Market Commentary

PORTLAND INVESTMENT COUNSEL™

March 10, 2014

News Highlights

Financial Services Companies

Bank of Nova Scotia Q1 earnings of $1.34, were in line with consensus estimates, with Return On Equity at 15.4%,compared to 16.8% y/y. Canadian Banking's contribution of $575 million vs $539 million y/y benefited from strong loan and deposit growth of 5% y/y, respectively. Notably, Canadian Banking's Net Interest Margin was up 1 bps to 2.07% q/q, with the segment posting positive operating leverage of 1.1% y/y. The overall core banking margin was up 4 bps to 2.35% q/q. International Banking posted a slightly lower quarter with net income $401 million vs $411 million y/y, with the headwind from lower margins at 3.93% vs 4.18% y/y and higher expenses. Results at Global Wealth Insurance of $327 million vs $285 million y/y, benefited from strong asset growth both organic and through acquisitions, while Global Banking & Markets results of $339 million vs $385 million y/y were impacted by continuing challenges in certain capital markets business, namely fixed income, with offset from higher investment banking fees and favorable credit performance. The overall credit environment remained favorable with loss rates in Canadian banking up slightly from historical lows. The Provision for Credit Losses ratio of 0.34% was up 3 bps q/ q, but seems contained. Under Basel III the Core Equity Tier 1 ratio was at 9.4%, up 30 bps from the prior quarter.

Lloyds Banking Group - is offering investors of bonds that helped rescue the bank in the financial crisis the chance to swap them for up to £5 billion ($8.4 billion) of debt instruments that meet new capital rules. Lloyds said it will offer institutional investors the option to exchange instruments, known as enhanced capital notes (ECNs), for new bonds. Retail ECN holders will also be able to exchange their holdings for cash, at a premium to face value. Lloyds issued the bonds in 2009 and they were designed to boost the bank's capital if it ran into trouble. But new UK and European capital rules in force this year mean the bonds may no longer count as capital when the bank hits trouble, and Lloyds warned last month it could buy them back at face value.

Royal Bank of Scotland is set to become the latest European bank to sharply pare back its US business in response to new rules from the Federal Reserve. The lender is planning to more than halve the assets in its broker-dealer operation in New York in order to pull assets below the US$50bn threshold. RBS's broker-dealer operation in the US had assets worth more than US$100bn as of June 2013. RBS is set to retain a broker-dealer operation in the US, but it is planning to wind down some operations and book some business in other entities. (Source : Financial Times)

The end of free banking for customers is probably only a matter of time, with direct charges for current accounts almost inevitable, according to the chief executive of the RBS. In an interview with The Telegraph, Ross McEwan warned that the end of free-if-in-credit banking was coming as it would lead to greater transparency about how banks funded themselves. He made clear, though, he had no plans to begin phasing out free accounts at the moment.

Standard Chartered – reassured investors about its capital strength on Wednesday, raising its dividend despite reporting its first drop in annual profits for a decade and giving a weak outlook for the first half. The bank said after a challenging year it had cut its bonus pool by 15% to $1.2 billion, with Chief Executive Peter Sands' own bonus down 21% to $2.5 million. It plans to introduce an allowance for hundreds of senior staff this year, which will effectively increase their fixed pay and reduce their bonuses, to meet EU rules that will cap variable pay at 200% of fixed salaries. The bank estimated its common equity Tier 1 ratio, a key measure of financial strength, was 11.2% under tough new global rules, above estimates of near 10.5%. The bank, which makes 90% of its profit in Asia, the Middle East and Africa, reported a 7% fall in underlying annual pretax profit to $7 billion. It had warned in December profits would fall due to losses in Korea, weak investment banking income and a slowdown in Asian economic growth. Revenue was flat and provisions for bad debts jumped by a third to $1.6 billion. The full-year dividend payout will rise to 86 cents per share. Market volatility is expected to hit income and profits in the first half of this year and Peter Sands said he expects modest growth in income, profits and loans in 2014. Sands confirmed the bank was seeking buyers for a Hong Kong consumer finance business. It is also selling consumer finance and savings units in Korea, where it took a $1 billion writedown last year after lenders there were forced to write off personal loans. In contrast, profits in Hong Kong, its biggest market, jumped 16% to $1.9 billion, or 28% of the total.

Press articles suggest that Standard Chartered will soon announce disposals of businesses in Europe, Asia and the Mid-East. Standard Chartered is in advanced talks to sell StanChart Savings Bank and StanChart Capital in South Korea and its Lebanese retail bank which are all small businesses. Some of these businesses are really small but the message is more important: StanChart is serious about cost savings and restructurings.

