trend.

US Federal Reserve Governor Ben Bernanke last week said the Fed will support a weak economy for the foreseeable future, in a testimony to Congress. The testimony did not signal a change in the Fed's policy making committee or the likelihood of so-called "tapering" of asset buying. Fed chairman said asset purchases will slow from $85bn-a-month later this year if the economy stays strong, but stated several times that they were not backing away from supporting the economy.

Japan - There was a sweeping victory for Japan's LDP: The victory, which had been widely predicted, will put the coalition in charge of both houses of parliament for the first time since 2007. Reuters reported BoJ governor says more stimulus is an option, two-year inflation target not rigid: The Japanese central bank is prepared to inject more stimulus if the economy's recovery is threatened, BoJ board member Takehiro Sato said in a speech today, as he pointed to risks such as the slowdown in Chinese growth. He also said the 2% inflation target was a flexible one that does not necessarily have to be achieved rigidly in two years.

Portugal - As expected, President Silva's push to have the 3 main political parties form a so-called "national salvation pact" ended unsuccessfully this weekend. Portugal's prime minister ruled out calling a snap general election two years ahead of schedule. "President Aníbal Cavaco Silva said on Sunday night that he had been given "additional guarantees" from the two government parties that they would keep their coalition together to see through the country's €78bn EU bailout program.

China's economy expanded at an annual rate of 7.5% in the 3 months to June, a rate which is slowing but is better than consensus expectations. However, given it wants to move away from its investment-led growth model, investment remained the single largest driver of economic expansion….its contribution being twice as large as consumption.

Financial Conditions

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% (June 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 2.17% and the U.K.'s 2 year/10 year treasury spread is 1.94 % - 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 4.37% - (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.

The VIX (volatility index) is 13.17 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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