Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Energy Sector

Total – French oil and gas major Total is reportedly in talks to sell its 40% stake in Russia's Kharyaga oil project to Russian state firm Zarubezhneft. The project, which is located in northern Russia, has recoverable reserves estimated at 49 million tonnes of oil. Kharyaga is a rare production sharing agreement in Russia. Total owns 40% in the project and 30% belongs to Norway's Statoil. Zarubezhneft owns 20%.

Financial Sector

Bank of America Corp has settled its portion of a U.S. antitrust lawsuit in which investors accused 12 major banks of rigging prices in the foreign exchange market. The settlement with the bank was disclosed last Thursday by Scott & Scott, a law firm for the investors. Terms were not disclosed. Bank of America is the third bank to settle investor claims related to the $5.3 trillion-a-day currency market. JPMorgan Chase & Co settled for $99.5 million in January, and Switzerland's UBS AG settled for $135 million in March. (Source: Reuters)

Barclays - The Financial Times Lex column reported last Friday on Chairman John McFarlane who has written to Barclays investors setting out his priorities, as he had previously at Aviva. What worked for the insurer can work for Barclays they say. He will "deal more swiftly with legacy conduct issues, running off non-core portfolios faster to achieve the bank's target capital levels, fixing or curtailing underperforming units. The Investment Bank drag on RoE is reason why the bank trades like a dowdy retail bank on a just 0.8x tangible book".

Brookfield Asset Management – is reportedly in advanced talks to acquire sugar processor Renuka do Brasil SA for about 1.5 billion reais (US$490 million) in debt. Brookfield will take on the debt and negotiate with Renuka's creditors over repayment terms. Renuka do Brasil, based in Promissao, Sao Paulo state, is owned by Mumbai-based Shree Renuka Sugars Ltd., which has 50.3% of the outstanding shares, and Sao Paulo-based Grupo Equipav. The company has two sugar mills with capacity to crush 10 million tons of sugar cane per year. Brazil's sugar producers have been struggling after prices for the commodity tumbled to a six-year low and the worst drought in eight decades wreaked havoc on producers' ability to meet obligations. Since 2011, 47 ethanol and sugar mills have closed and 70 are under bankruptcy protection, according to Unica, Brazil's sugarcane millers group. Brookfield has also been in talks to inject capital in sugar and ethanol producers Tonon Bioenergia SA and Virgolino de Oliveira SA, which are seeking to restructure dollar debt.

Brookfield Asset Management – Associated Estates Realty Corp agreed to be bought by Canada's Brookfield Asset Management Inc for about $1.66 billion, months after activist investor Jonathan Litt asked for a sale of the U.S. real estate investment trust. Litt's Land & Buildings Investment Management LLC said in June the trust's apartment portfolio was not best-suited for public markets and the company should sell itself to Litt's firm or another buyer. The offer of $28.75 per share is at a premium of 17.4% to Associated Estates' Tuesday closing price. The deal is valued at $2.5 billion, including debt, the company said. Associated Estates' portfolio includes 49 apartment communities containing 12,734 units across eight states in the U.S. Midwest. Brookfield Asset Management, which owns a vast portfolio of real estate, energy and infrastructure assets, said raised $1.1 billion earlier in the week by issuing shares to help fund some deals.

Citizens Financial reported GAAP EPS Of $0.38 per share, although after adjusting for one-time items ($8mm securities gains, $10mm in restructuring costs) it's estimated operating EPS of $0.37, beating the consensus estimate by $0.03. Despite the 3bps decline in Net Interest Margin to 2.77%, Net Interest Income was down just $4mm from 4Q despite there being 2 fewer days in 1Q. The steady NII result was thanks to healthy loan growth of 1.2% as Citizens again supplemented organic growth with acquisitions during the quarter. Adjusted operating income of $339mm fell below estimate largely due to a decline in deposit charges and card fees. After accounting for the impact of the Chicago branch divestitures, deposit surcharges would have increased $2mm Q/Q. These declines were offset partially by a strong 106% increase in mortgage banking revenues Q/Q, although this included a $10mm gain on sale of conforming mortgages previously held in the HFI portfolio. Excluding this gain, revenues were still up 60% Q/Q as origination volumes grew 87%. Operating expenses of $800mm matched estimates. Citizens had $10mm of restructuring charges during the quarter, and expects an additional $35mm-40mm in restructuring charges in 2Q. The bank posted loan growth of 1.2% Q/Q, although when adjusted for an estimated $266mm in net acquisitions during the quarter, its estimated organic loan growth of 0.9%. The student loan portfolio jumped 26.4% from 4Q as Citizens purchased approximately $300mm in student loans. Through the flow purchase agreement with Santander USA, it's estimated Citizens purchased a little over $350mm in auto loans after purchasing $415mm in 4Q. Citizens was contractually obligated to purchase at least $250mm from SCUSA during the quarter, which increases to a minimum of $400mm/quarter in May. Overall, it is positive to see Citizens increase the amount of organic loan growth to roughly 60% of loans put on balance sheet from 51% in 4Q14. We expect this outsized growth to continue through FY15 as the company has seen a pickup in organic activity and has already announced other deals to buy whole loan portfolios.