Dividend Payers

Aggreko – the world's biggest provider of temporary power generators, will return £200 million pounds to shareholders on top of a 10% increase in its dividend for 2013. The British firm, which is looking for a new chief executive, is also forecast trading profit this year to be similar to 2013 after a year in which pretax profits fell 8%. The company said profits were down in 2013 due to the impact of lower revenues from military work in Afghanistan and post-Fukushima reconstruction in Japan, as well as the absence of revenues from the 2012 London Olympics, a contract worth £60 million. Despite lower profits, net cash from operations rose in 2013 to £603 million pounds from £479 million in 2012. Aggreko proposed an increase in its dividend to 26.30 pence per share for the year and said it would also return £200 million pounds ($334.61 million) to shareholders in June, the equivalent of 75p each. Last week, British outsourcer Serco named Aggreko CEO Rupert Soames, who had increased the company's market capitalisation by ten-fold, as its new chief executive to help restore profits and its reputation following high-profile government contract failures. Chief Financial Officer Angus Cockburn will assume the role on an interim basis while a search for a successor, internally and externally, is conducted.

Enbridge – Canadian regulators last week approved Enbridge Inc's Line 9 oil pipeline reversal and expansion, conditional on the country's largest pipeline company undertaking additional work on consultation and safety. Enbridge plans to reverse its Line 9B pipeline, which extends from southern Ontario to Quebec, and boost capacity of the entire Line 9 line by 25 percent to 300,000 barrels per day (bpd), in order to ship western oil to refineries in Eastern Canada. The oil would enter Ontario through Michigan on its Mainline system. The approval of the 639-km (400-mile) pipeline reversal and expansion is contingent on the company meeting 30 conditions related to emergency response, continued consultation and pipeline integrity. Line 9 originally moved oil from Sarnia, Ontario, to Montreal, but was reversed in the late 1990s to pump cheap imported crude west. Enbridge applied in November 2012 to reverse the flow again, to pump oil eastwards to Quebec. That would benefit refineries in the eastern Canadian province, including Suncor Energy Inc's 130,000-bpd Montreal refinery.

Earlier in the week, Enbridge said it would undertake a C$7 billion replacement program in the mainline system running between Edmonton and Superior, Wisconsin. Mainline shippers had also agreed to support surcharges on all barrels moving on the mainline, according to a statement issued by Enbridge Inc and Enbridge Energy Partners LP. The line 3 replacement (L3R) program, which is targeted to be completed by the second half of 2017, will complement the existing line 3 segment replacement program and include all remaining segments of line 3 between Hardisty, Alberta and Superior, the statement said. Under the program, all segments of the line between Hardisty and Superior will be replaced with new pipe using the latest available high-strength steel and coating technology. "The L3R Program will be the largest project in our company's history and will serve to significantly extend our industry-leading earnings per share growth rate well beyond 2017," said Al Monaco, chief executive officer of Enbridge Inc. Enbridge expects to submit regulatory application in late 2014.

GEA Group – The German plant engineering company GEA Group's bottom line has risen in the last fiscal year by 6.7% to €336.4 million, as revealed in the annual report published on Friday. GEA announced a €0.60 dividend per share for 2013, a 9.1% increase. For 2014, group CEO Jürg Oleas is targeting an operating profit of up to €590 million – €60 million more than last year. Sales are expected to increase slightly compared to the €4.3 billion euros achieved last year.

Serco – British outsourcing group Serco said it was braced for another tough year as it recovers from government contract failures, profit warnings and management exits that pushed 2013 annual profit down 6%. The firm, which on Friday named Aggreko Chief Executive Rupert Soames as its new boss, said on Tuesday yearly adjusted pretax profit fell to £254.4 million ($425 million). Serco reiterated 2014 expectations for a 50-100 basis point reduction in its 5.6% operating margin and a fall of as much as 23% in adjusted operating profit from £285.4 million in 2013. Adjusted revenue will fall from £5.1 billion pounds in 2013 to £4.7-£4.9 billion at constant currency rates. The company, which had a six-month ban on winning new UK government work lifted in January, said its order book was worth £17.1 billion pounds, down £2 billion on a year ago. Its bid pipeline, which includes UK defence and transport deals, was worth £12 billion pounds over the next two years.

Wesfarmers – one of Australia's largest retailers, reportedly plans to sell its insurance broking business via an initial public offering worth around A$1.12 billion ($1.02 billion). The company is expected to announce the spinoff of its Oamps insurance broking business soon. Wesfarmers' part-owned investment bank Gresham is advising on the deal and Macquarie Bank and JPMorgan are likely to be the lead managers. Wesfarmers sold its insurance underwriting business to Insurance Australia Group Ltd last December for A$1.85 billion. Oamps operates in 26 locations and is one of the largest insurance broking networks in Australasia, according to the company website. There has been a resurgence in the initial public offer market in Australia in 2014 bolstered by a strong first-half reporting season.

