Market Commentary

PORTLAND INVESTMENT COUNSEL™

July 19, 2010

News Highlights on Current Holdings

Financial Services Companies

- **JPMorgan** headline Net Income of $4.8 billion / EPS of $1.09c a strong beat versus consensus of 71c. Company released $1.5 billion / 36c of loan loss reserves but partially offset by a charge of $ 550m / 15c for the UK bonus tax and hence the underlying number is seen as 87c… a solid performance across most of its businesses. In fact, every single major business line (ex. Internal corporate) posted a profit in the current quarter, a feat that hasn't been accomplished since 3Q08. Revenues came in at $25.6bn versus expectations of $26.6bn. The investment banking results were disappointing, as expected, with income of $1.38bn down from $2.5bn in 1Q. Investment Bank fees were basically inline with Q2 but Fixed Income, Currencies & Commodities revenues fell 35% QoQ to $3.6bn. Company has bought back over $500 million stock (at approx price of $38 per share) over last quarter and CEO, Jamie Dimon, is indicating to expect more of this …. while very modest, the resumption of share repurchases, is a welcome signal that excess capital redeployment could resume. Jamie Dimon also 'hopes' to see a more attractive dividend being reinstated at best by year end ..if not then early next year. Balance Sheet remains very strong with Tier 1 at 12.1% as is loan loss coverage ratio at 5.3% of total loans. Early-stage delinquencies continued to improve and management lowered the quarterly loss outlook for home equity, prime mortgage, and subprime mortgage.Group's Return on Equity for the quarter was improved to 12%...and still trading below its book value of $41… we still view as a core holding in several of our funds.
- JPMorgan announced last week that former Senator (Florida-Republican) Mel Martinez will join the firm to be its Chairman of Florida, Mexico, Central America and the Caribbean. Based in Orlando, he will serve on JPM's Executive Committee and will be the firm's senior executive in Florida and the region. Since acquiring Washington Mutual's banking operations in late 2008, JPM has hired hundreds of bankers to expand its presence in Florida in Consumer, Commercial, Private and Investment Banking. Chase also plans to add at least 20 branches a year to its network of 240 branches and 1,000 ATMs in the state.
- **Bank of America** reported 27c earnings per share beating expectations of 23c. Net income at $3.2bn boosted by gains on disposals of close to $2bn. The sale of its preferred and common shares of Itaú Unibanco Holding generated a $1.2 billion pretax gain; the sale of its equity position in MasterCard, resulted in a $440 million gain; the sale of Columbia Management's long-term asset management business generated a $60 million gain (reduced goodwill and intangibles by $800MM); an agreement to sell its entire 24.9% stake in Grupo Financiero generated a pretax loss of $428 million; and an agreement to sell a $1.9 billion portfolio of limited partnership interests in private equity funds generated a pretax loss of $160 million. The net of these transactions added $0.07 to EPS.
- Positive talk on credit quality improvements but net charge off's only moderately ahead at $8.1bn. Revenues beat by 2% at $29.45bn but Net interest income was slightly weaker and Non interest income the driver of the beat. A very similar qtr to JPM—Credit getting better, as the provision fell to $8.1bill, from $9.87 in 1Q, reserve releases, but core earnings are weaker. The Bank did miss on spread as their margin was down in the qtr, but they are attributing it to expensive hedges they put on in the quarter, its NPA (non-performing asset) ratio increased 5bps to 3.73% on lower loan balances and this diversified bank's Tier 1 Capital is strong at 10.67%.
- **National Australia Bank** has agreed to inject £300mn (A$516mn) into its UK subsidiary Clydesdale Bank to give the small lender a head start on its British rivals in capturing the expected growth in mortgage lending as the struggling economy shows signs of recovering. It's understood that the capital was not a response to pressure from the Financial Services Authority.
- **ICAP:** Interim Management Statement: The company indicate that first quarter revenues were up 8% YoY and profit up 5%. It sees full year profits as likely to be within the range of analysts' estimates (profit before amortisation, exceptionals £336m-£360m) providing exchange rates stay close to current levels. There are positive comments on the group's ability to benefit from regulatory changes as a result of its electronic broking and post trade capabilities. In particular it expects some interest rate derivatives to switch to electronic platforms this year. The company argues that its electronic businesses "will be a substantial beneficiary of a shift to more transparent markets arising from increased electronic transaction", a view we share. The company also says it expects certain areas for the interest rate swap market to be broked electronically in 2010. We believe this would be positive for the company. General message is that the company has continued to make progress both strategically and financially.
- **Santander:** the Eurozone's largest bank, last week confirmed its agreement to buy the German retail bank business of Skandinaviska Enskilda Banken (SEB) for E 555m. The goal

