



## News Highlights on Current Holdings

### Financial Services Companies

Australia and New Zealand Bank has a new debt team in Asia. The lender, which boasts one of the banking world's strongest balance sheets and is keen to grow its Asia operations, has made a raft of appointments to its Debt Capital Markets team in Hong Kong. Former Bank of America Merrill Lynch banker Jimmy Choi has been named as head of DCM and will be based in Hong Kong, reporting to Michael Luk, global head of debt origination, according to a spokesman. ( Source : Dow Jones). Also, ANZ is planning to hire 70 commercial bankers in its drive to expand operations across the Asia-Pacific region. Ivy Au Yeung, MD of Commercial Banking Asia Pacific, said the recruitment was to consolidate a 60% increase in revenues from commercial banking during the first 6 months.

Axa - Axa Private Equity has raised \$7.1bln in new financing with which they will seek discount sales of private- equity interests by banks and financial institutions according to the Financial Times. The figure is double what Axa originally expected according to the article.

Barclays CEO Bob Diamond said that his bank are keeping their 13% ROE target after core operations beat expectations in Q1. He also said that he expects Greece to stay in the Euro.

Credit Suisse and UBS : In its Financial Stability Report, the Swiss National Bank (SNB) clearly indicated that the big Swiss banks should continue to strengthen their capital, UBS by continuing with its current policy (notably not paying any dividend), but actively urging Credit Suisse to expand its loss-absorbing capital (common equity and high trigger contingent capital instruments) during the current year. The Swiss banks appear well capitalized by current standards: Credit Suisse had a Basle 2.5 Core Equity Tier 1 ratio of 14.9% in Q1 2012 and UBS 16.7%, the situation is different if we look at fully-loaded Basle III ratios (i.e. as if they were to be implemented today with higher risk-weighted assets and full capital deductions). In this case, Credit Suisse only has a fully loaded Basel III Core Tier 1 ratio that would be around 5.3% - at the low end of the range relative to its peers albeit Basle III

will only be fully implemented in 2019, so Credit Suisse still has time to build this up. However, it is doubtful that the market will now be that patient. Certainly, the SNB isn't. Indeed, it points to the fact that the Basle III ratios are below average and also indicates that substantial losses could be incurred if the adverse scenario (sharp deterioration in economic and financial conditions, euro zone recession, Swiss recession, etc) takes place, thus stressing the need for the banks to bolster their capital. However, since Credit Suisse should be able to achieve a return on tangible equity of at least 12% over the cycle, it should be able to build up its capital over time but the SNB is perhaps pushing Credit Suisse to act faster than it would like and so making cash dividends seem rather unlikely.

ING: announced last Tuesday that it will pay US\$ 619m (EUR 495m) penalty to settle US charges. ING moved US\$ 2bn through the US financial system on behalf of clients from sanctioned countries such as Cuban and Iran from 1990s to 2007. ING booked around US\$ 463m (EUR 370m) provisions for settlement with US authorities in 1Q12 which means another EUR 125m provisions are necessary. The additional charge is a negative but manageable (c2% of consensus pre-tax profit expectations).

JP Morgan : JP Morgan's consumer credit portfolio continues to show signs of improvement as its Chase Trust Non Conforming Obligations (NCO) decreased to 3.93% of average loans from 4.19% in April. The Trust's NCO rate for May is below earlier consensus expectations as delinquencies again reach lowest levels in ~9 years. Total delinquencies fell 12 bps in May to 2.09% of loans from 2.21% in April.

Lloyds - The Times reports that a flotation of a new standalone bank under the TSB brand now looks a distinct possibility. Hopes of a sale of Verde to the Co-Op are fading because of concerns among some Co-op board members that the deal is too large and complex to take the risk. The article suggest that unless there is a breakthrough in negotiations in the next few days the Lloyds board will press ahead with the IPO plans, timed for next year. The Co-Op board is expected to meet in the



next few days. Separately, the Mail On Sunday said that Lloyds will give an update on the sale of the 632 Verde branches in the next couple of weeks.

Nordea - Dagens Industri reported that Nordea, among other companies in Sweden, is facing a possible SEK1bn payment for back taxes, after a legal ruling. The case covers the sale of assets at a discount to overseas-registered entities which then sell on the assets at market price, avoiding tax. Nordea has made a reservation, but declined to comment further, the paper said.

Prudential Financial announced a \$1bn share buyback authorization for the next four quarters, which is mostly in line with expectations and is needed to improve its return on equity to 13%-14% in 2013. Prudential plans to deploy a total of \$3bn of capital over the next four quarters via share buybacks, supporting organic growth, M&A, de-leveraging, and shareholder dividends. Its recently announced \$26bn pension transfer agreement with GM should generate an ROE consistent with its 13%+ goal and could deploy roughly \$1bn of its capital.

## Financial Infrastructure

Hong Kong Clearing & Exchange announced last Friday it had entered into an agreement to purchase LME Holdings, the parent company of The London Metals Exchange. Pricing was £1.4 billion to be funded by both debt (HK\$9.2 bn) and equity (HK\$7.5 bn). The transaction represents 58x 2011 NPAT and 18x book value. The investment case for HKEx is longer-term growth as China opens up. Further expansion into commodities trading should help cement this role. However, in the nearer term the deal is dilutive to earnings given the high multiple paid and additional cost incurred in developing the Asian platform.

