Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights on Current Holdings

Financial Services Companies

Banco Santander says its board's executive committee approved a €1.51bn capital increase for its scrip dividend program.

Barclays: As reported in the Financial Times top Barclays shareholders are calling for both the new CEO and Chairman appointment at Barclays to go to outsiders following the testimony of Marcus Agius to the Treasury Select Committee. A review of Financial Services Authority criticism clearly highlights their view that Barclays management (i.e. Bob Diamond) took an aggressive approach to balance sheet valuation / regulation. This approach would clearly be revisited by any external appointments.

HSBC - Is to sell two of its Bermuda based insurance units to Catalina Holdings for an undisclosed sum, the sale is due to complete in Q3. The deal is part of HSBC's ongoing disposal program of non-core assets. This follows the banks last sale of its general insurance business 4 months ago for $914m.Financial Times reports that HSBC may be fined $1bn for failing to prevent money laundering. HSBC already warned at the beginning of the year that fines could be substantial. Part of the investigations relates to historical transactions with parties in Iran. HSBC continues to lead the UK mortgage market launching a 5 year fixed rate at 2.99% - some 0.80% below the next lowest. This highlights their attractive funding position making them one of the few banks still looking to add assets.

Intesa Sanpaolo – is reported to have completed a swap operation on two covered bonds worth some €3.5bn.

JP Morgan is aiming to become the leading prime broker in Europe. JP already has attracted 30 European clients since its opening launch 12 months ago, compared to its target of 25 and is currently 5th in size…. It's potential client base is 60 clients.

JP Morgan reported 2Q 2012 strong earnings per share of $1.21 ($4.96bn of net income) well above consensus expectations of around $0.80. Results included a $4.4bn pretax loss ($0.69) from the CIO trading losses and $1.0bn pretax benefit ($0.16) from securities gains in CIO's investment securities portfolio in Corporate. Excluding a 1Q restatement CIO losses would have been $4.9 bn, a little better than expectations. Results also included : a $755mn pretax 'gain' ($0.12) from Debt Value Adjustment in the Investment Bank (which in real terms should be ignored); a $545mn pretax gain ($0.09) reflecting expected full recovery on a Bear Stearns-related first-loss note in Corporate; and a $2.1bn pretax benefit ($0.33) from reduced loan loss reserves, mostly mortgage and credit card.

During the quarter, revenues declined 14% sequentially. Ex. DVA, revenues decreased 20%. Revenues increased in Retail Financial Services (+4%), Treasury & Securities Services (+7%) and Commercial Banking (+2%) and were stable in Asset Management. As expected revenues dropped in the investment bank (-8%; -27% ex. DVA. Ex. DVA, FICC trading revenues decreased 30%, or $1.5bn, to $3.5bn, while equity trading declined 27%,) and declined in the Cards division (-4%). Corporate/ Private Equity lost $2.5bn compared to a $1.0bn gain in 1Q12. Net interest income decreased 4% as average earning assets increased 6% but net interest margin declined 0.09% to 2.47% due to prior period gains, changes in loan mix, excess cash deposits with limited deployment opportunities and continued positioning impact (i.e. looking for higher rates).

The bank cited "meaningful" improvements in delinquencies and estimated losses in these portfolios. Mortgage repurchase losses were only $10mn, compared with $302mn in 1Q12. The current quarter reflected a $216mn reduction in the repurchase liability and lower realized repurchase losses ($226mn in repurchase losses). Non Performing Assets declined 5% ($0.6bn) to $11.4bn. Nonaccruals loans to total loans declined 9bps to 1.38% and its Net Charge Offs ratio on retained loans improved 9bps to 1.40%. The Credit Card net charge-off rate was 4.32%, down 5bps, and the 30+ day delinquency rate was 2.13%, down 42bps. Its loan loss provision was only $214mn, down from $726mn in 1Q12 ($1.8bn a year ago). This compares to net charge-offs of $2.3bn, which declined 5%. Its reserve/loan ratio declined 34bps to 3.29%.

