Market Commentary

PORTLAND INVESTMENT COUNSEL™

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News Highlights

Financial Services Companies

Bank of Montreal : reported Q1 2014 core cash EPS of $1.61. This compares to $1.62 last quarter, $1.50 one year ago and ahead of consensus of $1.53. Canadian retail banking earnings were up 8% YoY. The bank continued its momentum in Canadian retail banking, with revenue growth of 7% and expense growth of 4%, leading to positive operating leverage for the second quarter in a row. The net interest margin improved 0.01% sequentially. U.S. P&C earnings were down 7% YoY. In U.S. dollars, revenue growth remained challenged, down 7% YoY. Sequential volume growth was up 1% (in U.S. dollars) in line with 1% sequential growth in Q4/13. Margins were up 0.01% QoQ and provisions for credit losses improved sequentially to $19 million, from $96 million in Q4/13. Wealth and insurance revenues were down 17% QoQ, (but Q4/13 included a $191 million pre-tax securities gain). Excluding the prior quarters securities gain, QoQ revenue growth would have been up 2% sequentially. Capital markets revenues were strong, up 22% QoQ. Adjusted provisions for credit losses were $99 million, compared to our estimate of $133 million. The bank did not book any recoveries on the purchased credit impaired loan book and held its quarterly dividend at $0.76.. The bank's reported Basel III common equity Tier 1 ratio was 9.3%, below forecast of 9.8%, due to a 12% sequential increase in Risk Weighted Assets. Factoring in the potential acquisition of F&C would cost them an additional 0.75 % (to the Core Equity Tier 1 ratio), therefore on a pro forma basis the bank's Core Equity Tier 1 ratio would be 8.55%.

National Bank reported earnings of $380 million in Q1/14, or $1.15 per share, compared to earnings of $344 million, or $1.05 per share in the year-ago period. Included in earnings this quarter was a $30 million after-tax gain related to the rise in the fair value of restructured notes, partially offset by acquisition-related charges of $9 million after tax. Excluding these charges, adjusted cash earnings were a record $359 million, or $1.09 per share, which came in above consensus expectations of $1.05 per share. The beat in the quarter was primarily driven off of strong results from Financial Markets, which benefitted from strong trading revenues and gains on securities. In addition, Wealth Management exceeded expectations with adjusted earnings of $76 million due to the TD Waterhouse acquisition, net inflows and rising equity markets. Personal & Commercial Banking reported earnings of $168 million, which were up 3% y/y due to good loan growth, positive operating leverage, partially offset by slightly higher loan losses. Credit was stable this quarter with loan loss provisions of $51 million. The Core Equity Tier 1 ratio declined 0.4% to 8.3% in Q1/2014 due to the phase-in of the Credit Value Add charge, the acquisition of TD Waterhouse and higher market risk-weighted assets.

Royal Bank of Canada posted a steady quarter, with solid contributions from all segments and a continuing favorable credit environment, which should be supportive of spreads. Reported adjusted cash EPS were $1.47, which was better than consensus expectations of $1.45. Q1 earnings were $2.1 billion, up 2% from the prior year. Excluding one-time items, including restructuring charges in the Caribbean, net income was up 7% to nearly $2.2 billion, while Return On Equity was an impressive 18.9%. Canadian Banking had a solid start with net income up 4% to $1.1 billion, driven by 7% volume growth and positive operating leverage of 0.5%. Wealth Management benefited from higher Assets Under Management levels and strong net sales with income up 3% to $235 million. Earnings at Capital Markets of $505 million, a 9% increase, were boosted by a lower effective tax rate and a recovery of Provisions for Credit Losses (PCL). Total PCLs of $292 million were down 16%, largely from the recovery in capital markets. The Basel III Core Equity Tier1 ratio was 9.7%, up 0.1% q/q, with internal capital generation partially offset by a Credit Value Add charge. In line with expectations, RBC announced a 6% increase in the dividend to $0.71 per share.

