Market Commentary

PORTLAND INVESTMENT COUNSEL®

December 8, 2014

News Highlights

Energy Sector

Canadian Oil Sands announced its 2015 guidance and cut its quarterly dividend 43% to $0.20 (from $0.35) due to concerns over increasing debt in the current commodity price environment. Production guidance for 2015 was 96,000 to 111,000 Bbl/d, with a single-point estimate of ~103,700 Bbl/d, which implies utilization of ~81% and is ~2% below consensus of 106,100 Bbl/d. Capital spending of ~$564 million was ~9% below consensus of $620 million. Oil sands cash operating costs are expected to be ~$45.69/Bbl, below 2014 guidance of $46.80/Bbl.

Canadian Oil Sands lowered its capital expenditures (capex) outlook for 2015, as it announced that major capital projects, particularly for oilsands miner Syncrude Canada, are coming to a close. The $564 million in expected capex for 2015 is about 40% lower than the 2014 budget. Crude oil production at Syncrude Canada's oil sands operation averaged 283,500 barrels per day (bpd) in November, down 19.4% from October. Syncrude Canada is a joint-venture of seven partners - Canadian Oil Sands, Imperial Oil, Mocal Energy, Murphy Oil, Nexen, Sinopec and Suncor Energy.

Royal Dutch Shell – Shares of UK energy major BP rose more on Tuesday afternoon, with several traders citing market talk of a takeover bid from rival Royal Dutch Shell. Royal Dutch Shell and BP declined to comment.

Financial Sector

Bank of Nova Scotia: reported Q4 f2014 core cash EPS (excl. IFRS dilution) of $1.31 versus $1.31 in Q4 f2013 and $1.41 in Q3 f2014 about in line with BNS consensus. Excluding the notable items that impacted BNS' International Banking segment this quarter – particularly: (1) the revaluation of monetary assets at Banco del Caribe in Venezuela of Cdn$47 million pre-tax; and (2) restructuring charges of Cdn$41 million pre-tax –its estimated a pre-provision income (PPI) of Cdn$850 million reflecting a small miss to forecast. Net interest margin fell 2 bps sequentially to 4.03% - which was not overly surprising in light of trends throughout 2014 – but loan balances fell (for the second consecutive quarter) by 1.1% q/q on a Canadian dollar basis due to weakness in Asian trade finance. In addition, the contribution from BNS' investment in Thanachart Bank of Thailand declined materially this quarter. Net income (on a Cdn$ basis) from the International Banking segment has flat-lined for three years and BNS stated on the quarterly conference call that the segment's earnings in the first half of 2015 will remain as anemic as they were in 2014. In addition, the region faces broader economic uncertainty with the recent fall in commodity prices. BNS reported a common equity tier 1 (CET1) ratio of 10.8%, much higher than the 9.8% average of its domestic peers. By management's own reckoning, the bank has a sizable block of "surplus" capital which management has not yet redeployed. BNS may re-deploy that capital in an accretive fashion but in the meantime it's expected the bank to continue their common share repurchase programme – in Q4 2014, BNS repurchased 2.5 million shares for Cdn$176 million.

JP Morgan: Reuters highlighted that data compiled by industry analytics firm Coalition showed that U.S. bank JPMorgan retained its crown as the top-performing investment bank in the first nine months of the year, having made revenue of $17.1 billion in the year-to-date. According to the article, the report also showed that total investment bank revenue earned so far this year was 6% lower than a year earlier, driven largely by a downturn in fixed income, currencies and commodities (FICC) divisions. Most investment banks have seen trading revenues slump over the past year amid a low interest environment and tougher regulations requiring them to hold more capital, which have driven down returns. In contrast, equities divisions have performed much better, as well as revenues at investment banking divisions.

