# Market Commentary

PORTLAND INVESTMENT COUNSEL™

August 8, 2011

## News Highlights on Current Holdings

### US Credit Rating

For the first time in history, the US credit rating was downgraded by the Standard & Poor's to AA+ from its 'risk free' asset rating of AAA. Many have questioned the S&P's decision, pointing out a serious credibility shortfall stemming from the agency's generous approach in handing the top credit rating for the infamously opaque mortgage backed securities, which turned out to be collections of little or no values subprime lending contracts and which triggered the great financial crisis. The S&P's credibility took another hit when the US Treasury pointed out a $2 trillion calculation error in its US budget forecast, Friday afternoon, when the agency made public its decision. The debt to GDP ratio, in its corrected version, is expected to reach 79% for US in 2015, before reaching 83% in 2020, following the current fiscal path; while growing, the level of indebtedness is still significantly lower than some countries like Japan or some of the country in the troubled Eurozone. On the other hand, very few would argue that growth in public spending coupled with reduced revenues through tax cuts are a path to fiscal sanity and the US political class showed very little in way of political willingness to address the above issues. The months long debate over raising the US debt ceiling seems to have been the trigger in the credit downgrade, especially since political factors feature prominently on a list of criteria the S&P's considers in assessing the credit worthiness of various countries debt issues. What matters in assessing credit worthiness of an organization or country is the probability of default, on which, in the US case people are still divided whether the debt deal increased or decreased. Let's not forget that the US controls the printers for the world chief reserve currency and could inflate its way out, making a default virtually impossible. The trading impact of the credit downgrade, as surveyed by various street watchers over the weekend, it is perceived to be minimal, as very few organization are still bound by the necessity to hold triple A rated securities.

### Financial Services Companies

Axa SA - first-half profit more than quadrupled on gains from asset disposals in China, Australia and New Zealand, beating estimates. Chief Executive Officer Henri de Castries is banking on Asia to drive growth. He set a 2015 target in June to reach annual operating profit of more than €6bn compared with €3.88bn last year. Axa is expanding in Asia and scaling back in Canada and the U.K. as it aims for 10% annual growth in operating earnings per share through 2015.

BNP Paribas is planning to acquire IKB Deutsche Industriebank from Lone Star with IKB's leasing business not included in the deal according to Handelsblatt.

ING Groep - second-quarter profit climbed 24% as income from insurance countered a write-down of Greek government debt. ING's insurance unit, which it plans to sell before the end of 2013 as a condition for gaining European Union approval for state bailout, posted an 83% jump in operating profit. The firm plans an initial public offering for its U.S. business and another for the European and Asian parts of the unit.

Prudential Financial's profit rose 4.1% in its financial-services business and core earnings jumped on a surge in profit at its U.S. retirement unit and newfound strength at the domestic insurance segment.

Swedbank is planning to sell its Russian retail business to Raiffeisen according to Kommersant.

### Dividend Paying Companies

BHP – workers at Escondida, Chile, the largest copper mine in the world, which is controlled and operated by BHP Billiton, voted to end a two week long strike on Friday, renouncing to some of their demands. The initial workers' demand was for a special bonus of about $11,000 each, but they had to settle for $5,760, offered by the company shortly after the strike begun, as the company's tough stance and two weeks without pay caused them to grow weary. The mine is responsible for 7% of the world output and the strike is estimated to have cost BHP some 40,000 tonnes of copper. The company's determined approach however is expected to temper some other possible labour actions across the globe, as workers are bargaining for a bigger piece of the mining boom. The production interruption at Escondida, together with other actions at Codelco, the state run Chilean company, and Collahusi, operated by Xstrata, provided support for the copper pricing, at around $9,500/tonne before the settlement.

Hutchison Whampoa – reported half year net profit seven times higher compared to last year, when it announced its results on Thursday, the good performance being mostly due to a large gain as a result of listing is port assets located in Southern China. The earnings for the first half of the year reached $5.94bn. The 3 Group mobile phone division, once loss-making, has improved to become one of the key profit contributors, with roughly $98mm contribution in the first half of the year. Cheung Kong Infrastructure, a listed subsidiary, also posted robust results, reporting over $500mm of net profit. However, management stance is rather cautious going forward, as the company is concerned with the debt issues in Europe and US, as well as poor economic performance of the two regions.