Royal Bank of Scotland reported a 4Q 203 operating loss before tax of £4.4bn (cons -£3.8bn) and a reported loss before tax of £8.9bn (cons -£7.3bn) after £4.6bn of below the line charges. Basel 3 Core Equity Tier 1 was 8.6%, slightly above the guided 8.1-8.5% range and Net Asset Value Per Share was 363p. Income is c£0.6bn lower than consensus, but mainly in Non-Core and Central. The Strategy Review key elements are: (1) 2016 costs of £8.0bn, -£5.3bn vs 2013 after disposals with costs to achieve of £5bn (o/w £4bn incremental), (2) a 2016 funded balance sheet of £600bn (-£140bn from 2013), (3) a 12%+ RoNAV over the long-term with 9-11% in 2016. Putting the various parts of the guidance for the 'go to' bank together implies Core PPoP of £7bn and EPS of around 35p (provisional). We think this is a bold plan and should ultimately help RBS to become a more predictable, higher quality bank. The bank has also said it will increase its high street presence tenfold by piggybacking on the UK's vast network of Post Office branches. Later this year, personal and business customers of RBS and its NatWest brand will be able to pay-in cash and cheques at one of the Post Office's 11,500 locations. Many of these can be found in the same towns and cities as existing bank branches – raising the possibility of future NatWest and RBS branch closures.

Last year the bank's new CEO, Ross McEwan, pointed out that branch transactions had fallen by almost 30% since 2010. (Source Financial Times). RBS sold its final stake of 28.2% in Direct Line Group via an accelerated book build at 256p, representing a discount of 2.7% to last Tuesday's close. RBS held the stake on their books at 210p per share so would lead to a £195mn gain on sale.

State Street : held its annual Investor Day in New York City last week. Low rates, weak ancillary fee revenues and relatively low investor risk appetites remain headwinds, though transactional velocity has improved modestly. Management remains cautious given a weaker than expected start to the year but targets positive operating leverage in 2014. Cost Saves Still On Track. The Business Ops/IT Transformation remains on track to achieve ~$575-625m in cost saves by 2015 vs. 2010. We believe the program has made State Street a more nimble/responsive organization and lower cost provider, driving a competitive advantage. Revenue growth YTD appears to be tracking at the low-end of its 3-5% revenue growth target for 2014 (stable markets, low rates, more conservative client behavior and reduced FX volatility in Feb overshadow modest increase in securities lending), which is already below its long-term goal (which it reiterated) of 8-12% (also still targeting 10-15% EPS growth, 12-15% ROE). Despite continued revenue/regulatory headwinds, we view State Street as very well positioned longer term given leading positions in segments that we view as poised for higher growth/better margins.

TD reported Q1/14 core cash EPS of $1.061 compared to consensus of $1.05. The EPS beat was driven by better than expected revenues ($6,629), lower than forecast expenses ($3,841), partially offset by higher than expected provisions for credit losses ($456 million). The quarter benefited from the sale of Ameritrade shares in the quarter. On a segmented basis, Canada P&C core earnings came in better than expected ($1,050 million), while Wholesale net income of $230 million was also higher. These positives were partly offset by lower than forecast Canadian Wealth & Insurance earnings ($290 million), while the U.S. P&C segment's earnings were in line with expectations. Canadian personal & commercial revenue growth came in at 7% YoY, slightly higher than forecast for 6% growth. The better than expected revenues came from net interest margins increasing by 2 basis points on a QoQ basis versus the expectations that margins be flat sequentially. Loan growth in U.S. P&C (measured in USD) was 15% YoY, , a good result. Net interest income margins were down 6 bps QoQ. The bank's Basel III common equity Tier 1 ratio was 8.9% versus forecast of 8.8%, and compared to 9.0% in Q4/13. TD increased its quarterly dividend by $0.04/share to $0.47/share.

Dividend Payers

Bayer – Germany's largest drugmaker Bayer lifted its estimate for potential sales of new drugs by billions of euros on Friday, softening the blow of a fall in fourth-quarter earnings. Adjusted earnings before interest, tax, depreciation and amortisation (EBITDA) in the last three months of 2013 slipped to €1.77 billion, dampened by a weak Japanese yen and emerging-market currencies, the company said. But Bayer, the inventor of Aspirin and maker of Yasmin birth-control pills, also boosted its estimate of the peak sales potential of its five most important new drugs to at least €7.5 billion, from more than €5.5 billion previously. Medicines such as anti-clotting drug Xarelto and eye treatment Eylea will do little to boost the bottom line this year because Bayer first needs to marshal a much larger sales force, but those two products alone are each expected to generate sales of more than $4 billion as early as 2016. As a result, the outlook for 2014 fell clearly short of market expectations. The German group said it expects 2014 adjusted EBITDA to grow by a low to mid-single-digit percentage and that full-year sales would be €41-€42 billion.