is a significant step towards Santander achieving its goal of being a full-service retail bank in Germany. Santander Consumer Bank is already a leading provider of car finance and consumer loans in Germany with 6 million customers. The deal to buy SEB's 173 German branches, expected to be completed next year, nearly doubles the size of Santander's German branch network.

- **Standard Chartered** plans to hire 1,000 more workers to the 5,000 it already has in China by the end of this year, Business Times reported.
- **NYSE Euronext / New York Stock Exchange Euronext:** has launched a UK-based platform for new listings that is a direct challenge to the London Stock Exchange. Securities Exchange competition is intensifying as the larger operators build global networks.
- **Goldman Sachs** agreed to pay $550 million and change its business practices to settle U.S. regulatory claims it misled investors in Collateralised Debt Obligation's linked to subprime mortgages. The penalty is the largest ever levied by the Securities Exchange Commission against a Wall Street firm but is much lower than the $1bln that was expected. Of the fine $300mln will go to the US govt with $150mn going to IKB and $100mln going to RBS who were the investors in the CDO's. We view the absolute amount of the charge to be significant but digestible (1% of Tier 1, 5% of 2010 EPS) and importantly helps to remove an overhang that should help to heal GS and Morgan Stanley valuations. Importantly, Goldman agreed to settle the charges without admitting or denying the allegations; the settlement is subject to approval by the U.S. District Judge for the Southern District of NY.
- **Royal Bank of Scotland Insurance** The UK's largest motor insurer, is understood to be preparing for a multi-billion pound corporate restructuring in advance of a sale process likely to take place in 2012. Royal Bank of Scotland will recoup $100m after Goldman Sachs settles fraud case and Moody's has upgraded RBS's financial strength to stable from negative. This is the second upgrade last week after Fitch's earlier on.
- **US financial Reform:** US Senate approved a sweeping overhaul of the US financial sector last Thursday, introducing a raft of restrictions on banks to curb risk and sealing a landmark legislative victory for President Barack Obama. Lawmakers voted 60-39 in favour of the bill, sending it to Mr Obama to sign into law, which in spite of the smattering of Republican votes and some influence on the text, remains a partisan piece of legislation.

Dividend Paying Companies

- **Carrefour** – Carrefour announced its second quarter sales results, which were marginally ahead of the expectations as weaker sales in unemployment laden Spain and in Belgium only partially offset strong results in Latin America and China. More importantly, the like for like sales in French hypermarkets, the group's core market, improved in a weak consumer environment, a sign that the rejuvenation efforts are getting traction. The company maintained its earnings before interest and tax (EBIT) guidance for the full year at 3.1 billion EUR.
- **Posco –** Postco's Q2 results were in line with the consensus expectations, with the operating profit increasing 27% quarter on quarter on the back of a significant steel price increase induced by much higher raw materials pricing as well as a result of higher sales volumes, up 4.8% quarter on quarter. Operating profit growth is expected to revert in the coming quarter as the effect of the higher iron ore and coal pricing won't be entirely passed through to customers.
- Posco announced a 67% year on year increase in the interim dividend per share as well as a 20% stake in the Dongkuk Steel's steel plant in Brazil, which is in turn a joint venture with Vale. Posco is also interested in securing iron ore supply and as a result announced investing 195 billion KRW or approximately 160 million USD in Australia Premium Iron project in iron ore rich Pilbara region of Western Australia. Posco aims to increase its captive source of iron ore ratio to 34% from about 18% currently.
- Novartis – Novartis second quarter earnings per share at 1.20 USD exceeded mildly the consensus expectations, driven by robust sales growth in an otherwise very challenging environment for the industry as a whole. The company warned however of stronger headwinds in the second half of the year coming the European healthcare reform and an increase in the research and development expense. A number of important pipeline developments are improving the business outlook with the oral multiple sclerosis drug, Gilenia, likely to receive the green light in US this fall as well as the meningitis B vaccine which is making good progress towards approval in Europe.
- Syngenta, Bayer – Syngenta and Bayer signed a global cotton technology licensing agreement through which Syngenta has granted Bayer CropScience a worldwide, non-exclusive license for use of Vipcot, insect control biotechnology in cotton.
- The addition of this insecticide will complement Bayer's existing portfolio of cotton solutions while at the same time leverage Syngenta's technological platform. Vipcot contains

