Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Energy Sector

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Canadian Oil Sands/Enbridge/Suncor – Canadian crude exports to the United States topped 3 million barrels per day earlier this month for the first time, suggesting delays to new export pipelines such as TransCanada Corp's Keystone XL were failing to check oil sands development. Canada, the No. 1 supplier of crude to the United States, exported 3.248 million bpd of crude to its southern neighbor in the week ended Oct. 3, up 18% from the previous week and up 35% from the same period a year earlier. Much of the increase in crude exports was due to the ramp up in shipments of crude oil by rail from western Canada. The bulk of crude exports is still shipped south on Enbridge's 2.5 million bpd Mainline export network. The surge in exports was likely linked to increased rail loadings and demand for linefill on Enbridge's new 600,000 bpd Flanagan South and reversed Line 9 pipelines, both due to start operating in the fourth quarter. Suncor Energy Inc sent its first cargo of western Canadian heavy crude to Europe from Canada's east coast last month after shipping the crude by rail to Quebec.

Chevron – announced it would sell a 30% stake in its Canadian oil shale holdings to Kuwait's state-owned oil company for $1.5 billion. The deal with Kuwait Foreign Petroleum Exploration Co helps Chevron reduce production risk and gives it more capital to increase drilling in Alberta's Duvernay shale formation, one of North America's largest shale deposits. The deal, valued at about $15,000 per acre, boosts land valuations in the region and should help increase drilling., a step that will likely reduce production costs to about $12 million per well, down from about $15 million to $20 million currently. After the deal closes in November, Chevron Canada will remain the operator and will hold a 70% interest in the project.

Total – Kashagan, the world's most expensive oil project, will have to spend another up to $3.6 billion to replace leaking oil and gas pipelines, which also could delay the restart of production. Production at the Kashagan reservoir, the world's biggest oil find in recent times, started in September last year but was halted just a few weeks later after the discovery of gas leaks in the $50 billion project's pipeline network. The multinational consortium developing Kashagan has identified stress cracking due to sulphur-laden gases as "the root cause of the pipeline issues" at the oilfield. The Kashagan consortium includes Eni, Exxon Mobil, Royal Dutch Shell, Total, China's CNPC, Japan's and Kazakh state-run company KazMunaiGas.

Financial Sector

Barclays - have reiterated their position that NY Attorney General Eric Schneiderman's complaint on their dark pool is "based on clear and substantial factual and legal errors and as such we will continue to defend our position".

Barclays' settlement with the regulators over LIBOR fixing made clear that they and in their opinion a number of other banks, were submitting artificially low LIBOR rates for a considerable period during the financial crisis. Macquarie estimate that this resulted in the official LIBOR rate being artificially depressed by an average of c40bps during 2008/9. In this light Barclays' last week settling a LIBOR Class Action with a $20m fine - whilst relating to a reasonably small part of the action (futures traders in respect of Eurodollar futures contracts or options on exchanges) which was less than 1% of Macquarie' expected liability - may be seen as an "ice-breaker" settlement which gives the plaintiffs access to records, but given the modest amount, by any measure, is good news.

Citi posted higher than expected earnings based on revenues in Fixed Income, Currency and Commodities (FICC) and Global Consumer Banking. Citi reported results of $1.15 (excluding DVA losses), which compares favorably to the consensus at $1.14. However, the quarter including approximately $0.30 of legal and repositioning, which was $0.13 greater than estimated. Core revenues came in better than expected at $20.0bn.The Global Consumer Bank came in at $9.7bn, driven by 6% YoY growth in LatAm and 4% YoY growth in Asia. In addition, Investment & Corporate Group revenues came in at $8.4bn, primarily driven by Fixed Income, Currency and Commodities of $3.0bn.

In addition to the revenue beat, Non Conforming Obligations continue to come in below estimate. Operating expense came in at $12.4bn versus our estimate of $11.8bn. However, this quarter included approximately $600 million higher than expected legal costs. Excluding this impact, expenses came in at $11.7bn, or modestly below our estimate despite the revenue beat. Citi Holdings reported net income of $272 million, representing the first quarter of profitability. Partly as a result, Citi utilized $700 million of the Deferred Tax Allowance this quarter, bringing the total balance to below $50bn. Basel III capital is strong at 10.7% and the leverage ratio was 6.0%. Non Conforming Obligations came in at $2.1bn versus estimate of $2.3bn. Delinquencies were generally stable to modestly improving throughout the major markets.