Economic Activity, Consumer and Business Conditions

US – The US employment report revealed a stronger than expected 175,000 positions addition to the US economy in February, a month marked by adverse weather in many parts of the country. Growth was driven by a jump in professional and business services jobs and was also helped by government hirings, somewhat offset by weakness in the retail and construction sectors. The headline unemployment rate inched higher, to 6.7%, as the labour force pool expanded and participation held constant.

The non-manufacturing purchasing managers index (the NMI) contrasted with its manufacturing counterpart (the PMI), as it retreated in February to a 51.6 index points reading, significantly below the expected 53.5 level, likely affected by some of the same weather effects, but still pointing to a mildly expansionary trend in the sector. Meanwhile, the fourth quarter productivity report revealed a weaker than expected improvement, at 1.8% compared to 3.5%, which was also a deceleration from the third quarter's 3.5% advance. Not surprisingly, the labour costs retreated less than expected in the quarter, down 0.1% compared to expectations for a 0.9% pull-back.

The US international trade balance held steady in January, at $39.1 billion deficit, in line with the expectations, as both exports and imports retreated mildly in the month.

Canada – The Canadian economy lost 7,000 jobs in February, well short of the expectations for an additional 15,000 positions and offsetting some of January's robust 29,400 jobs growth. Arguably, the weather adverse effects were even more important than in the US, with most of the impact being felt in the part-time positions. The headline unemployment rate, at 7.0%, was in line with the prior month, as well as with the year ago level and with the expectations.

Canada's balance of visible goods trade improved to a $180 million deficit in January, from a $920 million deficit in December, significantly better that the expected $1.2 billion deficit, as exports grew modestly, driven by a rebound in energy exports, and imports inched lower.

Canada's labour productivity improved by an unexpected 1.0% in the last quarter of 2013, an acceleration from the third quarter's 0.3% advance. Coupled with a deterioration in Canadian dollar's rate of change relative to the US dollar, this should be welcome news to the Canadian export industries.

Meanwhile, the Canadian building permits were 8.5% higher in January, more than offsetting December's 4.8% drop, while housing starts for February were also stronger than expected, at 192,100 units annualized; so, no signs of hard-landing in the Canadian housing market, just yet.

Financial Conditions

Reserve Bank of Australia left rates unchanged at 2.5% and reintroduced bearish language on the Australian dollar with "remains high by historical standards", something that was missing at the last meeting.

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 through 2014 with the Federal Reserve carefully calibrating the beginning of unwinding quantitative easing by undertaking that the Federal Reserve will keep rates low until 'well past' the 6.5% unemployment rate threshold. Similarly, in the UK, Mark Carney, the new bank governor has established his dual mandate with the likelihood that his target to return unemployment to below 7% will for now, override concerns about inflation. In December 2013, the Fed announced it would scale down its $85 billion a month asset purchase program, initially by $10 billion per month. The U.S. 2 year/10 year treasury spread is now 2.41% and the U.K.'s 2 year/10 year treasury spread is 2.15% - meaning investment banks remain constrained from profiting 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 withdrawal of quantitative easing, the U.S. 30 year mortgage market rate has increased to 4.28% - (was 3.31%, end of November 2012 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 5.1 months supply of existing houses. So the combined effects of 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.

The VIX (volatility index) is 14.11 and while, by its characteristics, the VIX will remain volatile, we believe a VIX level below 25 augurs well for quality equities.

Mutual Funds

Portland currently offers 5 mutual funds:

- Portland Advantage Fund
- Portland Canadian Balanced Fund
- Portland Canadian Focused Fund
- Portland Global Income Fund
- Portland Global Banks Fund

Private/Alternative Products

Portland also currently offers 3 private/alternative products:

- Portland Focused Plus Fund LP
- Portland Private Income Fund
- Portland GEEREF LP

Net Asset Value:

At the close of business each day we publish the Net Asset Values (NAV) of our mutual funds onto our Portland website at http://www.portlandic.com/prices/default.aspx

Closed-End Fund

Spreads on the closed-end fund remain, in our view, very attractively priced to purchase.

The Portland Investment Counsel's 2013 Fourth Quarter Fund update is now available on the website.

At the close of business each day we publish the Net Asset Values (NAV) of our funds onto our Portland website at http://www.portlandic.com/prices/default.aspx

The price details published are replicated here below from which you can see we also highlight whether the funds share prices are trading at a premium or discount to their respective NAV.

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

PIC14-027-E(03/14)