Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Financial Services Companies

Barclays - New York's top securities regulator has sued Barclays alleging the UK bank favoured high-speed traders using its "dark pool" trading venue while misleading institutional investors. Eric Schneiderman, the state attorney-general, said Barclays had expanded its dark pool, Barclays LX, to one of the biggest off-exchange venues "by telling investors they were diving into safe waters...Barclays' dark pool was full of predators - there at Barclays' invitation". He said the lawsuit had been compiled with the help of former senior Barclays traders. The lawsuit, which alleges the bank violated New York's powerful Martin Act, is seeking an unstated amount of damages and restitution. Barclays said: "We take these allegations very seriously. Barclays has been co-operating with the New York attorney-general and the SEC and has been examining this matter internally." (Source Financial Times). Dark Pools allow investors to trade large blocks of shares anonymously with prices posted publicly only after deals are done. Dark pools account for ~15% of US equity trading. Data published by FINRA, the US securities regulator, shows that European Investment Banks run some of the largest pools, with Credit Suisse having the top market share in June (13% by number of shares traded) followed by Barclays (10%) and UBS (9%). Deutsche Bank is in 6th spot (6%).

Barclays - McGraw-Hill Financial Inc. and CME Group Inc. are interested in acquiring Barclays Plc's index business and merging it with S&P Dow Jones Indices LLC, (Source : Bloomberg). McGraw-Hill and CME are weighing a joint bid for the Index, Portfolio and Risk Solutions unit, or IPRS, which could fetch more than $500 million in a sale.

Barclays- Expansion report Caixabank have made the best non-binding bid for Barclays retail business Spain. However, Barclays decided to open up a final phase of auction process to seek to attract counter bids. Barclays are said to be opening the data room for sale process today.

BNP, prepares to plead guilty and pay an $8.9bn fine to settle the US sanctions investigation, according to NYT DealBook. It is to be announced on 30-Jun, NYT DealBook reports. People briefed on the case tell the NYT that the deal that has been tentatively agreed to prevent BNP's certain units in Paris, Geneva, and Singapore from clearing dollar transactions for at least six months. The financial impact of USD clearing restrictions is unclear - initial estimates are that the direct financial impact could be limited in the order of €40mn extra cost for a one year period or as much as US$1bn

Citi/ Santander/HSBC/Royal Bank of Scotland - The Federal Reserve has extended deadlines until next year for new capital plans from Citi and US units of HSBC, SAN & RBS. The four banks' June 26 deadline was pushed to Jan. 5. Regulators objected to the companies' submissions during the central bank's 2014 Comprehensive Capital Analysis and Review, a stress test measuring their ability to withstand a severe recession.

Deutsche Bank AG said last Wednesday it completed its 8.5bn euro ($11.6bn) capital increase, strengthening its capital buffers in line with expectations. The new shares, which will be included in trading of Deutsche Bank's stock at the end of this month, were sold at EUR22.50 each. Deutsche Bank is issuing new shares to quell concerns about the bank's capital strength. The core tier 1 capital ratio will rise to 12% from 9.5% as of the end of March. The capital increase boosted the number of Deutsche Bank shares by around 360mn to 1.38bn. The royal Qatari family took 60mn of the new shares in a first step, and the remaining 300mn were offered to existing investors. (Source The Wall Street Journal).

ING - ING have sold the remaining 10% stake in SulAmérica. ING expects to settle the transaction announced today on Wednesday 2 July. The statement says the deal was closed at BRL 15.31 per unit representing a 0.5% discount to the closing price of SulAmérica shares on 26 June. The sale generated approximately EUR 170 million in cash proceeds. The transaction is not expected to have a material impact on ING's financial results. As previously announced, ING intends to use the proceeds for the reduction of ING Group core debt.

Separately, ING may move some of its headquarters to London, Frankfurt, Het Financieele Dagblad reports citing people with knowledge of the matter, though ING says it is not exploring options to this effect.

Santander - has agreed to buy GE Money Bank AB, the consumer finance unit of GE Capital in Sweden, Denmark and Norway, for about €700m. GE Money Bank has loans of €2.35m, including direct loans and credit cards, Santander said. The deal will have an impact of -8bps on Grupo Santander's core capital.

Standard Chartered : Having seen some stability in the outlook at the time of the Q1 Interim Management Statement on 8th May, Standard Chartered has resumed its earnings downgrade cycle. Earnings are now expected to fall year on year compared to the company's previous expectation of 'modest growth', reviving the question of whether Standard Chartered is facing structural challenges that require a strategic rethink. I remain concerned that this maybe a structural issue although management is keen to highlight the higher returns in the Financial Markets business and don't seem keen on a change in strategy. Guidance is for 1st Half to be down c20% Year-on-Year but for 2nd Half profits 'likely to be higher than the same period last year' with a resulting decline in full-year earnings. The improved YoY trend in the second half of the year seems more about easier prior-year comparisons - underlying earnings fell 27% Half year on half year in 2H13 and look to be up 9% HoH in 1st Half 14. Assuming YoY growth of 5% in 2H14 would imply a 4% HoH fall and full year 2014 earnings down close to 10% YoY.