Deutsche Bank - is understood to be preparing to sell a $2bn portfolio of U.S. commercial real estate loans as the North American property markets heat up. The bank is in early stage talks with several buyers including private equity investors as it markets the deal, which is expected to be completed within six weeks. The transaction is commercially driven and is expected to be profitable. It is understood not to be related to efforts by Deutsche and other European banks to trim their balance sheets ahead of a health check by the ECB later this month.

ING - CEO Ralph Hamers tells Het Financieele Dagblad that they aim to repay last tranche of state aid this year. ING will look to start the process for repayment after the outcome of ECB asset quality review.

JPMorgan - operating EPS is close to $1.35-$1.40 ex. a number of items that essentially offset. Results appear to be pretty close to expectations, with better trading results and better credit quality offset by higher expenses and softer loan growth. Overall, total core trading results beat expectations (up 1% Y-Y) as September appears to have been a decent month for trading, particularly currencies and emerging markets. Investment-banking fees decreased $0.2B Q-Q to $1.5B, as advisory was up slightly but underwriting fees were lower. The Corporate & Investment Bank (CIB) posted a 10% core ROE (vs. the longer-term target of 15%), which was impacted by elevated legal expense. The core compensation ratio came in at 32%, in-line with the 30%-35% historical range. Average Value-at-Risk was down to $35mm from $43mm in 2Q, with a notable change in fixed income perhaps due to the environment. Net interest income was up slightly. Period-end loans declined 0.5% Q-Q. Modest growth in card, auto, and CRE was more than offset by lower corporate loans and continued residential run-off. The net interest margin was stable at 2.19%, and NII was up 3% to $11.4B. Total deposits were up 1% on a period-end basis, although average interest-bearing deposit growth was flattish. Core fees were down slightly vs. 2Q, largely due to seasonally softer Investment-banking fees and lower Mortgage Servicing Rights hedging results. Otherwise, asset mgmt. revenues, card fees, and lending/deposit fees were flattish. For mortgage, production revenues were up 3% Q-Q on a 26% increase in mortgage originations (particularly correspondent). MSR hedging results were lower for the quarter ($76mm vs. $338mm last quarter) and there was more modest putback reserve release (at $62mm vs. $137mm). Core costs (ex. $1.1B pre-tax of firm-wide litigation expense) were $14.7B, essentially in-line with 2Q. The 3Q results were a little higher than expectations, but likely reflects stronger trading results. Management's outlook now calls for 2014 firm-wide expenses (ex. litigation) to be above $58B (vs. $58B+/- previously), which is likely due to higher compensation costs associated with better revenues. The Basel III Tier 1 common equity ratio increased 30bp Q-Q to 10.1% (vs. the 10%+ target by YE14) and the Supplemental Leverage Ratio (SLR) ended the quarter at 5.5% (up 10bp) at the firm-level and 5.7% (up 10bp) at the bank. Tangible book value was up 2% to $44.13 and the bank repurchased 26mm shares (or $1.5B in aggregate).

Wells Fargo - reported 3Q14 EPS of $1.02. Consensus was $1.02. Reported revenues rose 1% to $21.2bn, compared to consensus of $21.1bn. It posted a Return on Equity of 13.10%.

Results included a $300mn loan loss reserve release ($0.04), down from $500mn in 2Q14. Securities gains were $253mn ($0.03), up from $71mn in 2Q14, while equity gains were $712mn ($0.09), up from $449mn. Net Mortgage Servicing Rights hedge gains were $270mn ($0.03), down from $475mn. It released $81mn ($0.01) of mortgage repurchase reserves. These types of items added $0.20 to EPS in 3Q14, $0.20 in 2Q14, and $0.22 in 1Q14. Its tax rate also declined from 2Q14 to 3Q14. Its Common Equity Tier 1 ratio under Basel III (Advanced Approach, fully phased-in) was 10.46%, up from 10.09% in 2Q14. It had net unrealized AFS securities gains of $6.6bn, down from $8.2bn, primarily due to an increase in interest rates and realized securities gains. Its period-end common shares outstanding declined 34.9mn on 48.7mn of purchases. It entered into a forward repurchase transaction for an additional estimated 19.8mn shares ($1bn) expected to settle in 4Q14.

Net interest income rose 1% driven by commercial and consumer loan originations, larger mortgages held for sale balances and higher interest income from trading assets, as well as higher purchased credit-impaired accretion and an extra day. Average earning assets rose 4%. Loans were relatively stable (+1% ex. 2Q transfers to HFS). Period-end loans increased 1.2% with commercial up 1.3% and consumer up 1.1%. Excluding its $63bn non-strategic/liquidating portfolio (8% of total loans; -$2.3bn), loans increased 1.6% with consumer up 1.9% and commercial up 1.3%. Loan growth was driven by growth in C&I, R/E construction, mortgage, credit card, auto, and other revolving credit and installment loans. Its net interest margin dropped 9bps to 3.06%, primarily due to higher cash and short-term investment balances. Mortgage origination gains were up largely due to an increase in the gain on sale margin, but this was more than offset by a decrease in servicing income, which was driven by lower net MSRs results and an increase in unreimbursed direct servicing costs. Net MSR hedge gains were $270mn, down from $475mn. Mortgage applications declined 11% to $64bn, while its unclosed pipeline fell 17% to $25bn.

