Market Commentary

PORTLAND INVESTMENT COUNSEL™

August 20, 2012

News Highlights on Current Holdings

Financial Services Companies

BNP Paribas - Le Monde reports that BNP aims to raise $400mn by selling its Egyptian banking division. Potential buyers for the 70 bank branches include National Bank of Abu Dhabi and Qatar National Bank.

Credit Agricole - Standard Chartered has won approval from Turkey's antitrust board to buy Credit Agricole's Turkish unit. Credit Agricole Yatirim Bankasi offers corporate and investment banking services to clients in Turkey since it was established in 1990. The bank had 74.9 million liras ($42 million) of assets at the end of 2011.

Credit Suisse – reported last week that its two capital raising measures have generated CHF930mn in incremental Basel III common equity for 2012. This exceeds the CHF800mn target included for these two measures in the capital plan announced July 18, 2012. The two capital raising measures include the execution of the exchange offer for deferred compensation awards and the tender offer to repurchase certain outstanding public capital and senior funding instruments.

Deutsche Bank - The New York Times reported on Saturday that Deutsche Bank and several other global banks are being investigated by US prosecutors over business linked to Iran, Sudan and other nations currently under international sanctions. The U.S. Justice Department and the Manhattan District Attorney's office are investigating the banks for allegedly using U.S. branches to move billions of dollars in Iran-linked transactions, according to the report, citing unnamed law enforcement officials. "Deutsche Bank had decided by 2007 to reject any new business with Iran, Syria, Sudan and North Korea and to end existing relationships to the extent it was legally possible," Deutsche Bank spokeswoman Friederika Borgmann said, declining to comment on the U.S. investigation.

Lloyds Banking Group - announced it is to sell more than £1bn of investments in private equity, joining other financial institutions looking to reduce their stakes in buyout funds. Lloyds is selling the bulk of the private equity positions to Coller Capital, a London-based investment group that specialises in buying second-hand portfolios. (Source: Financial Times)

National Australia Bank - reported flat earnings in 3Q and said revenue fell slightly because of higher funding costs for its UK unit. NAB said its unaudited net profit in the 3 months ended June 30 was $1.2bn, with cash earnings $1.4bn, unchanged from a year earlier and just below the A$1.47 billion consensus. CEO Cameron Clyne said the stable result reflects a "difficult" operating environment with "continued uncertainty in the euro-zone and the US, volatility in global financial markets, and slowing growth in the big emerging economies".

Prudential Financial : has emerged as the lead bidder for Hartford Financial Services Group's individual life insurance business, which may sell for about US$1bn. (Source : Bloomberg)

Santander : Spain's Santander SA plans to sell up to 25% of its Mexican unit via a dual public offering on the Mexican Stock Exchange and NYSE, according to a preliminary description of the offer filed with the Mexican bourse last Thursday.

Standard Chartered - The New York bank regulator has reached a $340 million settlement with British Bank Standard Chartered regarding its alleged mishandling of funds to Iran. Standard Chartered has agreed to install a monitor for money laundering controls for at least the next two years. (Source: Bloomberg)

Dividend Paying Companies

Chemring – The company's stock price was buoyed on Friday by its announcement of a preliminary expression of interest from the private equity group Carlyle. By the end of the trading in London, the stock had appreciated by 26%. However, following the initial investor enthusiasm, the stock retraced some of the Friday's run-up, trading down some 12% at the open of trade this morning, as a number of analysts have expressed doubts over the likelihood of a bid actually been tabled. Carlyle has until September 14th to either make a firm bid for Chemring or pull out, as per the takeover code. The company has been under pressure over the last several months, as lower defense budgets in the US and Europe, coupled with uncertainty surrounding future cuts affected the company's capitalization.

Schindler Holding AG – reported a broadly in-line set of results for its second quarter, as orders reached CHF2,344mm, some 2.5% ahead of consensus, while sales, at CHF2,067mm, and operating profit, at CHF250mm, were as expected. The group operating profit margin moved 30bps (basis points) higher to 12.1%. The company also reported good progress on newly introduced products, such as the Schindler 5500 elevator and the lower cost variants Schindler 3600 for China and Schindler 3100 for India. Going forward, the company expects higher top line growth, at a 6% rate ex-currency effects, compared to previous guidance of 5%. Given competitive pressure and portfolio effects, with fast up-take of its lower cost versions, as per above, management downgraded its operating margin outlook, aiming for a 12.5% margin, compared to its previous 13% goal.