Fifth Third Bank reported core EPS of $0.37, including a $15mm ($0.01-$0.02) Q-Q benefit from Mortgage Servicing Rights valuation adjustments. Net Interest Income and expenses beat expectations, but core fee income was weaker than expected across several categories. Net interest income was down $36mm Q-Q to $852mm, due to modifications to the deposit advance product, a lower day count, and continued core yield compression. Total loans were up nicely on an end-of-period basis (up 1.3% Q-Q), but were down slightly on an average basis, likely reflecting the restructuring of the deposit advance product. Avg. securities grew 3.3% Q-Q and NIM declined 10bp to 2.86%. Core fees decreased $23mm Q-Q to $566mm, even with support from a $15mm positive Q-Q change in MSR valuation adjustments. The decrease was primarily driven by seasonally weaker corporate banking income, service charges on deposits, and "other" fee income. Core expenses (ex. a litigation reversal and severance), were up $5mm Q-Q, as seasonally higher compensation (FICA and merit) were partially offset by lower "other" expense, which benefited from lower credit-related expenses ($14mm in 1Q15 vs. $33mm in 4Q14). Net charge-offs decreased $100mm Q-Q to $91mm in 1Q, following the $87mm TDR charge-off in 4Q14. Provision was $30mm lower Q-Q to $69mm in 1Q, with a $22mm reserve release. Nonperforming loans decreased 9% to $526mm. Basel III Tier 1 common equity ratio ended the quarter at 9.6%, up from 9.4% last quarter. Tangible book value was up $0.47 at $14.87. Fifth Third repurchased 9.3mm shares in 1Q15, reducing its average diluted share count by 9mm shares in 1Q15.

HSBC: Speculation in the market that the bank will examine the disposal / IPO of its UK business. Price suspected to be at £20bn (c100p a share). Rationale is that with "ring-fencing" the benefits of being part of a larger group are largely dissipated, whilst the cost of ring-fencing alone is speculated at £2bn. On the plus side, any moves to break up the bank must sadly be seen as positive given singular failure of business to deliver synergy benefits of a large group. Furthermore Core Tier 1 of 11% is less impressive given scale of franchise with disposal securing 6% yield. Finally, a smaller bank would have lower GSIFI (global systemically important financial institution) capital requirements. However, I would still attach low probability to the split as c20% of Global business is Global banking & Markets centred in London and benefiting from UK franchise related business. Having already exited US, a split from UK would leave HSBC as a rather odd mix of businesses, largely based in Hong Kong but with bits in France, Asia, LatAm. If the management wanted to break up the Group it would be a good first start, but I suspect that they do not and that the consideration reflects their frustration at treatment by UK regulators and politicians, with UK Bank levy actually taking c7% off EPS.