Hutchison Whampoa/ Cheung Kong Infrastructure – reported a 20% rise in 2013 profits, in line with expectations, thanks to strong growth in its retail and European telecoms businesses. The company is controlled by Asia's richest man, Li Ka-shing, whose empire spans commercial properties in Hong Kong and China to telecommunications in Europe and energy in Canada. It said full-year net profit totaled HK$31.11 billion ($4 billion), up from a revised HK$25.9 billion a year earlier. It reported 17% revenue growth in its health and beauty operations in China, the highest profit growth within the retail division. The Chinese health and beauty market is forecast to grow by around 40% to $186 billion by 2015. Hutchison said last year it was conducting a strategic review of A.S. Watson, a retail division operating more than 11,500 stores across 31 countries that could drive the expansion of a health and beauty business in China. The company, which proposed a dividend of HK$1.70 per share, up from HK$1.53 last year, also recorded strong growth in its European telecoms business with 15% growth in revenue in 3 Group Europe as it seeks to strengthen its position in Europe where it operates in six countries. A one-off €95 million ($129.97 million) net gain from the sale of Austrian telecom brand Yesss boosted the group's profits, the company said. Hutchison is awaiting the final decision by EU competition regulators on its $1 billion bid to take over Telefonica's O2 Ireland business. Husky Energy Inc, Canada's third-largest integrated oil producer, controlled by Li, posted a better-than-expected fourth quarter profit, helped by an 11% rise in U.S. crude prices.

Cheung Kong Infrastructure Holdings Ltd, also controlled by Li, reported 2013 net profit at HK$11.64 billion, up 23% thanks to increased profit from Hong Kong-listed Power Assets from growth in its businesses in the United Kingdom.

Pearson Plc - Britain's Pearson warned its earnings would fall sharply again in 2014 as the publisher entered the second year of a restructuring sparked by the deterioration in its main U.S education market. Pearson, the 170-year-old world leader in education which is under new leadership after years of good growth, suffered a tough 2013 and downgraded its outlook. Pearson, which also owns the Financial Times and a 47% stake in the Random House Penguin book group, for years beat market expectations as it rolled out its education and testing business around the world. But it was hit by a string of managerial changes and slowing growth in 2013. CEO John Fallon took over from the 16-year veteran Marjorie Scardino last year and, faced with stalling earnings growth, embarked on a £150 million restructuring programme to boost margins and counter tighter educational budgets. It has been hit particularly in the United States where fewer people are enrolling in college courses as the economy recovers, and where states have put off spending on school books as they wait for a new Common Core education programme to roll out.

Pearson's restructuring programme is designed to accelerate the move from print to digital services, and increase its presence in fast-growing emerging markets such as China, Brazil and India to tap into the rise in spending by a burgeoning and aspirational middle class. The 2013 results showed that North American education made up more than 535 of the £5.2 billion of group sales, while international education made up 30%. Adjusted earnings per share fell to 70.1 pence, after restructuring charges, from 82.6 pence in 2012. The company said at current exchange rates, adjusted EPS should be between 62 pence and 67 pence this year. The group announced a 7% rise in the dividend, which the group said reflected its confidence that it would return to growth in 2015. The dividend raise was the 22nd straight year of above inflation dividend growth.

Aggreko/Serco – British outsourcer Serco named Rupert Soames, a grandson of former Prime Minister Winston Churchill and chief executive of Aggreko, as chief executive on Friday to restore profits and its reputation following high-profile government contract failures. Serco CEO Chris Hyman quit in October after the tagging scandal was compounded by related police inquiries, allegations of fraud on a prisoner-escorting contract, a review of all its government work and warnings on 2013 and 2014 profit. Soames has worked at Misys and was at conglomerate General Electric Company, now part of BAE Systems, for 15 years prior to joining Aggreko. Soames said he had always admired the services delivered by Serco which he will join on June 1, taking over from Ed Casey. Serco, which employs over 100,000 staff in some 30 countries running services from London's light railway to air traffic control towers in the United States, said it was confident in the group's ability to realise its full potential under Soames' leadership. Aggreko Chief Financial Officer Angus Cockburn will assume Soames' role on a interim basis while a search for a successor, internally and externally, is conducted.

Vivendi – French media-and-telecoms company Vivendi held off giving forecasts or proposing dividends ahead of spinning off its domestic mobile brand SFR, rattling investors who were hoping for some indication on a possible payout. Vivendi aims to spin off the SFR division, which has suffered from an intense price war in France, as part of a broader company restructuring to pay down debt and focus on media. The company reported a fall in underlying annual profit in line with forecasts on Tuesday. The drive to shed assets and bring in a new management team under the chairmanship of billionaire Vincent Bollore has lifted Vivendi's share price over the past six months. The sale of most of Vivendi's stake in Activision Blizzard helped drive its 2013 net profit up tenfold to €1.97 billion.

