# Market Commentary

PORTLAND INVESTMENT COUNSEL™

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## News Highlights on Current Holdings

### Financial Services Companies

Bank of America's US$8.5bn settlement with mortgage-bond investors is now being considered by a New York judge, two years after the lender struck the deal to resolve claims over home loans bundled into securities.

Barclays : One of the pivotal investors in the first of Barclays' 2008 scrambles to raise fresh capital has halved its stake, taking advantage of a 10% jump in the UK bank's share price over the past month. Sumitomo Mitsui Banking Corp said last Thursday that it had sold half its 1.3% stake in Barclays for about ¥40bn, cutting its shareholding to 0.66%. The sale marks a significant unwinding of the emergency financing the UK lender had sought at the height of the financial crisis. ( Source : Financial Times).

BNP Paribas: The Financial Times reporting the co. is looking at options to merge some of its US businesses in order to reduce the impact of US subsidiarisation proposals. The plan involves merging its US BancWest retail business with the corporate and investment bank, improving both the capital and funding position in the US. Its estimated BNP has a potential US capital shortfall of $5-10bn and a funding gap of $13bn, the combined cost of which could lower earnings by up to 8% in a worst case. A merger would be most beneficial in addressing the funding gap since the US retail subsidiaries have a surplus of stable $ funding that could be used to offset deficits in other businesses, notably the NY branch entity.

Credit Suisse - is considering the sale of part of its wealth management business in Germany, according to three people with knowledge of the matter. The bank may focus on ultra-rich clients and sell the remainder to boost the profitability of the German business. CEO Brady Dougan told investors last week, Credit Suisse are aiming to save about CHF750 million ($796 million) annually at the private banking and wealth management division by the end of 2015.

Deutsche Bank co-CEO Anshu Jain said the company's revenue was "sound" in the first two months of the second quarter. While revenue at the investment-banking unit was "solid" in the period, the lender's performance was hurt by low interest rates and pressure on margins in some regions and businesses, he said. The funds Deutsche Bank spends to implement a cost-savings plan that will take full effect in 2015, will boost expenses in the second quarter through the end of the year, Jain said. He also said Deutsche Bank still intends to meet profitability and capital targets he set for 2015. ( Source : Bloomberg).

Lloyds Bank – Financial Times reports the UK Treasury is considering selling a first 10% stake in Lloyds before the end of the year, with the Chancellor expected to signal a desire to begin privatising both Lloyds and RBS before the 2015 general elections, at his Mansion House speech June 19th. The process for Lloyds is expected to be executed principally through a placing with institutions, although a significant offering to retail investors, possibly at a discounted price, is also feasible, the Financial Times say. The UK Banking Commission meets today for a 2 day private session to finalise a report on banking culture and standards, which will shape the industry's future, and is expected to include heated exchanges over what it should say on RBS & Lloyds, with the Chancellor promising to listen to proposals. The Chancellor is facing new calls to accelerate the reprivatisations and to announce a radical pre-election share distribution to the public. The Financial Times reports that the 'Policy Exchange' think tank, which has close links to the UK Treasury, will today urge George Osbourne to distribute bank shares before the general election, saying it is the only way to return the banks to the private sector before the election and would offer the best value to the taxpayer.

Dividend Payers

Barry Callebaut – EU regulators gave the green light on Friday for Swiss chocolate maker Barry Callebaut to buy the cocoa business of Singaporean group Petra Foods. The EU's executive Commission found that the market would still face sufficient competition after the two firms merged. "In the markets for the production and sale of semi-finished cocoa products, the parties' activities focus on different regions, since Petra Foods is mainly active in

Asia," the Commission said in a statement.

The Swiss-based firm is the world's biggest maker of finished chocolate products and serves clients such as Nestle and Hershey. Barry Callebaut buys roughly 650,000 tonnes of cocoa annually around the globe. The $950 million acquisition of Petra Food's cocoa business should raise that number to roughly 1 million tonnes, and give Barry Callebaut access to high-growth emerging markets.

BHP Billiton – announced the completion of the sale of its interest in East and West Browse gas fields joint ventures. The company said all required approvals have been secured and relevant documents were signed Friday in Beijing to finalise the transaction. The deal was initially announced at the end of last year and involves the acquisition of BHP's 8.33% stake in East Browse and 20% stake in West Browse for roughly $1.63Bn.

GlaxoSmithKline - U.S. health advisers voted on Thursday to recommend relaxing market restrictions on GlaxoSmithKline's diabetes drug Avandia, the former blockbuster at the center of one of the biggest drug controversies in recent years. The vote, by a divided Food and Drug Administration advisory committee of outside health experts, could modestly enlarge the market for Avandia in the United States and lay the groundwork for further research into the drug's health risks. FDA will now take the vote into consideration for a final decision on how the pill also known by the generic name 'rosiglitazone' can be used.

