Market Commentary

PORTLAND INVESTMENT COUNSEL™

April 14, 2014

News Highlights

Financial Services Companies

Barclays settled the first UK lawsuit filed over allegations the bank manipulated Libor, weeks before the trial was scheduled to start. Barclays agreed to restructure the debt of Graiseley Properties Ltd., which filed the lawsuit, as part of the settlement, Barclays said. The company was seeking to rescind interest-rate hedging contracts linked to Libor. The settlement spares the bank a trial that would have featured testimony from former Barclays officials, including ex-CEO Bob Diamond. Barclays has said Guardian owes about £70mn including loans. The swaps, which were designed to lower the company's exposure to rising interest rates, ended up costing Guardian about £12mn.

Citigroup: operating earnings per share was $1.30 vs. consensus of $1.14. The beat was driven by better revenues (trading results down 13% Year-on-Year, ahead of expectations) and a larger magnitude of reserve release. Investment -banking and trading results ahead of expectations. Investment-banking fees decreased $0.1B Q-Q to $1.1B as advisory revenues declined but equity and debt underwriting were flattish. Overall, total core trading was slightly better than expectations with revenues up 66% Quarter-on-Quarter but down 13% Year-on-Year. Management had earlier indicated that core trading results were tracking down by a high mid-teens percentage Year -on-year in early March, so March appears to have been a better month. Overall, firm-wide Citigroup revenues of $20.1B were higher due to better trading results and slightly better Citi Holdings revenues. Net interest income decreased 1.8% Q-Q to $11.8B, largely due to fewer days in the quarter. Total loans declined 0.2% as seasonally lower card balances (down $9B Q-Q) and continued run-off of Citi Holdings loans (down $3B) offset growth in corporate loans (up $8B). The Net Interest Margin expanded 2bp (to 2.90%) as lower long-term debt costs continue to be a helper. Core expenses were pretty much well controlled being $12.1B, up $0.2B sequentially (ex. last quarter's $0.4B fraud charge in Mexico). Note that first quarter expenses included still-high litigation expense ($945B vs. $809mm in 4Q) and repositioning costs ($211mm vs. $234mm). Citicorp's 1Q efficiency ratio was 57% which is getting nearer to management's 2015 target (mid-50's). Provision expense declined $98mm Q-Q to $1,974mm. Charge-offs decreased ($2,439mm vs. $2,547mm last quarter) largely due to lower Citi Holdings net charge-offs. Reserve release was fairly stable Quarter-on-Quarter at $646mm, as Citicorp release was up Quarter-on-Quarter (largely in card) while Citi Holdings was slightly smaller. The Basel III Tier 1 common capital ratio ended the quarter at 10.4% vs. 10.1% in 4Q (inclusive of the step-up in operational risk weighted assets). Citi utilized an additional $1.1B of deferred tax assets in 1Q, and tangible book value ended the quarter at $56.40 (vs. 55.31 last quarter).

Citi earlier last week also announced it has reached a US$1.1bn settlement with a group of institutional investors including BlackRock and Pimco over repurchase claims on US$59.4bn of mortgage-backed securities. To prepare for the deal Citi is taking an additional charge of US$100mn against this quarter's first-quarter earnings. The deal relates to repurchase claims whereby the bank was expected to buy back securities when the loans did not conform to how it had presented them. The settlement still requires approval by the Federal Housing Finance Agency, and the trustees of the securities have until June 30 to accept the offer. The trustees, which include Deutsche Bank, HSBC, US Bancorp and Wells Fargo, can accept the deal without court approval or can opt to seek a ruling, a move that would probably draw out the process.

JPMorgan reported below-consensus results, largely due to a core revenue miss. The company reported EPS of $1.28 per share; however, adjusting for a $0.4bn net Mortgage Servicing Rights loss and $0.53bn Debt Value Adjuated loss, we arrive at an operating result of $1.35, $0.04 below consensus and we note that private equity gains were $350 million, about $0.04 above expectations. Core revenues came in at $24.3bn. of which Investment banking came in in-line at $1.45bn, but FICC was slightly below estimates at $3.8bn. Equities trading was $1.3bn. about as expected. Wealth management revenues came in lower than expected ($2.8bn versus $3.0bn) partly due to lower incentive fees. Net Interest Margin was flat linked quarter at 2.20%, while average loans were up less than 1%.

Expenses came in better than expected at $14.6bn versus the broad expectation of $15.2bn. Management's full-year expense guidance remains unchanged at below $59bn. The balance sheet remains strong, Basel III ratio was 9.5%, flat with the prior quarter. Shares repurchased during the quarter were $400 million.