Morgan Stanley reported 1Q15 EPS of $1.18. Excluding a net discrete tax benefit of $564mn ($0.29) primarily associated with the repatriation of non-U.S. earnings at a lower cost than originally estimated and DVA of $125mn ($0.04), EPS was $0.85. Consensus was $0.77. Stronger-than-expected trading revenues (FICC and equities) more than compensated for softer-than-anticipated investment banking fees. Wealth Management and Investment Management approximated expectations. Ex. DVA, operating revenues rose 11% y-o-y and jumped 22% sequentially to $9.8bn (consensus $9.2bn). Its Return On Equity ex. DVA and discrete tax benefit was 10.1%. Tangible book increased to 2% $28.91 (1.3x). Its Core Equity Tier 1 ratio was 13.1% (advanced approaches). During the quarter, it repurchased $250mn of its common stock, or 7mn shares. Institutional Securities revenues ex. DVA rose 17% y-o-y and jumped 66% from 4Q14 to $5.3bn. Investment banking fees rose 3% y-o-y and fell 9% from 4Q14. Relative to 4Q14, advisory (-3%), equity underwriting (-11%, fewer IPOs) and debt underwriting (-15%, lower loan volumes) all declined. Total trading revenues increased 26% y-o-y and jumped 110% from 4Q14. Equity trading (ex DVA) increased 33% y-o-y, reflecting strong performance across products and regions on higher levels of client activity. FICC (ex. DVA) increased 15% y-o-y, reflecting strength in commodities and higher revenues in rates and foreign exchange, partly offset by lower results in credit products. Its average VaR was $47mn, unchanged from 4Q14 and compared to $50mn in 1Q14. Wealth Management revenues rose 6% y-o-y and increased 1% from 4Q14 to $3.8bn. It pre-tax margin was 22%, approximating the prior quarter (ex. the impact of comp expense deferral adjustment). Fee-based asset flows for the quarter were $13.3bn, down from $20.8bn in 4Q14, though total client assets were a record $2.0trn (+1%). Investment Management revenues declined 11% y-o-y and increased 14% from 4Q14 to $669mn. Relative to 4Q14, traditional asset management (+2%) and merchant banking/real estate investing (+47%) increased. Assets under management or supervision were $406bn (+$3bn). It recorded net inflows of $1.3bn, down from $3.5bn in 4Q14. Core expenses rose 6% y-o-y and increased 8% from 4Q14. Comp expenses rose 5% y-o-y and gained 13% from 4Q14. Its comp ratio was 46% in 1Q15, compared to 48% in the year ago quarter. Non-comp expense increased 9% y-o-y and rose 1% from 4Q14. The effective tax rate from continuing ops was 13.6%, or 33.3% ex. the net discrete tax benefit. It was 33.1% in 1Q14.

State Street reported 1Q GAAP EPS of $0.90. Results included $0.27 of one-time items. These include a legal accrual related to indirect FX matters (+$0.36), acquisition costs (+$0.01), discount accretion (-$0.04) and tax adjustments related to these one-time items of (-$0.06). Ex. these items State Street is calling operating EPS $1.17. A lower tax rate of 28.5% vs. guidance of 30-32% contributed $0.04 to the beat. All in, it's estimated core EPS as $1.14, nicely ahead of consensus ($1.05) estimates. GAAP ROE came in at 7.9%, while non-GAAP ROE came in at 10.4%—recall that management's compensation is contingent on generating a 9% ROE in 2015. State Street also highlighted $20 million in securities processing costs and $8 million in a bank levy–we view these as costs of doing business. Management continues to execute well in light of the multiple headwinds facing the franchise (rates, regulation, capital, legal fines). With respect to today's results, like peers revenues were aided by FX (State Street: +21% qtr/qtr, Bank of New York:

+32% and Northern Trust +18%). However, unlike those peers the trajectory of NIM was not reset higher by balance sheet re-mixing away from cash, in fact the balance sheet was de-risked away from mortgage-backed securities. Expenses were well controlled in light of the beat. Regulatory pressures remain–compliance and legal costs are likely to remain higher, capital ratios declined and will we believe likely be bolstered by issuing preferred stock. Revenues ex. accretion of $2.7 billion (+4% yr/yr, -2% qtr/qtr) were in-line with forecast ($2.7 billion), though the composition was in our view suboptimal–less fees and more FX. Total fee revenues were up yr/yr (+7%), but flat relative to both the prior quarter. Specifically, servicing fees (+3% yr/yr, -2% qtr/qtr) and management fees (+3% yr/yr, flat qtr/qtr) were mixed as a stronger dollar impacted fee revenue. FX trading was a highlight (+51% yr/yr, +21% qtr/qtr) as 1Q volatility helped trading here. Securities finance revenue was higher than 1Q14 (+19% yr/yr, -5% qtr/qtr) due to continued enhanced custody throughout the year, though was lower than 4Q14. Spread revenues remained under pressure as NIM contracted further (-3 bps qtr/qtr) trumping I/E asset growth (+1%). Operating margins improved to 27% compared to 25% in 1Q14. Operating ROE was 10.4% versus 8.8% in the year ago quarter. Pro-forma balance sheet for the Basel III final rule, on both a standardized (10.4% vs. 10.8% in 4Q14) and advanced basis (12.1% vs. 12.5% in 4Q14) Tier 1 common slipped a bit due to the FX legal matters, but remained above requirements as of March 31st, 2015. State Street repurchased $472 million of stock (1.6 million shares), as expected. The firm is authorized for $1.8 billion in repurchases through 2Q16 under the new CCAR capital plan approval, and will be raising their quarterly dividend to $0.34 (old: $0.33). Management is targeting a net reduction in non-operational deposits (currently at $54 billion earning 15-20 bps) by the end of the year and reiterated the plan to issue an additional $750 million in preferred stock in 2015 given the lower cost of capital vs. common.

Activist Influenced Companies

Restaurant Brands International reported first-quarter revenue which was more than double compared with the fourth quarter of 2014, to $932 million from $416.3 million, helped by product launches and promotions. The company was formed by Burger King's takeover of Canadian coffee and doughnut chain Tim Hortons last year. Restaurant Brands said comparable sales at Tim Hortons rose 5.3% in the first full quarter since the merger, compared with a 4.1% rise in the fourth quarter, driven mainly by continued daypart expansion and new menu items such as crispy chicken club sandwiches. Comparable sales at Burger King rose 4.6% in the first quarter compared with a 3% rise in the preceding quarter, helped mainly by the chain's '2 for $5' platform and the introduction of the spicy BLT whopper sandwich.

Global Dividend Payers

AT&T reported better-than expected earnings and said fewer wireless customers switched to other networks at a rate not seen in any first quarter. The company, awaiting regulatory approval for its $48.5 billion proposal to buy DirecTV, sees additional cost savings of more than double than it previously forecast from the deal. It still expects it to close in the current second quarter. The second-largest U.S. wireless carrier posted net income, excluding items, of 63 cents per share, ahead of analysts' average estimate of 62 cents. Revenue was $32.58 billion compared to $32.48 billion a year earlier. AT&T said it expects cost savings from the DirecTV deal to total at least $2.5 billion on an annual basis by the third year after the deal closes.

Novartis – Swiss drugmaker beat first-quarter profit forecasts, defying the impact of a strong dollar thanks to surprisingly strong margins. The Basel-based group confirmed its guidance for sales and operating profit growth this year. The group reported a 7% year-on-year fall in first-quarter net sales from continuing operations to $11.9 billion, while sales rose 3% in constant currencies. Core net income of $3.2 billion was down 4% in dollar terms but up 8% at constant currencies. Core operating profit of $3.65 billion also beat expectations. Chief Executive Joseph Jimenez said he was on the lookout for "bolt-on" acquisitions worth $2-5 billion. Novartis maintained its 2015 guidance of mid-single-digit sales growth in 2015 and high-single-digit growth in core operating income after stripping out currency fluctuations.

Procter & Gamble sales fell in the first quarter as a stronger dollar took its toll, with currency fluctuations likely to hurt 2015 sales by 6%-7%. The world's largest household products maker, which gets roughly two-thirds of sales from outside the United States, reported a steeper-than-expected 8.3% fall in quarterly sales. Procter & Gamble expects to start at least 18 new manufacturing plants in developing markets in the next few years as a measure to further localize its supply chain and mitigate foreign currency fluctuations. The company is also driving savings from cost of goods sold to $1.6 billion this year, ahead of its $1.2 billion target per year along with increasing manufacturing productivity by 5% this year. Since August, where P&G outlined a plan to sell slow-growing brands and cut jobs to revive sales growth, a total of 40 brands have either been sold, discontinued or will be consolidated. The new company will retain 65 leading brands and the consumer goods maker will be in a position to announce a large part of its brand divestiture program by as early as this summer.