Glaxo, which no longer plans to promote Avandia, issued a statement saying the company would work with FDA as it considers its decision. "We continue to believe that Avandia is a safe and effective treatment option for type 2 diabetes when used for the appropriate patient and in accordance with labeling," Dr. James Shannon, Glaxo's chief medical officer, said in a statement. Much of the advisory committee's two-day meeting focused on a Duke University reexamination of a Glaxo safety study known as Record that confirmed initial findings of no significant increased heart risk from the drug.

Avandia was once the world's best-selling treatment for type 2 diabetes, with annual sales of $3.2 billion. In 2010 its use in the United States was heavily restricted and it was withdrawn from the market in Europe because of the possibility of increased risk of heart attack and stroke. Only 3,000 people in the United States take it today, down from about 120,000 just before the restrictions were put in place.

Jonson Matthey, the world's largest maker of catalysts that control vehicle emissions, was badly hit by the impact of weaker metals prices on its division that refines, markets and distributes platinum - used in catalytic converters - and other precious metals. Better-than-expected progress in the division that makes catalysts for cars, trucks and the chemicals industry helped the bottom line. U.S. auto sales have seen a recovery as consumer confidence improves, and sales in May were boosted by construction workers and oil drillers snapping up pickup trucks to meet demand for their services. Johnson Matthey posted a 9% drop in underlying pretax profit to just over £389 million for the year to the end of March. The fall was smaller than analysts had forecast. The company had warned of a tough year for its precious metals unit - normally the largest contributor to its bottom line. Results in the trading division were also impacted by changes to a distribution deal with Anglo American Platinum, the world's largest platinum producer. Last Thursday, Johnson Matthey forecast profit growth, helped by chemicals processing, the impact of bolt-on acquisitions and recovering prices.

Underlying operating profit at the group's environmental technologies division, which makes catalysts for cars and trucks, climbed 7% - despite weaker sales of catalysts for cars in Europe where the outlook remains uncertain. Even with depressed consumer demand there, Johnson Matthey expects to benefit from tighter emissions legislation in Europe from January. New rules are coming into force that will require improved catalysts for trucks and buses, resulting in a three to four times increase in catalyst sales value per vehicle. China and India are also expected to adopt similar emissions rules.

As expected, the precious metals products division was hit by low platinum and palladium prices and smaller volumes feeding through to its distribution business due to strikes across the South African mining industry last year. That unit reported a 27% drop in underlying operating profit, although the group said it was seeing improvement. Johnson Matthey paid a full-year dividend of £0.57.

Tesco - the world's third largest retailer, has posted a drop in quarterly underlying sales in its main British market, as the effects of its £1 billion turnaround plan are yet to be seen. The supermarket group said it had suffered from weak demand for general merchandise, as cash-strapped Britons cut back on discretionary purchases in a flagging economy, as well as the fall-out from Europe's horsemeat food contamination scandal.

Tesco, which makes about two thirds of its revenues in Britain, still sells a higher proportion of non-food goods than other grocers do. Current management also emphasised that years of underinvestment saw it lose ground to rivals like J Sainsbury and Asda. Philip Clarke, chief executive since 2011, has tried to rectify that by investing £1 billion pounds on more staff, new food ranges, revamped stores and lower prices. Sales at Tesco's UK stores open over a year, excluding fuel and VAT sales tax, fell 1% in the 13 weeks to May 25, reversing a rise of 0.5 percent in the previous quarter, which was the strongest quarterly result in three years.

Despite the fall in underlying UK sales, the group CEO told reporters his recovery plan was on track. Clarke said he was not expecting UK economic conditions to improve in the near term, despite an industry survey on Tuesday showing retail sales rebounded in May. He forecast non-food like-for-like sales would remain down in the current financial year, but stressed it was a "top line" (sales) rather than a "bottom line" (profit) drag. Tesco was reducing its exposure to weaker categories like consumer electronics, and increasing its focus on higher growth, higher margin categories like clothing, he said. Tesco's food sales were hit by the discovery across Europe of horsemeat in products labelled as beef. Tesco was one of several firms forced to withdraw some goods and apologise to customers.

Though total international sales rose 5.5%, the outcome was helped by favourable currency movements. Like-for-like sales, excluding fuel, retreated 3.8% in Asia, hit by restrictions on trading hours in South Korea, Tesco's largest overseas market, and weaker demand in China. They also dropped 5.5% in its continental European markets, hit by recession and stiff competition. Tesco, which trails France's Carrefour and Wal-Mart, the world's biggest retailer by annual sales, makes about 12.5% of its group revenues in continental Europe. In April the firm confirmed it would withdraw from the United States.