Royal Bank of Scotland has agreed amendments to its restructuring plan with the European Commission, which we view as good news. The key changes are (1) the Dividend Access Share (DAS) can be retired at a cost of £1.5bn, (2) the deadline for the Williams & Glynn disposal has been extended to end-2016, which is no surprise, (3) the Citizens disposal becomes part of the formal restructuring agreement, but had been planned anyway, and (4) the option of the Government to request a buyback of the B Shares if “prudent and practicable” will be removed. The last change is the most important in our view, as any buyback would have been at a cost of 600p per share in 2014 and 650p thereafter. In theory, once the DAS has been retired, the government is free to convert the B Shares into ordinary shares upon which there is no price restriction on repurchase by RBS. Subject to minority shareholder approval, this has the potential to largely normalise the capital structure and allow management to articulate a dividend policy in due course. RBS cannot pay dividends until the DAS shares have been bought out (agreement now but buyout not due until 2016).

Wells Fargo reported a big headline beat with earnings of $1.05 per share well ahead of consensus of $0.97. However, after excluding Mortgage Servicing Rights net hedging gain, tax benefit and securities gains, the operating estimate is $0.91 which includes a private equity gain which exceeded estimates by $0.07 per share. Net Interest Margin at 3.2% was down about 0.07% whereas non-interest expense of $11.95bn was largely expected with an estimated core efficiency ratio of 58.7%. Wells Fargo recorded a lower than forecast provision of $325mn, representing a related $0.02 beat. The Basel III Tier 1 common capital ratio ended the quarter at 10.0% (vs. 9.8% last quarter). Wells repurchased 34mm shares during 1Q, but common shares outstanding increased 9mm Q-Q as issuance related to employee benefit plans more than offset (although average diluted shares declined 5mm). Following the CCAR stress test, Wells did not help size the magnitude of potential buyback step-up this year, but its estimated the bank will repurchase $8B-$9B of shares this year vs. $5B in 2013.

The eight biggest US banks must raise a total of about $US68bn in capital by 2018 to comply with a new rule designed to prevent another financial crisis, prompting industry complaints that international standards are less restrictive and give their global competitors an advantage. Banks will have to fund part of their business through less risky sources such as shareholder equity, rather than by borrowing money. The final rules would require the eight biggest US banks to hold capital equal to 6% of their total assets. Their bank holding companies would have to meet a 5% ratio. That’s higher than the 3% ratio included in the Basel agreement. Smaller US banks would be held to the 3% ratio, regulators said.

Dividend Payers

Coca-Cola Amatil – Australia’s Coca-Cola Amatil Ltd forecast core earnings to fall about 15% in the first half of 2014 on weak domestic consumer spending and rising costs in Indonesia. The food and beverage company also said it has started a review of its business strategy under the group’s new managing director, Alison Watkins, who came to the job six weeks ago. The CCA forecast for the decline in 2014 first-half profit refers to earnings before interest, tax and significant items, which was A$373.9 million in the first half of 2013. “The grocery channel continues to be challenging with aggressive pricing activity which has limited CCA’s ability to recover cost increases while consumer demand in the non-grocery channel has been soft in the first quarter and there has been a mix shift to lower margin customers,” Watkins said in a statement.

Total – France’s Total said it had decided to go ahead with the Kaombo oil project offshore Angola after reducing its cost by $4 billion to $16 billion, an advance that could help Angola keep up oil output over the long run. The decision to invest in the ultra-deep sea project, which has been repeatedly delayed because of its cost, is seen as important for Africa’s No. 2 oil producer to replace older fields and hit its production targets. “Total has significantly optimized the project’s design and contracting strategy in recent months. Kaombo illustrates both the group’s capital discipline and objective to reduce capex,” Yves-Louis Darricarrere, Total’s president for upstream, said in a statement on Monday. Total is already the top operator in Angola, with equity production of 186,000 bpd, mainly due to its Girassol, Dalia and Pazflor deepwater fields in the huge Block 17. The blocks it operates produce a total of 600,000 bpd, over a third of the country’s output.