the same gene as Agrisure Viptera, which is to be launched by Syngenta in the US corn market later in 2010.

- The agreement with Bayer CropScience means that cotton growers will also see an expansion of the technology options available to them." Dr. Joachim Schneider, Head of the BioScience business unit of Bayer CropScience stated "We have one of the most robust cotton technology pipelines in the business, and we are pleased to be working with Syngenta to advance yet another insect control technology offering to benefit cotton farmers worldwide." We view this announcement as typical of the types of business agreements we expect in future – and that the synergies of such actions play well to creating value for both businesses.
- Bayerische Motoren Werke AG (BMW) raised its sales and earnings forecast for the year as demand for models such as the new 5-Series sedan increased. BMW predicts sales this year to rise about 10% to more than 1,4 million cars and SUVs, while the operating margin in the automotive unit will advance more than 5%. Strong demand from China, a rebound in US and Europe and cost-cutting have all come together – BMW is still targeting an operating margin of between 8% and 10% for 2012 and a return on capital employed of more than 26% for its automotive division…. these seem increasingly credible.

Economic Activity, Consumer and Business Conditions

US – Signs of the manufacturing slow-down in US are increasingly evident with the Philly Fed and the Empire State surveys leading the way. The New York Empire Manufacturing index dropped dramatically to 5.1 from 19.6 and well below the expected 18.5 figure in July, while the Philly Fed Survey Index retreated to 5.1 from 8.0 in the same month while the expectations were for an improvement all the way to the 10.0 level. The industrial production reading for the month of June did not change compared to the month prior, which was more or less in line with the expectations of a mild -0.1% decrease after a strong 1.2% advance in the month prior. The capacity utilization dropped to 74.1% in June from 74.7% in May.

The US retail sales ended up falling for the second month in a row in June, with the decline being led by the auto sales and the building and garden equipment. The core retail sales actually rose by 0.2% in the month, being led by the sales in electronics and appliances as well as clothing and accessories. On the foreign trade front, the US trade deficit widened to an 18 month high of 42.266 billion USD, with very strong growth on both the imports as well as on the exports side. Imports were up 2.9% in the month with the growth coming from the consumer goods and the capital equipment. The exports rose by 2.4% being supported by growth in all the goods categories.

The headline consumer price index (CPI) in US decreased by -0.1% and is sitting at 1.1% on a year on year basis, while the core CPI (excluding food and energy) actually increased by 0.2% and is sitting at a 0.9% level on a year on year basis, which helped dissipate some of the deflationary fears. University of Michigan's Consumer Sentiment index preliminary reading tanked in July to 66.5, a full 8 index points below the expected 74.5 reading and 9 index points below June's reading of 75.5, as the US consumer is battling with the effects of a protracted period of high unemployment and worrying macro-economic developments.

Greece sold last week E 1.625 billion ($2.1 billion) of 26-week Treasury bills at a rate below the 5% charged by the European Union for its bailout package, easing concern the nation faces punitive costs to borrow.

Greek Auction: Greece sold last week EUR1.625bn of 26 week T-bills at 4.65% this was covered 3.64x according to the Greek debt management unit (PDMA) who also said foreign investors were involved in the auction. The rate is below the 5% charged by the EU on its bailout package and hence eases concerns the nation faces punitive costs to borrow. About EUR4.5bn of short-term securities are due in the next two weeks.