## Economic Activity, Consumer and Business Conditions

United States – The US employment report for May, while marginally better than the consensus expectations at 175,000 non-farm payrolls additions compared to 170,000, is still a reflection of an economy that is growing slowly and which is likely to have continued need for unprecedented expansionary policies to continue to do so. April's number was revised lower, to 149,000 additions. Headline unemployment rate inched higher, to 7.6%, mostly due to an increase in the labour force, a good sign in itself undoubtedly, as formerly 'discouraged' workers find it appealing to start looking for employment. Private payrolls, up 178,000 in the month, were roughly in-line with the expectations, while the manufacturing sector actually shed 8,000 positions in May. With employment improving ever so slightly, the US consumer continues to resort to credit, up $11.06 billion in April, an acceleration from March, albeit a relatively muted level compared to last couple of years.

On the business activity side, the non-manufacturing PMI (purchasing managers index) by the Institute for Supply Management (ISM) for May helped take the edge off a bit of its manufacturing counterpart's poor showing, as it marginally beat expectations for a mild improvement to a 53.5 index level. The previous reading, for April, had been 53.1. US labour productivity bounced back up in the first quarter of the year, by 0.5%, reverting some of the 1.7% drop in the last quarter of the 2012.

The US international trade balance (deficit) widened less than expected in April, to $40.3 billion from $37.1 billion, with both imports and exports expanding in the month, a sign of improved business activity.

Canada – The Canadian employment report for May took everybody by surprise with a 95,000 jobs gain in the month, the second highest on record, and which bore little resemblance to the expected 15,000 additions. Full time employment was up by 76,700 positions, while the private sector added 94,600. The biggest gain came from the construction sector (42,700 additions – one might expect this to revert sooner or later, given the recent Canadian housing dynamics), but other sectors chipped in: retail, administration, hospitality and education. The headline unemployment rate improved one tenth to 7.1%. Not surprisingly, the Canadian labour productivity gains, though positive and in-line with the expectations, at 0.2% for the first quarter, is modest, especially when placed in the context of previous readings, such as the meagre 0.1% improvement for the last quarter of the 2012.

Readings from the much talked about Canadian housing sector, did little to assuage the worries of the housing bubble theory supporters. The April building permits jumped 10.5%, on top of a 6.0% advance for March, while May housing starts exceeded expectations by a wide margin, up to a 200,200 annualized level, from 175,900 in April.

UK banks/Help to Buy Scheme - the UK's Help to Buy policy helped sell 4,000 new homes in its two months of existence, according to industry-produced data. The Home Builders Federation said it had received about 500 registrations a week under the scheme, which gives buyers a five-year interest-free loan for up to 20% of the value of a new-build home priced below £600,000. An extension of Help to Buy beyond new homes launches next year, allowing house buyers to borrow with only a 5% deposit with a government guarantee, the Financial Times reported.

### Financial Conditions

ECB: ECB kept interest rates unchanged last week as economic data has shown signs of improvement. The main refinancing rate stayed unchanged at 0.5%. Deposit rate was held at zero and marginal rate at 1%.

Cross-border lending is falling drastically across the western world as banks slash exposure to Europe and bend to tougher capital rules, according to data from the Bank for International Settlements. Volumes fell by US$284bn across the Eurozone, a 20% rate of contraction. The BIS said the Eurozone's share of the global interbank market has fallen from a record high of 55% at the top of the EMU bubble in 2008 to just 38% at the end of 2012, a sign of fragmentation as banks return to their home markets.

UK banks: Figures from the Bank of England Funding for Lending Scheme (FLS) last week were disappointing but not surprising, with the stock of loans made by the 40 banks participating in the scheme falling £300m in Q1 2013 (with Barclays the only big four bank to be expanding its loan book). Any analysis of gearing highlights UK consumers amongst the most geared in the world. It is not banks unwillingness to lend that is the problem, but consumers / business unwillingness to borrow – for completely rationale reasons.

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 until the unemployment rate falls below 6.5% (April 7.6%) which is likely to be through 2014. Fed Reserve Chairman, Ben Bernanke has indicated 1% or less would be considered exceptionally low. In September 2012, the Fed announced it would buy $40 bn per month of agency mortgage-backed securities and in December 2012 that it would also buy $45 bn per month of treasuries (4 year maturity and above) which means all parts of the yield curve will benefit from a near-zero anchor until late 2014. The U.S. 2 year/10 year treasury spread is now 1.89% and the U.K.'s 2 year/10 year treasury spread is 1.69 % - 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 3.91% - (3.31%, end of November 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 4.7 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. A recovery in house prices appears increasingly sustainable 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 is easing 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 should suffice, enabling banks to continue to post increasing earnings per share (as credit improves) over the next 14 – 20 months 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 16 in 2013 (compared to 49 in 2012, 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..

The VIX (volatility index) is 15.14 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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