It stated since the end of 1Q12, it has significantly reduced the total synthetic credit risk in CIO. The reduction in risk has brought the portfolio to a scale that allowed it to transfer substantially all remaining synthetic credit positions to the Investment Bank. As a result of the transfer, the Investment Bank's VaR ($74mm to $113mm) and RWAs (+$30bn) will increase, but it believes they will come down over time. Importantly, it believes it has put most of this problem behind it and an extreme simulated scenario indicate potential losses between $0.8-$1.6bn. JPM said CIO will no longer trade a synthetic credit portfolio. CIO's $323bn portfolio had $7.9bn of net unrealized gains at 2Q12. This portfolio has an average rating of AA+, has a current yield of 2.6%, and it believes it is positioned to help to protect the Firm against rapidly rising interest rates. In addition to CIO, it has $175bn in cash and deposits, primarily invested at central banks.

JPM believes based on its capital position, balance sheet and earnings power, it could resume its buyback now. But after discussion with the Federal Reserve, it determined not to buyback stock until its Board completes its CIO review and it submits a new capital plan. It hopes to complete these actions and reinstate repurchase program by 4Q12 or earlier. The bank reiterated it expects to pay its $0.30 dividend (3.5% yield). Its Basel I Tier 1 common ratio was 10.3%. The company put its estimated Basel III Tier 1 common ratio at 7.9% (after the impact of mitigates and runoff through 2014), after the impact of final Basel 2.5 rules and the Fed recent NPR. This compares a restated 8.1% at 1Q12. Its Return on tangible capital was 15%. Tangible book increased 6% to $35.71 and Jamie Dimon indicated that at this price, if buyback was in force he would be buying back stock now.

Lloyds Banking Group is aiming to more-than double its Australian project finance lending by 2015 as it seeks to capitalise on the pullback by many of Europe's debt-hit lenders. Global Head of Project Finance Debt, Chris Heathcote, said Lloyds remains "committed to Australia for the long term," where it is looking to finance projects in liquefied natural gas, renewable energy, public-private partnerships and mining infrastructure. Dealogic data shows Lloyds mandated $866mn last year, equating to a target of $1.7bn by 2015. This year, Lloyds has mandated $465mn in project finance loans, over 10 times as much as in 2010. (Source : Dow Jones).

Manulife : Bloomberg reports that Manulife Financial Corp., Korea Life Insurance Co. and KB Financial Group Inc., are among firms that made second-round bids for ING Groep NV's Asian insurance operations. According to the article, Manulife offered to buy most of the regional unit, while Korea Life bid for ING's Southeast Asian business, and KB Financial made an offer for the South Korean operations. The article notes that the latest offers are binding, and also states that Blackstone Group LP, teaming up with Mark Wilson, the former head of AIA, and other investors including reinsurer Swiss Re, as well as J.C. Flowers & Co. LLC, are among the potential bidders for the Asian business.

National Australia Bank : NAB will cut 730 jobs from its UK workforce as it pulls out of commercial real-estate lending and investment in the UK economy, according to the Unite union. The cuts, equal to around 10% of the UK staff, come after NAB announced in April that it would shed a total of 1,400 employees over the next three years as part of a strategic review of its struggling Clydesdale and Yorkshire banks. (Source: Dow Jones)

Wells Fargo has agreed to pay US$175mn to resolve allegations it discriminated against qualified African-American and Hispanic borrowers in its mortgage lending, the US Justice Department said. (Source :Reuters)

Wells Fargo reported earnings per share of $0.82 and core eps $0.80 both slightly lower than consensus estimates due to higher mortgage putback provisioning and operating expenses. Mortgage banking revenues were largely flat at $2.90 billion from $2.87 billion in 1Q12 but mortgage repurchase expense rose to $669 million from $430 million in 1Q12 as losses rose to $349 million from $312 million and the company noted higher projected GSE putback demands on 2006-2008 vintages. However, total outstanding repurchase demands fell 10.2% last quarter to $1.67 billion from $1.86 billion in 1Q12. Importantly, net interest margin was stable at 3.91%.