Lloyds - sold a £1.6bn Irish mortgage portfolio to Goldman Sachs & CarVal, the private equity group. The portfolio is made up of both buy to let residential and commercial mortgages. The purchase price is said to be slightly less than half of the face value of the underlying assets. The deal leaves Lloyds with only £1bn of net exposure to Irish non-performing loans. It also has about £5bn of performing Irish mortgages left in its non-core division, which is being steadily wound down. (source Financial Times)

Royal Bank of Scotland Plc has launched the sale of private bank Coutts International, and has invited at least 10 potential suitors. BMO Financial is cited as one of the potential bidders. Reuters notes that the sale could fetch about $1 billion for RBS, which manages about $36 billion, of which about one-third comes from Asia. Further, Reuters highlights that to increase the competitive tension and secure a better price, RBS could break up the business into Asia and Europe, but if RBS decides to sell the business in one chunk, Swiss private banks are seen as frontrunners for the business.

UBS - must face a two-year-old lawsuit accusing the Swiss bank of hiding a bet against the housing market that led to $331mn in losses on collateralised debt obligations, a New York state appeals court ruled, Bloomberg reports.

UK Banks/Autumn Statement - Bloomberg reports that Lloyds will probably be most affected by U.K. Chancellor of the Exchequer George Osborne's plan to raise £4bn more in tax from banks over five years. Osborne said that as of April he will limit the tax relief banks can claim from past losses. Deferred Tax Allowance utilisation will go to 50% from 100% for 5 years. Lloyds will be most affected as it has more deferred tax assets than any other British lender, however actual impact is limited as there is no need to write down book value and there is zero impact on EPS. For Lloyds it will results in a hit to capital of 60bps over 5 years and 30bps out to 2016. For Lloyds its estimated its Core Equity Tier 1 ratio will now only strengthen to 13.5% rather than 13.9% ...still strong. Barclay's little impact and RBS about 10bps as most of the DTAs were written down when the bad bank was created.

Separately, no change announced in bank levy rate as we expected. We still think it will come at some point in the future though.

Canadian Dividend Payers

Brookfield Property Partners ("BPY) announced last week that its subsidiary Brookfield Property L.P. has issued $1.8 billion of exchangeable preferred equity securities ("Preferred Equity Units") to Qatar Investment Authority ("QIA"). As a result of the issuance, QIA will own an approximate 9% interest in BPY on an as-exchanged basis. In a separate announcement, a 50/50 joint venture between BPY and QIA announced its intention to make an offer to acquire the outstanding ordinary shares of Songbird Estates plc ("Songbird"), which owns approximately 69% of Canary Wharf Group plc ("Canary Wharf"). Under the offer, which is subject to certain conditions, each Songbird shareholder would receive £3.50 per share in cash. Should the Songbird offer be successful, the joint venture will make an offer to acquire the 31% of the outstanding shares of Canary Wharf not already owned by Songbird at an equivalent price on a look-through basis. QIA currently owns approximately 29% of Songbird, and BPY owns approximately 22% of Canary Wharf. Ric Clark, CEO of Brookfield Property Group, stated, "The placement of $1.8 billion of equity is a great endorsement of our global premier asset strategy. We are on the path to building the world's leading portfolio of best-in-class property assets. This capital will enable us to launch BPY to the next phase." QIA said, "We are making this strategic investment in Brookfield Property Partners as part of our investment plan to diversify globally in the real estate sector. This transaction takes our existing institutional relationship with Brookfield Asset Management to the next level, establishing a global platform for us to continue our collaboration with Brookfield." The Preferred Equity Units are exchangeable at the option of QIA into BPY limited partner units ("BPY units") at a price of US$25.70 per unit and will be issued in three tranches of $600 million each, with an average dividend yield of 6.5% and maturities of seven, ten and twelve years. After three years for the seven-year tranche and four years for the ten- and twelve-year tranches, BPY can effectively require the holder to exchange the Preferred Equity Units into BPY units as long as BPY units are trading at or above 125%, 130% and 135%, respectively, of the exchange price. Upon maturity, the Preferred Equity Units that remain outstanding will be redeemed in exchange for BPY units valued at the 20-day, volume-weighted average trading price at such time.

Global Dividend Payers

ABB – announced it had won orders worth $55 million to strengthen the electricity network in India.