Expenses were stable with 2Q14. Its reported efficiency ratio of 57.7%, compared to 57.9% in the prior quarter. It expects to operate within its targeted efficiency ratio range of 55-59% in 4Q14. Its effective tax rate was 31.6%, down from 33.4% in 2Q14, due primarily to tax benefits resulting from charitable donations of appreciated securities.

Its Non Performing Assets ratio declined 7bps to 2.10%. NPAs declined by $406mn or 2%. Its Non Conforming Obligations ratio was 0.32% (-3bps), with commercial recoveries of 0.02% and consumer losses of 0.62%. Its loan loss provision was $368mn, up from $217mn in 2Q14. Results included a $300mn loan loss reserve release, down from $500mn in 2Q14. It continues to expect future reserve releases, but expect a lower level of future releases as the rate of credit improvement slows and the loan portfolio continues to grow. Its reserve/loan ratio declined 6bps to 1.61%.

The largest global banks will have to hold more capital and liabilities than previously reported that can automatically be written off in a crisis -- as much as a quarter of risk-weighted assets -- as regulators take on lenders deemed too big to fail. The Financial Stability Board (FSB) is developing minimum standards that will limit the double-counting of capital banks use to meet existing international rules, according to an FSB working document sent for comment to Group of 20 governments and obtained by Bloomberg News. The restriction means that, while the basic requirement will be set at 16% to 20% of risk-weighted assets, the final number will be higher because the banks must separately meet "other regulatory capital buffers," according to the document, dated Sept. 21. The FSB in Basel, Switzerland, declined to comment on the non-public document. Bloomberg

Global Dividend Payers

BHP Billiton – Australia must hold urgent talks with China to exempt coal producers from new tariffs in a free trade agreement due to be completed this year, an industry body said, following Beijing's move to reintroduce coal tariffs after nearly a decade. China, the world's top coal importer, said on Thursday it would impose import tariffs on the commodity. China took nearly a quarter of Australia's metallurgical coal exports in the year to June 2014, buying A$5.5 billion ($4.83 billion) of the coal used in steel mills. It also took A$3.5 billion worth of thermal coal, accounting for about a fifth of Australia's exports of coal used in power stations.

BHP Billiton aims to cut its iron ore production costs by more than 25% and squeeze more tonnes from its mines as it aims to overtake rival Rio Tinto as the world's cheapest producer. Miners' focus has shifted to cost cutting as iron ore prices have dropped from about $190 a tonne in 2011 to less than $80 now, sinking to five-year lows as supply growth from the mega producers has exceeded demand growth by more than two to one. BHP said it aims to cut production costs, excluding freight and royalties, to less than $20 a tonne in the medium term, from $27.50 for financial year 2014. It now expects to boost its output capacity by 65 million tonnes to 290 million tonnes a year by June 2017 for 40% less than previously flagged, at a cost of about $1.95 billion.

Johnson & Johnson - delivered a modest beat on earnings per share despite falling in-line on revenues (18.46B USD group revenues for the quarter) this morning, with MDD and Consumer very modestly below expectations on revenues of 3.59 and 6.57B USD. Olysio continues to be solid, with 790mm USD sales vs 796mm USD expected, and $1.50 EPS (beat vs. $1.44 consensus) on stronger than expected operating margins driven by R&D expense at 11.0% of sales, vs. an estimated 12.3% of sales. Tax rate was above expectations at 24.2% vs. 22.1% estimates, largely driven by increased concentration of sales in the US (weakness in OUS Consumer and MMD businesses combined with continued strength in Olysio in the US). Management increased 2014 Earnings Per Share guidance to $5.92-$5.97, from $5.80- $5.87 last quarter, with the new guidance in line with our FY estimates including two full-quarters of Olysio sales pre-Harvoni launch. Questions for the call will likely center around 1) the status of the patent dispute over biosimilar Remicade 2). Outlook of MDD and potential transactions for lower margin/slower growth parts of the business 3) the Pharma pipeline and data releases through year-end, including any additional combination trials or indication expansion for Imbruvica.