Average loan balances were flattish at $768.2 billion (also flat in 1Q12). Deposits decreased in the quarter, as deposits declined 0.1% linked quarter to $928.9 billion from $930.3 billion in 1Q12 though deposit costs declined (-1 bp LQ to 0.19%). Wells reported a quarterly expense run rate of $12.4bn, which is an increase but in-line with expectations. The mortgage pipeline remains robust, with an unclosed pipeline of $102bn at quarter-end 2Q vs. $79bn quarter ago. As such, Wells noted that 4Q 2012 expenses will come higher than the previous target of $11.25bn. due to higher revenue expectations. Hitting consensus expenses estimates for 2013 are clearly reliant upon Wells meeting Project Compass goals but if the mortgage business does not experience a commensurate slowdown of about 20% compared to 1st half 2012 then even though expense targets will move higher, earnings should remain robust. Wells Fargo's capital continued to improve as Tier 1 common rose 10 bps to 10.08% from 9.98% in 1Q12 and Tier 1 Core capital under Basel III fell to 7.79% from 7.81% under an updated calculation methodology. Share repurchases accelerated as the company bought back ~53 million shares in 2Q12 and a further ~11 million shares for forward settlement in 3Q12 (vs. ~8 million in 1Q12).

The ECB's decision to cut the rate on overnight deposits to zero caused Goldman, J.P. Morgan and BlackRock to suspend subscriptions into their European money-market funds—a development that could point to wider unintended consequences. (source : Wall Street Journal)

Financial Infrastructure

CME Group : The entire futures industry, including CME Group CME, received another regulatory challenge last week when it was announced on Monday that another futures brokerage firm, PFGBest, was insolvent with customer funds gone missing. The futures industry and CME are still suffering from decreased confidence and lower trading volumes following the MF Global affair, and this second failure of a brokerage will mean regulation and customer protections in the industry need to be shored up.

Dividend Paying Companies

National Grid: next price review could place the current level of dividend at risk. The allowed rate of return on equity is as much as 0.5% below the company's expectations and the quantum of expenditure that Grid is to be incentivised to undertake is considerably lower. National Grid had been pressing for limits that would have seen bills rise by £15-£20 per customer, but the regulator, Ofgem has suggested an outcome of £11 on average across the eight year period.

National Grid now faces a hard negotiation. As things currently stand, dividend cover was seen by consensus as averaging 1.33x over the first three years of the new price control period. With allowed revenues having fallen a long way short of expectations, the cover ratio will now look stretched, not least because net debt/EBITDA was seen as averaging 4.7x over those first three years, during which time net debt would increase by over £7bn. As ever in the world of utility regulation, these concerns are happening at the margin with a gradual narrowing of the gap between rising revenue and cost – with the gap between them setting the dividend paying ability.

Vodafone : will more than double its fixed line telecoms business in New Zealand after buying rival TelstraClear for NZ$840 million in cash from Australia's Telstra Group. This will take Vodafone's market share to about 29% compared to market leader Telecom Corp which has close to 50%. Vodafone is already the largest mobile phone operator in New Zealand.

Vivendi – The company's chairman, Jean-Rene Furtou, confirmed earlier rumours by disclosing that the group is looking at selling its over $8Bn stake in Activision Blizzard Inc, the leading global video game publisher. Maroc Telecom, a majority controlled subsidiary of Vivendi, announced a cost saving program which will see some 11% of its workforce being curtailed. The savings are expected to amount to about $33mm and help the Moroccan operator preserve its 40% margin in a maturing market. Maroc Telecom also has developed networks in Burkina Faso, Gabon, Mali and Mauritania, yet staff cuts will be centered on its Moroccan home operations.

Economic Activity, Consumer and Business Conditions

US – Macro-economic news focused on the all important US consumer sector over the past week, culminating with the retail report for June issued earlier today and which revealed a less than rosy picture. Retail sales in the US surprisingly fell by 0.5% in the month with weakness across most retail categories, including autos, furniture, electronics and appliances, building and garden supplies, sporting goods and health and personal care. The consensus expectations were calling for a modest 0.2% improvement, an expected reversal of the 0.2% drop in May. June thus turned out to be the third month in a row of negative retail sales growth, underlying weakness revealed by other consumer indicators. The consumer sentiment, as measured by the University of Michigan, had been shown to weaken, down to 72.0 index points in July from 73.2 in June and against consensus expectations forecasting an improvement to a 73.4 level. A drop in 'consumer expectations' component drove the retreat, while the 'current conditions' reading was actually ahead of the expectations. Such a development is not entirely surprising given the protracted slow growth, poor employment prospects and continued negative real income growth. Not even a higher than expected growth in the level of consumer credit, up by $17.12Bn in May, helped boost consumer spending.