Economic Activity, Consumer and Business Conditions

US – After a long string of sub-par economic releases, US economic announcements last week had a decidedly positive tone. On the housing front, the CaseShiller price index for the 20 US metropolitan areas was up 13.4% year on year in December, a notch ahead of the expected 13.3% reading, while new home sales unexpectedly jumped to a 468,000 units annualized level in January, from a 427,000 reading in December and way ahead of the expected 400,000 level. The good housing news were only partly offset by the 0.1% increase in the level of pending home sales in January, which, while an improvement on December's 5.4% drop, fell short of the expected 2.0% rebound.

US business activity is also showing signs of improvement, with the Institute for Supply Management's (ISM) Purchasing Managers Index (PMI) advancing to 53.2 index points in February, from 51.3 in the prior month, and ahead of the expected 52 index points reading. Most components in this composite index, including new orders and inventories, contributed to the improvement. The US durable goods order report for January, released earlier in the week, showed a better than expected 1.0% pull-back in the headline index, chiefly impacted by a weak transportation goods orders month. The ex-transport figure was up 1.1%, ahead of the expected 0.3% pull-back. Computers and electronics orders were the key drivers of growth in the month.

On the consumer front, the US personal income report revealed a better than expected rate of personal income growth in January, at 0.3% from 0.0% in December. The core personal consumption expenditures (PCE) price index, the US Fed's favourite inflation gage, was up 1.1% in year on year terms, a notch lower than in the prior month and not posing any sort of problems to the ultra-expansive US monetary policy. In term of consumer sentiment, the U of Michigan consumer sentiment index advanced to 81.6 points in February from 81.2 in January and ahead of the expected 81.3 reading, as both the consumer's views of 'current conditions' and 'expectations' have improved.

Last week was a larger than expected downward revision in the US fourth quarter preliminary GDP figure, to a 2.4% annualized rate of growth from the advance estimate of 3.2%, short of the expected 2.5%. The culprits were lower government and consumer spending, larger trade gap and a smaller inventory buildup.

Canada – Canadian economy expanded at a 2.9% annualized pace in the last quarter of 2013, ahead of the expected 2.5% pace, driven by better than expected performance in net exports, inventories and consumer spending and despite a weaker than expected GDP number in December, which was down 0.5%.

Ukraine sending a chill through global equity markets this morning, given the worsening situation over the weekend, bringing Russian tensions to the forefront. There were reports of a Russian "invasion" and we learned Saturday that Russian President Putin had secured parliamentary approval to use military force in the region. US has confirmed the Russian presence with Russia now in full control of Crimea. There are reports that Putin has set his sights on large industrial cities in eastern Ukraine. The UK has pulled out of G8 meetings. John Kerry, US secretary of State, calls the Russian actions "an incredible act of aggression". So far, supply of Russian gas from Ukraine to Europe still operating as normal. Russia Central Bank raised rates by 1.5% in surprise move to combat inflationary forces from record low rouble. The most liquid Russian stocks are getting hit the most with Gazprom -10%, Sberbank -10%, Lukoil -7%.

Italy - Italy's new Prime Minister Matteo Renzi won, as expected, his second and final vote of confidence in Italy's lower house on Tuesday, but emerged from a two-day long parliamentary debate with a weaker majority than expected. The former Mayor of Florence, who earlier this month led his Democratic Party in a revolt that forced his predecessor Enrico Letta to resign, needs a strong backing in both Italian chambers if he wants to deliver his ambitious agenda and help the euro zone's third largest economy re-emerge from its longest recession since World War II. In the lower house the new leader won the vote by 378 to 220, pretty much in line with Mr. Letta's previous government

Financial Conditions

U.S. regulators on said eight big U.S. banks could use their own, tailored risk models to determine their capital requirements in the future. Under rules being implemented by the Federal Reserve and the Office of the Comptroller of the Currency, the biggest U.S. banks will use their own models for judging their riskiness. The banks are Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, Northern Trust, State Street and US Bancorp. They will begin reporting their risk-based capital ratios using these models during the second quarter of 2014 (Source Reuters).

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 2.31% and the U.K.'s 2 year/10 year treasury spread is 2.05% - 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 4.37% - (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 14.00 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

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