## Dividend Paying Companies

Tesco – Announced it had finally found a way to exit the Japanese market, home to the smallest of its 13 international businesses. The firm decided a funded withdrawal is the best way to proceed after nine unsuccessful years trying to gain market share and turn a profit. The withdrawal will happen in two stages, with the first stage involving the selling of 50% of Tesco

Japan shares to Aegon, for a nominal sum, followed by a £40mm investment by Tesco to finance the restructuring. At the end of the process Tesco would have no further financial exposure to the Japanese business. Other firms, such as Carrefour and Boots, have decided to exit Japan, which had been affected by prolonged deflation, increased competition and changing consumer tastes. Carrefour also announced a deal to pull out of Greece last week. Tesco's move shows a greater focus and capital discipline following the appointment of Philip Clarke as its CEO. The firm is channelling its resources in turning around its British business, which accounts for about 70% of the operating profit.

## Economic Activity, Consumer and Business Conditions

US – The US economy continues to exhibit signs of weakness, with the key consumer and manufacturing sectors reporting underwhelming results last week. US retail sales retreated by 0.2% in May, as expected and in line with April's 0.2% revised drop, with most retail categories being affected, led by building and garden equipment and general merchandise. Sales excluding sales of autos were down by 0.4%, on top of a revised drop in core retail sales for April, at 0.3%. The US consumer is once again struggling with sub-par real income growth and a deceleration in consumer credit growth, while being reluctant to draw from the already very low levels of savings. The US consumer sentiment, as measured by the University of Michigan, fell more than expected in June, to a 74.1 index level from 79.3 in May as both the current conditions and the expectations components retreated in the month.

US industrial production pulled back by 0.1% in May, a considerable slow-down from the 1.0% advance in April and worse than the expected 0.1% improvement, mostly affected by a drop in production of motor vehicles and parts. Capacity utilization unexpectedly dropped in the month to 79.0% from 79.2%. Conversely, the US National Association of Homebuilders' housing index rose again in June to 29, the highest reading in 5 years.

On the inflation front, the headline reading registered a drop to a within target of 1.7% level, from 2.3% year



on year rate in May and lower than the expected 1.8% reading, with energy prices contributing the most to the retreat. The core (excluding the volatile energy and food components) consumer price index (CPI) year on year reading remained relatively flat at 2.3%. Current inflation levels seem to offer enough breathing room for the US monetary policy, providing scope for further easing if need be.

US' terms of trade deteriorated in May as export prices continued to retreat, by 0.4% in May, on top of April's 0.4% drop, while import prices only pulled back 0.1% in the month, on top of a flat reading in April.

Canada – Canadian new housing prices continued to grow in April, albeit at 0.2% a whisker short of the expected 0.3% advance, on top of a 0.3% improvement in March. Such persistent rates of growth are likely to help maintain Bank of Canada's hawkish stance when it comes to asset bubbles and household leveraging, although other considerations, such as the state of manufacturing and events overseas should also impact any change in the monetary policy going forward.

The first quarter capacity utilization reached a surprising 80.7% level, ahead of the expectations for a flat 80.5% reading, chiefly helped by a recovery in capacity utilization in the transportation equipment manufacturing sector.

Greek elections : New Democracy has won first place with 30% of the votes, Syriza in second with 27% and Pasok in 3rd with 13%. Translated to seats, ND has 130, Syriza has 71, and Pasok has 33 of the 300 seat parliament. The negotiations are now under way to see who will form the minority government. Pasok says it supports the government but does not want to join the coalition without Syriza joining as well. Syriza has already publically announced it will sit in the opposition. Chances are that Pasok will eventually join ND to form the government (but not until after they get what they want) and the two parties in turn will start negotiating with the Troika to get friendlier terms on the bailout. Troika will want to reward the ND/Pasok for winning the election and will likely relax.

## Financial Conditions

A single regulator to oversee banks across all 27 EU states could be in place as early as 2013 according to the European Commission. A controversial new bank bailout fund financed by a tax on financial institutions is also planned. ( Source : BBC News)

Europe's securitisation industry has officially launched a new labelling system that aims to revive the fortunes of a financial product that some dubbed as toxic during the US subprime crisis. The Prime Collateralised Securities project will award a stamp of approval to high quality European Asset-Backed Securites that meet a set of criteria in terms of quality, transparency, simplicity and standardisation. (source Financial Times).

UK announcing new extraordinary measures to mitigate contagion risks from the eurozone crisis as follows:

- (i) Funding For Lending. UK will offer multi-year loans (4-year program) to banks at below market rates so banks can extend credit to the real economy. UK Treasury will indemnify banks against any losses. Indications are the plan could inject up to GBP 5bn per month into the financial system and is expected to be operating within weeks (me – this could be similar to US TALF program).
- (ii) Emergency Liquidity Facility. Banks will be able to swap a wider range assets with Bank of England at monthly auctions for six-month loans. The program was setup at end of 2011 “in response to actual or prospective market-wide stress of an exceptional nature” and is being activated for the first time (me – this is the UK LTRO but with a shorter term).

The Federal Reserve has been repaid for its roles in the US government bailout of AIG in 2008 and the rescue of Bear Stearns earlier that year. The central bank's US\$53.1bn of loans to vehicles called Maiden Lane and Maiden Lane III, created to help save the companies, were paid back with interest, the New York Fed said. A separate entity, Maiden Lane II, finished being unwound through sales of mortgage assets earlier this year (Source: Bloomberg).



Federal Reserve policymakers appear 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 advent 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 1.26% and the U.K.'s 2 year/10 year treasury spread is 1.41% - 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 3.71% - (3.67 in early June is 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 improved to 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 increase 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 31 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 21.11 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](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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# Market Commentary



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