National Grid - The regulator, OFGEM on Friday released their base revenues for FY March 2016 the RIIO-T1 and -GD1 price controls. To recall, the price controls are dynamic and annual revenues are adjusted for efficiencies, outputs and the cost of debt index. We have reviewed the models, and we interpret the models as giving a -c£34m drop in NG Electricity transmission, +£28m in NG Electricity transmission and +£70m for Gas distribution, all-in nominal terms. So on our forecasts, NG will see an overall c£64m rise in revenues in FYmar16, excluding system operators. This compares to +c£170m overall in the prior year. Further, NG will be seeing net cost inflation in its UK businesses (inflation greater than real price effects). The challenging revenue allowance reflects the challenges laid down to the companies to drive returns and share efficiencies under RIIO.

Tesco last week announced a series of personnel changes to its Executive Committee. Perhaps the most notable change is that the CEO Dave Lewis is taking charge of the UK business, on a temporary basis. This puts Dave Lewis firmly in charge of the UK (similarly to how Terry Leahy ran the group during all his tenure). The other key moves: Benny Higgins in charge of 'group strategy'. We would assume that means the banker (ex CEO of Tesco Bank) is leading the disposal program. This makes sense in our view; he probably knows better how to deal with M&A Bankers than the rest of the management team. Jason Tarry: head of commercial for UK and the Group … another dual role. The matrix structure from the previous CEO, Philip Clarke, created some very heavy overheads and decision making paralysis. Jason appears very respected within Tesco, and he has had a successful run being in charge of clothing (F&F) for Europe. Simplification: David Hobbs (group business planning and strategy director) and Matt Atkinson (Chief Creative Officer) are leaving. This fits with the need for simplification (elimination of roles, less matrix, bigger responsibilities and oversight for remaining Exec members). Jill Easterbrook will lead business transformation program. Jill was in charge of a wide set of businesses before (Ireland, Mobile etc.). The fact that she is now in charge of just business transformation program, indicates to us that in those other business units, a layer of middle management has been removed.

Economic Conditions

US – Part of the US employment report, the US average earnings were up a robust 0.4% in November, ahead of the expectations for a 0.2% improvement and accelerating from October's 0.1% advance. The US consumer credit meanwhile saw a $13.23 billion increase in October, less than the expected $16.48 billion and less than September's $15.44 billion.

US employment: Nonfarm payrolls vaulted 321,000 in November, the most since early 2012, and the prior two months' figures were revised up a total of 44,000. The report should lay to rest any concerns that job growth is slowing—the 3-month average of 278,000 is the fastest since the early days of the recovery. Every major industry cranked out more jobs in the month, even the federal government. Notably, manufacturing and construction are showing good strength, and they tend to pay more than the average wage. Average hourly earnings rose 0.4% in the month, pushing the yearly rate up slightly to 2.1%. That's still low, but warrants closely monitoring in coming months given ebbing slack in the labour market.

The unemployment rate stayed at six-year lows of 5.8%, as household survey employment was nearly flat. However, this followed a massive (683,000) gain the prior month—the fact there was no retracement shows just how sturdy the labour market really is, as also suggested by a further decline in the "all-in" U6 jobless rate to 11.4% and in the median duration of joblessness to 12.8 weeks. The strong jobs report could push the Fed to abandon its "considerable time" pledge for rate guidance on December 17.

US trade deficit disappointed in October, narrowing just slightly to $43.4 billion in October from an upwardly-revised level. While exports rebounded 1.2%, this did not fully retrace the prior month's drop, as a stronger dollar and sluggish global backdrop weighed. Imports rose 0.9% after a couple of flat months. After a large positive contribution to Q3 growth, trade will undercut Q4 GDP. Still, broad strength elsewhere, notably in consumer spending, should more than compensate to keep the expansion on solid ground.

US nonmanufacturing ISM beat expectations in November. The index (which includes government services) surprisingly improved last month, the first increase in three months and at 59.3, is just 0.3 pts from a 9-year high. Of the 18 industries in the survey, 14 reported growth, which is 2 fewer than October but in-line with the average over the past year.