Dividend Payers

ABB announced last Friday that it is divesting the assets of Meyer Steel Structures, the utility steel structures division of Thomas & Betts, for a purchase price of approximately USD 600m. The deal is expected to be completed during Q3 2014, following regulatory approval. Meyer had revenues of USD 325m last year, and ABB has disclosed EBIT-margins of 16%, 12% and 24% in 2010, 2011 and Q1 2012 respectively. ABB acquired Thomas & Betts for USD 3.9bn in 2012. Thomas & Betts operated in electrical, HVAC, and steel structures, and ABB has subsequently divested the HVAC business for USD 260m (expected to close in Q2 2014) and now also the steel structures business, bringing the total amount of divestments from Thomas & Betts to USD 860m. ABB also recently announced the divestment of Power-One Solutions for USD 117m, bringing the total tally close to USD 1bn since late March (~2% of market cap). We think it is positive that ABB is streamlining its acquisitions and believe only small parts of the electrical business remain for divestment consideration in Thomas & Betts.

ABB : 'Bard Offshore 1' (400 MW offshore windfarm) had to be shut down post a fire in March. The grid connection is via the ABB-supplied Borwin I platform, which was energised last August and is expected to be handed over to the customer, Tennet, this year. It's understood the converter station is now operational again, but tests deemed to determine who is at fault had to be postponed last week. ABB remains confident that the handover will take place this year. Dolwin I should be completed in 2015, whereas Dolwin II will most likely be handed over in 2016. The last project benefited from some adjustments to the timetable and terms and conditions gleaned from prior experience. Together with the solar EPC projects, which should all be completed this year, these problem contracts represent around 15% of Power Systems sales. Since Alix Partners was hired, progress has been made on the execution front. New projects will not be signed with the same risk profile and ABB aims to work with partners. While working capital is being negatively impacted by the delays this year, its estimated by the end of 2014, the group should have much greater visibility on the residual risks, allowing the market to focus on the other 95% of the business.

Bunzl : issued its Q2 trading update. It is reassuringly similar to the Q1 update. Margins are trending up and constant FX revenue growth is expected to be 6%. Stripping out the effect of acquisitions this falls to organic sales growth of 2% - this is all however before FX which is likely to significantly impact on the reported revenue growth rate since half of revenues and profits are in USD. Consolidation continues with two acquisitions announced last week, bringing the acquisition spend in the year to date to £95m. Bunzl states that the pipeline for further deals remains good.

Roche announced last Friday that the EU Committee for Medicinal Products for Human Use (CHMP) recommended that the European Commission approve the use of Avastin in combination with chemotherapy as a treatment for women with ovarian cancer that is resistant to platinum-containing chemotherapy. Ovarian cancer has the highest mortality rate of all gynaecological cancers. Of the 230,000 women diagnosed worldwide each year many will have advanced disease that will return after initial treatment. When treating recurrent ovarian cancer, the time between receiving the last dose of platinum-based chemotherapy and disease recurrence is used to help determine the choice of chemotherapy used in the next line of treatment. Patients are said to have 'platinum-resistant' disease if their disease worsens between one and six months following completion of their platinum-based chemotherapy, and 'platinum-sensitive' disease if it worsens more than six months after. The positive opinion granted by the CHMP bodes well for approval of Avastin in patients resistant to platinum-containing chemotherapy patients (nearly 60,000 women a year globally), but it had been expected following the positive results of AURELIA study. The drug has been approved by the EU as a front-line (first-line following surgery) treatment for women with advanced ovarian cancer since 2011 and in recurrent, platinum-sensitive patients since mid-2012 and this upcoming approval will thus expand its label indication. The potential of Avastin in ovarian cancer in Europe is approximately CHF1bn and is included in our peak sales forecast of CHF7.3bn.

Syngenta : Monsanto, the world's largest seed company worth $64 billion recently explored a takeover of $34 billion Swiss rival Syngenta in a deal that would have allowed the US firm to move its tax location to Switzerland. The deal, is now defunct as Syngenta's management are understood to have decided against negotiations – as reported by Bloomberg.

Toyota said on 25 June that it will begin selling a sedan-type fuel cell vehicle (FCV) in Japan in 2015 and is also gearing up for a summer 2015 launch in the US and Europe. The car will be priced at around JPY7mn in Japan. This will be a hydrogen-powered FCV with a refueling time of approximately three minutes and a range of around 700km. This is a much shorter refueling time and a much longer range than electric vehicles, but construction of hydrogen fueling stations lags that for charging stations.