Portugal had its credit rating cut two notches to A1 at Moody's Investors Service because of a growing debt burden and weak economic growth prospects.

The Bank of Thailand (BoT) raised its policy rate by 25bp to 1.5% last week, as expected. The social unrest has inflicted little damage on the economy while inflation is set to rise. Last week's move is probably not a one-off adjustment with more rate rises to come.

Financial Conditions

Policymakers continue to accommodate a recovery in bank profits. The U.S. 2 year/10 year treasury spread is 2.35% and the U.K.'s 2 year/10 year treasury spread is 2.57% - enabling financial services companies' assets booked at these levels, to be very profitable.

Our concerns are mostly focused around the later cycle issues facing financial services companies – particularly commercial real estate and unsecured consumer loans/credit card loans. However, commercial real estate exposure is more acutely held by US, Spanish and German regional banks – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (96 to-date in 2010) and we expect will exceed last year's 140 which was the highest annual tally since 1992. This supports our view that franchises are being acquired/absorbed as convergence of the financial services industry accelerates – favouring we believe the stronger, better managed banks. Typically banks acquiring collapsed bank franchises from the Federal Deposit Insurance Corporation (FDIC) are paying little or no premium for deposits, assets are purchased at a discount and are covered by loss sharing agreements – so that such deals can be expected to be immediately accretive to earnings per share. The FDIC changed the loss share arrangement on assisted deals from absorbing 95% of losses down to absorbing 80% although this is still attractive to acquiring banks it does probably lower the Internal Rate of Return.

The year to date cost of the 96 closures so far is $18.1bn. In terms of run rate the FDIC is closing banks considerably faster than it did last year, but the loss estimates are lower as the institutions being closed are generally smaller and mostly concentrated in the states of Florida, Georgia, Illinois or California. Of the 264 banks that have been closed since the crisis began more than half have come from those four states.

The U.S. 30 year mortgage market has remained low and has now fallen back to 4.57% - the rate marks another record low over the last 39-years. A year ago, rates for 30-year mortgages averaged 5.20%. Existing U.S. housing inventory has reduced to 8.3 months supply of existing houses – but that is still higher than what we believe is a more normal range of 4-6 months. We believe it remains premature to consider a recovery in house prices but a measure of stability from which to build is welcomed…. particularly for those financial services companies holding such assets in their portfolios.

A concern which remains is the extent to which loan modifications are an exercise in loss deferral but 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.

The VIX (volatility index) is 26.92, which is below the levels experienced prior to the ECB bail out and substantially lower than last August/September. While, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

We believe the next few years will highlight the growing polarization between strong and weak institutions. Companies that have capital strength will buy assets from those required to divest. Companies that have a strong presence in emerging markets will likely grow quicker than those that do not. Banks that have strong retail deposit franchises will take market share from those that rely on wholesale markets to fund loan growth at attractive margins. Financial services companies that have breached client trust will keep losing business to those reputations that have been enhanced by the crisis. We believe the Funds we manage are extremely well positioned to benefit from the strength of their portfolios of strong, dominant, attractively priced financial services companies.

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Closed-End Funds

Spreads on the closed-end funds are narrowing but remain, in our view, very attractively priced to purchase.

The Portland Investment Counsel Inc. 2009 Closed End Annual Reports are now available on the web site. Below you can find the link to access the closed end annual report.
http://www.portlandic.com/Info.aspx?disp=Financial_Reports

At the close of business on Fridays and at the end of each month we publish the Net Asset Values (NAV) of our funds onto our Portland website at http://www.portlandic.com/Funds/WeeklyPricing.aspx. The NAV for the AIC Global Financial Split Corp. can be found on the AIC/Manulife website at http://www.aic.com/EN/PricePerformance/AICClosedEndFunds/Pages/Price.aspx and the Copernican World Financial Infrastructure Trust, Copernican World Banks Split Inc. and the Copernican International Financial Split Corp. can be found on the Copernican website at http://www.copernicancapital.com/Funds/WeeklyPricing.aspx.

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