Mondalez - announced the hiring of a new CFO, Brian Gladden (formerly of Dell, Inc and General Electric), and the transition of its current CFO, David Brearton, to a new role (EVP, Strategic Initiatives) effective December 1. It appears Mr. Brearton's will be primarily focused on managing some of the significant transformation work that is currently underway at Mondalez, with a particular emphasis on ensuring smooth execution of the implementation of the coffee JV with D.E Master Blenders. All in, we view today's announcement as a positive on two different levels. First, the willingness to bring in talent from outside the consumer industry, as we believe this can often shed light on internal processes and highlight possible opportunities for improvement. Second, while we recognize that today's announcement reflects a broader board decision and that the process was potentially commenced prior to the addition of investor Nelson Peltz to the Board of Directors in January, we would simply observe that Mondalez has implemented a number of strategic initiatives since his appointment, including: 1) the planned divestiture of its coffee operations to a JV with D.E Master Blenders, 2) the announcement of an incremental restructuring program intended to provide additional visibility to margins in 2016 and beyond, and now 3) a CFO succession.

SSE – The Scottish government has given the green light for four offshore wind farms to be built which would be capable of generating enough electricity to power more than 1.4 million homes. The wind farms will be located off the coast of Scotland and have a total capacity of around 2.3 gigawatts (GW).

Approval was given for Mainstream Renewable Power's 450 megawatt (MW) Neart na Gaoithe wind farm, Repsol and EDP Renewables UK's 800 MW Inch Cape project, and the 525 MW Seagreen Alpha and 525 MW Seagreen Bravo wind farms being developed by SSE and Fluor. Britain plans to reduce its greenhouse gas emissions by at least 80% from 1990 levels by 2050.

Economic Conditions

US Federal Reserve Vice Chairman Stanley Fischer - said Saturday the U.S. central bank, which has been criticized for ignoring the impact of its policies overseas, is very much cognizant of the global repercussions of its actions.

Mr. Fischer, whose vast international experience at the International Monetary Fund and the Bank of Israel make him the Fed's de facto diplomat, said an interconnected world economy makes it impossible for U.S. policy makers to assess the country's economic outlook in a vacuum. "The tightening of U.S. policy will begin only when the U.S. expansion has advanced far enough, in terms both of reducing the output gap and of moving the inflation rate closer to our 2% goal," Mr. Fischer said at an event on the sidelines of the International Monetary Fund meeting. "If foreign growth is weaker than anticipated, the consequences for the U.S. economy could lead the Fed to remove accommodation more slowly than otherwise." As the Fed approaches the time for eventual interest rate increases after more than five years of keeping borrowing costs at effectively zero, Mr. Fischer said the Fed will remain very much aware of the potential international repercussions of higher U.S. interest rates. "In the normalizing of its policy, just as when loosening policy, the Federal Reserve will take account of how its actions affect the global economy," he said. With Fischer warning that the Fed could remove stimulus even more slowly if foreign growth is weaker than expected, my view is forward expectations for the pace of 2015-16 interest rate hikes likely has to be scaled back. My view is although the Fed will still move ahead with hikes in 2nd half 2015, the pace could be as low as one rate hike (just to keep credibility and to maintain medium term inflation expectations). With this in mind, a UK-type economic scenario now looks likely to me for the US (ie. economy and inflation moving ahead but rate hikes delayed and/or slower than expected).

Financial Conditions

US Federal Reserve policymakers remain determined to flatten the yield curve as much as possible, having indicated they expect 'exceptionally low levels of interest through 2014 with the Federal Reserve carefully calibrating the beginning of unwinding quantitative easing and undertaking that the Federal Reserve will keep rates low until mid 2015. The US 2 year/10 year treasury spread is now 1.82% and the UK's 2 year/10 year treasury spread is 1.51% - meaning investment banks remain constrained from profiting 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 6-9 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 withdrawal of quantitative easing, the US 30 year mortgage market rate has increased to 4.12% - (was 3.31% end of November 2012, 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 US housing inventory is at 5.5 months supply of existing houses. So the combined effects of 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 24.64 (compares to a post-recession low of 10.7 achieved in early June) and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Mutual Funds

- Portland currently offers 6 Mutual Funds:
- Portland Advantage Fund
- Portland Canadian Balanced Fund
- Portland Canadian Focused Fund
- Portland Global Income Fund
- Portland Global Banks Fund
- Portland Global Dividend Fund

Private/Alternative Products

Portland also currently offers 4 private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland GEEREF LP
- Portland Advantage Plus Funds

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

Sources: Thomson Reuters, Bloomberg, Macquarie, Credit-Suisse, KBW, Bank of America, TD, BMO

Source: Thomson Reuters, Bloomberg, Company reports

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