Canada – The Canadian employment report contrasted with its US counterpart, as the economy lost 10,700 positions in November. The job losses were driven by a drop in part-time positions, while full-time jobs actually advanced in the month, by 5,700. Most losses were in service sectors, including retail, professional services and transportation, while the resource, goods producing and construction sectors added positions in the month. The headline unemployment rate inched higher, as expected, to 6.6%.

Canada's trade balance was positive in October, although at $0.1 billion, barely so, as a 0.1% rise in exports fell short of a 0.5% increase in imports.

The Canadian housing sector reported a couple of strong readings earlier today, with the level of housing starts reaching 195,600 units annualized in November, ahead of the expected 195,000 units, driven by increased activity in Ontario, Quebec and British Columbia. Multi-unit starts pushed the reading higher, while single starts were actually weaker in the month. The building permits for October were also higher than expected, up 0.7%, on top of September's 12.5% jump.

Reserve Bank of Australia: left rates unchanged at 2.5% and kept to a similar message. The RBA stuck to its "period of stability" comment on interest rates and said the currency remained "above most estimates of its fundamental value". Markets have priced in a higher probability of a RBA hike by August 2015 from 40% last month to 75% this month. This should keep AUD under pressure along with falling commodity prices. Iron ore is down 30% since the end of June and China is struggling with maintaining its economic pace of growth. RBA continues to talk the AUD lower.

Australian GDP data showed slower growth than expected for the third quarter. Q3 GDP grew +0.3% versus the +0.7% that was expected. The annual number came in at +2.7% versus the +3.1% expected. Markets are now pricing in a full 25 bps cut for next year. AUD weakened on the headline.

Financial Conditions

The Bank of England left policy unchanged, as expected. The Bank's statement was short, with no new information as usual, reinforcing the view that the BoE isn't likely to move rates in the near future amid subdued inflation and wage growth.

The ECB, as expected, kept rates on hold last week. The introductory statement was quite telling of the central bank's stance and gave strong hints that more action is forthcoming in early 2015 (not necessarily in January).

The staff projections for growth and inflation were published and on both counts, they were revised downward; no surprise. Real GDP growth for 2014 is now pegged at 0.8% (from 0.9% in September), 1.0% in 2015 (from 1.6% in September), and 1.5% in 2016 (from 1.9% in September), with downside risks. Inflation for 2014 is now forecast at 0.5% (from 0.6% in September), 0.7% in 2015 (from 1.1% in September), and 1.3% in 2016 (from 1.4% in September), with the lower profile reflecting oil prices and the downward outlook for growth. President Draghi also warned that the inflation forecasts may be revised lower as oil prices have fallen below previous projections.

In early 2015, the ECB will assess what has been achieved and the outlook for price developments, and the impact of the drop in oil prices. Should it become necessary, "the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate." The ECB staff has stepped up technical preparation for further measures, and all sorts of measures were discussed, including various measures of Quantitative Easing. The ECB is concerned about weak growth and now, weak oil prices feeding into inflation expectations. Look for further QE steps to be taken in early 2015, quite likely, buying sovereign debt.

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US Federal Reserve policymakers remain determined to signal that although Quantitative Easing has stopped, the stimulus remains via keeping rates at present low until mid 2015. The US 2 year/10 year treasury spread is now 1.66% and the UK's 2 year/10 year treasury spread is 1.42% - 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 US 30 year mortgage market rate has increased to 3.89% - (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 US housing inventory is at 5.3 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 11.82 (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 6 Mutual Funds:

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

Private/Alternative Products

Portland also currently offers 4 private/alternative products:

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

Net Asset Value:

The Net Asset Values (NAV) of our investment funds are published on our Portland website at http://www.portlandic.com/prices/default.aspx

Sources: Thomson Reuters, Bloomberg, BMO, KBW, Barclays, TD

Source:Thomson Reuters, Bloomberg, BMO, KBW, Barclays, TD

Portland Investment Counsel Inc., 1375 Kerns Road, Suite 100, Burlington, Ontario L7P 4V7 Tel.:1-888-710-4242 • www.portlandic.com • info@portlandic.com

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