Toyota Motor Corp, in its second-largest recall announcement, said on Wednesday that it would call back 6.39 million vehicles globally, and analysts saw automakers increasingly turning to recalls rather than risk bad publicity or legal costs. Rival General Motors Co is in the midst of its own recall of 2.6 million cars related to an ignition switch problem, which has been linked to at least 13 deaths. Toyota, the world’s biggest automaker said, it was not aware of any crashes or injuries caused by the glitches, which were found in 27 Toyota models including the RAV4 and Yaris subcompact. It uncovered five different faults involving parts ranging from steering to seats. The automaker did not say how much the recalls would cost, and it was not clear if the faults stemmed from Toyota’s suppliers or its manufacturing process. In the largest of the recalls announced on Wednesday, Toyota said some 3.5 million vehicles were being recalled to replace a spiral cable that could be damaged when the steering wheel is turned. That could cause the air bag to fail in the event of a crash, the automaker said. In total, about 2.34 million of the vehicles to be recalled were sold in North America. Another 810,000 were sold in Europe. In the second-largest of the Toyota recalls, some 2.32 million three-door models made between January 2005 and August 2010 are being recalled to check for a fault in the seat rails that could cause the seat to slide forward in a crash, risking injury for the driver or passengers. The other recalls are for faulty steering column brackets, windshield wiper motors and engine starters. In the first two months of 2014, major automakers had announced 18 separate recalls in the United States, now the second-largest auto market behind China, according to the latest data compiled by the National Highway Traffic Safety Administration.

Wesfarmers, the Australian retail-to-coal-mining conglomerate has agreed to sell its insurance broking division to Arthur J Gallagher for A$1.15bn (US$1.06bn) subsequent to which Richard Goyder, Managing Director, is considering acquisitions rather than sitting on ‘ a whole pile of cash’. (Source Financial Times).

Economic Activity, Consumer and Business Conditions

US – The all-important US consumer sector was at the centre of macro-economic releases over the last week, as the sector reported a stronger than expected headline retail sales figure for March, up 1.1%, likely helped by the pent-up demand build during the harsh winter months. The consensus expectations were for a 0.8% advance. The retail sales excluding auto sales were also up a solid 0.7%, ahead of the expectations for a 0.5% improvement, with most retail categories, including building materials, clothing, furniture, general merchandise and hospitality contributing in the month. The consumer sentiment, as measured by the University of Michigan, improved to an 82.6 index level in April, ahead of the expectations, with both the ‘current conditions’ and the ‘expectations’ components of this composite index exceeding the consensus levels. In line with the above readings, the US consumer credit also expanded more than expected, by $16.49 billion in February.

U.S. initial jobless claims plunged 32k to 300k in the week to April 5, hitting the lowest level since May 2007, and handily beating the consensus estimate of a smaller improvement despite a slight upward revision to the prior week. This pulled the 4-week moving average down to 319.25k (its best level since last September) while continuing claims declined 62k in the week to March 29 to 2,776k, more than reversing the prior week’s increase and reaching the lowest levels since January 2008.

Canada – Canadian housing related statistics released last week point to a cooling of the construction activity, with the Canadian housing starts retreating to a 157,000 units annualized rate in March, from a 191,000 units annualized level in February, undoubtedly partly hindered by one of the coldest winter seasons on record. The biggest drop was in multi-units, reflecting, we believe, a much welcomed break in the pace of Toronto condo starts. The most recent Canadian building permits release revealed a 11.6% drop in February, consistent with the above-mentioned reduction in housing starts for March. In Ontario, the annualized figure for housing starts for March was 39,000 units, compared to the 12 month average of 60,000 units annualized.

Meanwhile, the Canadian New Housing Price Index, has continued chugging along, up 0.2% in February, following a 0.3% increase in January. New housing prices were up in all Ontario metropolitan areas in February, including St. Catharines-Niagara, by 1.3% and Kitchener-Cambridge-Waterloo, up 0.7%. On a year on year basis, new home prices were up by 1.5% in February, including 3.4% in St. Catharines-Niagara, 2.7% in Hamilton and 1.7% in Toronto-Oshawa.

Greece raised €1.3bn euros with a sale of six-month treasury bills, and later in the week raised a €3bn, 5 year bond at 4.95% as it returned to borrowing for longer periods after being frozen out for four years (and just 2 years since it defaulted).

Financial Conditions

Germany has given its banks long-awaited legal certainty on the tax treatment of Contingent Capital “Co-Co” bonds that can be converted into shares to bolster their capital, the finance ministry said last Thursday. The ministry said banks will be allowed to deduct interest payments on these contingent convertible bonds from their taxes, paving the way for German banks to issue the securities. “The finance ministry, together with the federal states, today created legal certainty on the treatment of instruments of banks' additional core capital, so-called CoCo-bonds," the ministry said in an email to Reuters. "On the basis of existing tax law, banks in Germany can use these instruments with comparable conditions to their European competitors."

US – 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 and undertaking that the Federal Reserve will keep rates low until mid 2015. The U.S. 2 year/10 year treasury spread is now 2.27% and the U.K.'s 2 year/10 year treasury spread is 1.99% - 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 4.34% - (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 17.03 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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PIC14-036-E(04/14)