Toyota – announced a first fiscal quarter operating loss of ¥108bn, significantly better than the expected ¥190bn loss, as the company had to cope with the effect of the devastating March earthquake. Another contributor to the loss was the strengthening of the Japanese currency, with recent central bank interventions set to provide some relief. The management raised the full-year operating profit forecast to ¥450bn ($5.9bn) from ¥300bn previous guidance, as supply chain and production at its own facilities recovered sooner than expected. Its full year vehicle production was raised to 7.72mm units, some 330,000 units more than previously estimated.

Vivendi – the company's 63% controlled listed subsidiary, Activision Blizzard, posted second quarter results which exceeded analysts' expectations by a wide margin as revenues from the company's leading franchise, 'Call of Duty', continued to grow strongly. Management also revealed that it had seen strong pre-ordering activity for the next iteration of 'Call of Duty', the 'Modern Warfare3', due to be released on November 8. Sales for the quarter hit $699mm, ahead of the expectations for $600mm, while the underlying net income reached $355mm or $0.29/share. Reported earnings reached $0.10/share, ahead of the expectations for $0.05/share. Earnings guidance for the full year was raised to $0.77/share, ahead of the $0.75/share.

## Economic Activity, Consumer and Business Conditions

US – A relatively positive US employment report for July, showing 117k jobs non-farm payroll additions and a retreat of the unemployment rate to a 9.1% rate, was shunned by the markets on Friday, as legitimate concerns about the US credit downgrade and debt issues in Spain and Italy took primacy. Part of the same report, the manufacturing sector added 24k positions, ahead of the consensus, which was calling for 11k job additions only. The monthly improvement of the average earnings came in strongly at 0.4%, hopefully providing support for the battered consumer sector. More support is also coming from a further increase in consumer credit, higher by $15.53bn in June, ahead of expectations for a $5.0bn increase and May's $5.08bn consumer credit addition.

Earlier in the week, the Non-manufacturing index (NMI) as measured by the Institute for Supply Management (ISM), gave little reason for optimism, as it fell to 52.7 for July, from 53.3 for June, indicating growth, but slower still for this important area of the economic activity.

Canada – the Canadian employment report, although even less up-beat than the US one, showed improvement, with 7,100 being added, but more importantly showing an improvement in private payrolls and in full time jobs. The unemployment rate retreated to 7.2%, doubtlessly as a result of a smaller labour force.

Canadian building permits for June continued to show growth, moving higher by 2.1%, unlike the expected 5.0% correction and on top of the 20.9% advance in May.

Meanwhile, the Ivey Purchasing Managers Index (PMI), the Canadian equivalent of the US PMI, dramatically and unexpectedly dropped to 45.4 from 68.2 in June and compared to the expected 60.2 value, indicating contraction in the manufacturing sector. However, this indicator has been highly volatile.

## Financial Conditions

Policymakers continue to accommodate a recovery in bank profits, albeit less than 6 months ago. The U.S. 2 year/10 year treasury spread is 2.21 % and the U.K.'s 2 year/10 year treasury spread is 2.10 % - enabling financial services companies' assets booked at these levels, to be profitable.

Later cycle issues continue to challenge 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, albeit at a more moderate pace (63 in 2011) compared to 157 in 2010 which was the highest annual tally since 1992 (140 in 2009). 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.

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The U.S. 30 year mortgage market has remained low at 4.39 % - (the lowest rate since the Federal Reserve began tracking rates in 1971 was 4.17% on Nov. 11, 2010), as the Federal Reserve effectively continues to seek to incentivise home ownership. Existing U.S. housing inventory has increased to 9.5 months supply of existing houses – a 7 month high and much higher than what we believe is a more normal range of 4-7 months. We believe it remains premature to consider a recovery in house prices but a measure of stability would be welcomed….particularly for those financial services companies holding such assets in their portfolios.

A concern which remains is the extent to which mortgage foreclosures have been properly documented, thereby enabling mortgages to be "put back" to the originating bank. However, from recent bank investor relations presentations it does seem the rate of "put backs" are now expected to decline, suggesting current levels of provisions should suffice. 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 32.00 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

## 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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Sources: KBW - EuroAsian Daily, TD: Morning FX Outlook ,Thomson Reuters, Global Financials Daily (JPM, SEB, Asian banks, VR, Italy, STB, UBS, CS, ASHM, PAY, TNN, RBS, HIG, SIFI, Mortgage, DBS, RHB, Mizuho, JGBs), Credit Suisse - MONEY NEVER SLEEPS, Eight Banks Fail Stress Test With $3.5 Billion Capital Shortfall, CNBC.com – article dated August 5 "United States of American Long-Term Rating Lowered to 'AA+' Due to Political Risks, Rising Debt Burden; Outlook Negative"



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