Nestle told shareholders recently it was taking steps to maintain its position at the head of the global food industry, where consolidation will create two big new rivals. Nestle Chairman Peter Brabeck-

Lemathe told the company's annual shareholder meeting the creation of Kraft Heinz Co and Jacobs Douwe Egberts, as well as "spectacular" growth of some other companies in developing markets, required two things of Nestle in order to remain the global leader. "First of all, an acceleration in our policy of adjusting our portfolio of activities and at the same time better use of our size," Brabeck said.

Nestle, the world's biggest food group by sales, has already taken steps toward both of those goals. It has sold underperforming businesses including PowerBar and the bulk of Jennie Craig, and created a new executive board role to oversee several corporate support functions globally. The move was aimed at making the most of its scale.

Brabeck's comments come three weeks after the announcement that H.J. Heinz Co agreed to buy Kraft Foods, backed by Warren Buffett's Berkshire Hathaway and private equity firm 3G Capital, creating the third-largest packaged food company in North America. "3G and Buffett have pulverized the food industry market, particularly in America with serial acquisitions," Brabeck said. "3G's partners are known in our industry for ruthless cost-cutting and have already proven numerous times that they are capable of reducing operating costs in particular by between 500 and 800 basis points, which has a revolutionary impact on all the other members of the industry." 3G's founders orchestrated the formation of Anheuser-Busch InBev, and the takeovers of Burger King, Tim Hortons and Heinz. European coffee company D.E Master Blenders is in the process of forming a joint venture with the coffee business of Mondelez International. The combined company will be the world's largest standalone coffee company, though it will still be far behind Nestle's coffee business.

Brabeck also voiced support for the Swiss National Bank's recent currency move, saying the stronger Swiss franc would aid Swiss competitiveness in the long run by encouraging innovation. He also dismissed the possibility of Nestle moving to report in any other currency. "I've often said that for as long as the Swiss flag flies over our corporate buildings, Nestle will stick with the Swiss franc," he added.

Roche the world's biggest maker of cancer drugs, beat expectations for the first-quarter with a 3% rise in sales, on a strong showing from its cancer drugs and a recently launched treatment for a deadly lung disorder. For this year, Roche repeated it expects low- to mid-single-digit sales growth and for core earnings per share to grow ahead of sales, if exchange rates remained constant. The drugmaker, which paid an 8.00 franc per share dividend for 2014, said it planned to further increase its payout in Swiss francs. Roche said the strong franc knocked 2% points off its sales in the quarter. Roche's sales in the first three months climbed to 11.83 billion francs ($12.4 billion) from 11.5 billion a year ago, beating an average forecast of 11.49 billion in a Reuters poll.

Economic Conditions

US durable goods orders jumped 4% in March, driven chiefly by the notorious bulky aircraft orders, handily beating the expectations for a 0.6% improvement. However, core orders, which excludes transportation and defense orders, were down 0.5% in the month, significantly below the expected 0.3% advance, dragged lower by a pull back in orders for machinery, communications, appliances and primary metals, partly offset by gains in computers and motor vehicles orders. All in, a rather weak showing for the sector, broadly in line with other recent indicators pointing to soft business activity, which might just give the Feds pause on their quest to exit their long standing accommodative monetary policy.

U.S. new home sales fell 11.4% to 481,000 annualized units (lowest in four months) the largest % decline since July 2013. However, the March drop follows three consecutive monthly gains, and is coming on the heels of February's upwardly revised level of 543,000 units, which was the highest in seven years. There were also upward revisions to the prior three months. In other words, some retracement was expected. And, it took a little longer to sell a home….4.0 months, from being completed to being sold, which is the longest in nearly two years. Overall, the pace is sluggish but the trend in new home sales is still higher. Homebuilder confidence perked up for the first time in half a year, and they continue to report more orders. Don't be surprised to see a bounceback in April.

Financial Conditions

US Federal Reserve policymakers remain determined to signal that although Quantitative Easing has stopped, the stimulus remains via keeping rates at present low until earliest mid-late 2015. The US 2 year/10 year treasury spread is now 1.42% and the UK's 2 year/10 year treasury spread is 1.17% - 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 3.65% (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 4.6 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 12.44 (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 5 private/alternative products:

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

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, KBW, BMO, Macquarie

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