Wesfarmers – revealed full year earnings which were in-line with the expectations on an as-reported basis, yet exceeded the consensus view when excluding one-off charges. The main drivers of the outperformance were a better than expected sets of results at Coles, the company's supermarkets chain, responsible for about 40% of the total profit, as well as strong earnings beat from its Kmart discount retail operations. Food and liquor earnings before interest and tax (EBIT) from Coles were 16.3% higher year on yea, while Kmart earnings surged 31% over the same period. Government handouts to Australian households in the months of May and June, to offset a carbon tax, are likely responsible for the strong year end. Bunnings, the home improvement store chain, a perennial strong performer, grew 4.9%, while Target, the department store chain, fell by 13% as it is coping with a restructuring process following a top management shuffle. At the group level the net profit rose 11% in the year, reaching AUD2.126Bn; the company increased its final dividend by 11.8%, to AUD0.95, taking the full divided to AUD1.65, which represents a yield of roughly 4.8%.

Economic Activity, Consumer and Business Conditions

US – The US consumer sector related economic announcement surprised on the upside last week, as the US headline retail sales in July unexpectedly moved higher by 0.8%, reversing the June 0.7% drop, way ahead of the expectations, which were calling for a 0.3% improvement. Most retail categories contributed strongly in the month and even when accounting for the effect of auto vehicles retail sales were up a strong 0.8%. We continue to be cautious though as this is the first outperformance in a string of months of retail sales deceleration and labour market. Muted sentiment and lower imports point towards a slower paced set of numbers in the near future. However, the consumer sentiment, as measured by the University of Michigan, improved in August to an 73.6 level, helped chiefly by a rise in the 'current conditions' component, albeit offset by a reduction in the 'expectations' component.

On the business side, the industrial production for July came in a slightly ahead of expectations, higher by 0.6% compared to 0.5%, helped by strong motor vehicles and parts output as well as an improvement in the materials sector. The US capacity utilization improved to 79.3% in July, from June's 78.9% level. The US leading economic indicators index for July also turned out better than expected, yet in effect offsetting most of June's 0.4% reduction.

Inflation in the US continues to make it easy for the Federal Reserve to maintain its ultra-accommodative policy as the headline year on year price change dropped to a 1.4% level, from June's 1.7%, way past the expected 1.6%, dragged down by lower energy costs. Even when excluding the effects of food and energy prices, the core inflation rate maintained a tame 2.1% level, a notch lower than expected.

Lastly, the US housing sector continued to improve in both sentiment, as attested by the National Association of Home Builders (NAHB) housing market index, up to a 37 level in August, from a 35 level in July, as it did in term of building permits, which moved higher to a 812k units annualized level in July. One less bright spot as the number of housing starts, which actually retreated in July to a 746k units annualized level.

Canada – Inflation in Canada for the month of July followed a similar pattern with its US counterpart, unexpectedly retreating to a 1.3% headline level, impacted mostly by the same energy prices. At the core level inflation in Canada dropped to a 1.7% level, from June's 2.0% annualized change and materially lower than the consensus expectations, with the main culprits being clothing and transportation.

On the manufacturing front, the manufacturing sales report for June disappointed with a 0.4% retreat, relative to expectations for a 0.3% advance and a flat May reading, with the same energy sector products being to blame.

Financial Conditions

The European Central Bank has again opted not to resume its programme of buying up bonds of eurozone nations, data suggested Monday, despite widespread expectations that the bank may do so soon. According to data published on the bank's website, it did not buy any sovereign bonds last week for the 22nd week in a row.

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 "at least through late 2014". which is still an "exceptionally low level" in the grand scheme of things. Fed Reserve Chairman Ben Bernanke has indicated 1% or less would be considered exceptionally low. The extension of the US 'twist' (whereby the Federal Reserve is selling 3 year and less maturities to buy 6 years and longer) means all parts of the yield curve will benefit from a near-zero anchor until mid to late 2014. The U.S. 2 year/10 year treasury spread is now 1.53% and the U.K.'s 2 year/10 year treasury spread is 1.53% - 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 US 'twist', the U.S. 30 year mortgage market remains very low at 3.62% - (3.49% end of July was 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 6.6 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. While we still believe it remains premature to consider a recovery in house prices prospects of a measure of stability are likely to increases as a result of the Fed actions – which is 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 and whether bank's have mis-represented the quality of those assets sold to Freddie Mac and Fannie Mae. Such legal debates are likely to drag on for years but from recent bank investor relations presentations it does seem the rate of "put backs" are now beginning to decline and that litigation reserves have been increased suggesting overall current levels of total provisions should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 2 years by when we expect more normalized earnings power to have returned. 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.

As concerns have swung from commercial real estate and unsecured consumer loans/credit card loans to European sovereign debts the number of small U.S. banks failing continues to grow, albeit at a more moderate pace with 40 in 2012 (compared to 95 in 2011 and 157 in 2010 which was the highest annual tally since 1992). 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 VIX (volatility index) is 13.45 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.

Chris Wain-Lowe
Executive Vice President
Portland Investment Counsel Inc.
Phone: 905-331-4250 Ext. 4232
Fax: 905-331-4368
www.portlandic.com

Source: Thomson Reuters, Bloomberg, Company reports

Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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