The US foreign trade deficit continued to narrow in May, to $48.7Bn, largely in line with the expectations, as exports grew by 0.2%, while imports retreated by 0.7%, consistent with a weaker retail environment as discussed above.

US: The worst drought in the US in 25 years has wrought havoc on the country's most important crops, putting the global economy at risk of its third food inflation shock in five years. The US Department of Agriculture on Wednesday slashed its forecast for the corn crop by the most since the drought of 1988, cutting its 2012-13 production estimate by 12% and its season-end inventory estimate by a hefty 37%. (Source : Financial Times)

Canada – The international merchandise trade for Canada continues to disappoint, as the deficit opened up to $790mm in May from $620mm in the month prior, contrary to the expectations calling for a shrinking of the trade balance deficit to a $0.380mm level. The Canadian goods exports were dragged down by a drop in energy exports, including a drop in volumes, and a surprising reduction in automotive exports, while imports continued to rise, albeit modestly.

Meanwhile, the housing sector continues to see unexpected improvement, with the number of annualized housing starts moving higher to 222,700 units in June, from 217,400 units in May and way ahead of the expectations forecasting a 205,200 units level. The new housing price index grew by 0.3% in May, on top of April's 0.2% improvement and ahead of the expectations.

Eurozone - Finance Ministers agreed on a blueprint for Spain's €100mn bank bailout plan, with the first €30bn of aid expected by month end. The official agreement will be signed July 20th and will include conditionality in a further in depth stress test of 14 of Spain's largest financial institutions which will see distressed assets segregated into a 'bad bank'. Until the bank-by-bank review is completed, the €30bn in initial bailout aid will be held by Madrid as a "contingency in case urgent needs" arise, Mr Juncker, Eurogroup head, said. The aid will initially be funnelled through the FROB (Fondo de Reestructuracion Ordenada Bancaria) meaning it will add to Spanish sovereign debt but once the new eurozone banking supervisor is established, loans will go directly to banks wiping the debt from the sovereign books. Olli Rehn said his staff would also begin "technical work" on "concrete proposals" for giving Irish banks similar treatment, a process that could eventually allow Dublin to wipe away a chunk of its €64bn in bank bailouts now counted as part of its national debt. In addition, Spain has been given an extra year to meet its 3% deficit target as the finance ministers agree that Spain would have until the end of 2014 to meet the target. Their deficit target for 2012 is 6.3% and 4.5% in 2013.

Spain last week announced €65bn ($80 billion) of austerity measures in a renewed effort to meet European Union budget targets after it was granted a one-year extension on the deadline to meet EU limits. European leaders also held out the prospect of buying Spanish debt to trim yields as long as Prime Minister Rajoy complies with their conditions, which include transferring powers from the Economy Ministry to the Bank of Spain and bolstering the central bank's independence. Rajoy is also seeking additional cuts from the 17 regional governments. The central government is planning to help states fund themselves on markets. The new measures are in line but the fiscal adjustment estimated at €65bn for 2012-14 seems larger than expected. Overall most of these measures (VAT, tax benefit on house buying, unemployment benefits, lower social security contributions) were included in the EC review of the Spanish fiscal progress few weeks ago and required in order to obtain the extra one year to achieve the <3% deficit, but some of the cuts and the size of the VAT increase (increase of standard rate to 21% from 18% and reduce rate to 10% from 8% with the super low rate of 4% unchanged) look larger than expected..

China : Chinese released GDP data totaling 7.6%, which is slowing but was about in line with expectations.

Financial Conditions

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 1.23% and the U.K.'s 2 year/10 year treasury spread is 1.29% - 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 3.56% - (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 33 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 16.74 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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