Economic Activity, Consumer and Business Conditions

US Q1 GDP : The Commerce Department's final tally of Q1 real GDP showed the economy contracted 2.9% annualized in the quarter, almost three-times faster than previously estimated. Exports were lowered (-8.9%) and imports raised (1.8%), and consequently trade carved 1.5% from growth. Business inventories were also trimmed, slicing 1.7% from growth. Both factors reflect disruptions to export shipments and car sales caused by the harsh winter weather. Stuck with bloated inventories, auto makers cut production. The more worrisome aspect of the GDP report is that consumer spending growth was knocked down to 1.0% (from 3.1% previously, and the weakest showing in four years), due to a hefty pullback in health care spending (that should reverse in Q2) as well as weakness in non-durables. This hefty Q1 setback suggests 2014 growth of around 1.7%, the worst annual performance since the recession. However consensus economist estimates still believe the U.S. economy will see growth rebounding in Q2. Last week's durable goods orders report suggests business capital spending has rebounded after declining 2.8% in Q1. Nondefense capital goods shipments, though down 0.7% in May, are still up 4.4% annualized in the past three months.. Meantime, capital goods orders, excluding defense and aircraft, rose 0.7% in May, and are up 18% annualized in the past three months. This points to continued strength in business spending ahead, which should support estimates of about a 3% GDP growth in the second half of the year, which is lower than earlier hoped .

US Spending : However, after the 1Q weather-related set back spending did not bounce back in recent months. Despite a solid 0.4% rise in personal incomes, consumers bought more homes and cars and saved a little more (the savings rate inched up to an 8-month high of 4.8%) but overall spending edged up 0.2% in May, half the expected pace. More importantly, in real-terms, consumption fell for the second straight month, down 0.1% in May, and down 0.2% in April (originally at -0.3%). There were notable downward revisions to February and March as well (especially February). And in the latest month, a 1% rise in durables spending (cars, household equipment, recreational goods & vehicles) was completely offset by cutbacks in nondurables (eating out, clothes, utilities)and services (food services and accommodations). Health care spending was flat for two straight months. Other areas, such as business investment, are improving but consumers still account for the lion's share of the economy. Also the core PCE deflator, which is what the Fed is closely eyeing, edged up 0.2% in the month. This was expected but at 1.5% above year-ago levels, that's the highest in just over a year.

U.S. existing home sales surpassed expectations (for a 1.9% increase) in May with a 4.9% jump to 4.89 mln units, annualized, the highest level since October. This is the second increase in a row, although sales are still 5% below year-ago levels. There was a small upward revision to April, to 4.66 mln units from the initial estimate of 4.65 mln. There was a 5.7% jump in single-family homes, a category that accounted for 88% of total homes sold. Condo sales were unchanged after rising 7.3% in the prior month. Despite more options available to them, first-timers accounted for just 27% of overall sales, the smallest share since earlier this year and still short of the 40%'ish that is typical during a normal market. Investors saw their share decline as well (to a one-year low of 16%), which left repeat homebuyers at 57%. So it is still encouraging that regular home buyers are doing their share to support sales, not institutional investors. Perhaps drawn by the higher price one could fetch these days (the median sales price was up 5% y/y, but is slowing). The inventory of homes available for sale rose for the 5th straight month, with May's 2.2% increase leaving the supply of homes that could be bought at the highest level in nearly two years. Single-family homes available for sale climbed 3.6% to just over 2 mln units, which is also the highest in nearly two years but still short of the long-term average.

U.S. Ruling Loosens Four-Decade Ban On Oil Exports: President Obama's administration has cleared the way for the first exports of unrefined American oil in nearly four decades, allowing energy companies to start chipping away at the longtime ban on selling U.S. oil abroad.

Financial Conditions

The Bank of England said mortgage demand increased significantly this quarter and lenders forecast it will rise further in the coming months. In its quarterly Credit Conditions Survey, the central bank said availability of secured credit to households increased slightly in the period. The survey also revealed that new mortgage rules may be having an impact on the market, with lenders forecasting the first decline in maximum loan-to-income ratios in more than two years. "Some lenders noted that changes introduced as a result of the Mortgage Market Review might reduce approval rates somewhat," the BOE said last week. Lenders also suggested that tougher lending standards on high LTI loans might lower their approval rates. (Source : Bloomberg).

The Bank of England (Mortgage restrictions): The Bank of England has become the first leading central bank to try to prevent a new credit boom from derailing the economic recovery after it has imposed limits on mortgage borrowing. Lending at income multiples above 4.5x can account for no more than 15% of a bank's new lending for residential purposes. At present no bank exceeds this limit. In addition, the Bank of England has said lenders must ensure new borrowers could still afford their loans if interest rates rose 3% in the first five years of the mortgage.

The European Central Bank is unlikely to raise interest rates from record lows until 2016 when the euro zone economy starts to pick up more strongly, ECB Governing Council member Ewald Nowotny said in a newspaper interview. "Interest rates will turn as soon as there is clear growth, so more than 2%, but from today's perspective that will hardly be before 2016," he said in an interview with the Krone paper that was posted on its website last weekend. He said a recovery in the euro zone was showing only signs of green shoots and the ECB's cheap money was not always making its way to companies wanting to borrow. "The psychological mood is lacking a bit," he said. (Source Reuters)

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 2.07% and the U.K.'s 2 year/10 year treasury spread is 1.80% - 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 6-9 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 4.14% - (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 5.2 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 11.78 (compares to a post-recession low of 10.7 achieved in early June) 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 Banks Fund
- Portland Global Income Fund
- Portland Global Dividend 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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