Market Commentary

PORTLAND INVESTMENT COUNSEL®

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News Highlights

Energy Sector

Enbridge/Canadian crude volumes – A combination of two pipelines is starting to do what the controversial Keystone XL oil-pipeline plan hasn't been able to accomplish: sharply increase flows of Canadian heavy crude to the U.S. Gulf Coast. Enbridge Inc's Illinois-to-Oklahoma Flanagan South line, coupled with Enterprise Products Partners' Oklahoma-to-Texas Seaway Twin line, are delivering their first large-volume shipments to the biggest refinery market in the United States, most of which is built to handle viscous oil like that produced in Canada. "We are connected all the way from Canada to Houston, Texas City, Beaumont and Port Arthur," Jim Teague, chief operating officer of Enterprise, which operates the 850,000 bpd Seaway system, said Friday near the end of the line on the coast, where a new marine terminal can double as an export platform. Unlike Keystone, the Flanagan South-Seaway Twin combination has been largely overlooked by environmental groups and has bypassed the need for U.S. federal approval as neither crosses the Canadian border. The existing Mainline system already feeds Flanagan South from Canada. Flows from 600,000-barrels per day Flanagan South and 450,000-bpd Seaway Twin began in December, after some delays. The Twin parallels the original 400,000 bpd Seaway line, which moves both heavy and light crude to the Gulf Coast from the U.S. crude futures hub in Cushing, Oklahoma. The incoming Canadian could displace heavy imports from Venezuela, Mexico and even Saudi Arabia, threatening to further pressure crude prices, which have fallen by half since June on global oversupply. Canada sent about 3 million barrels per day of oil to the United States in October, according to government data. Much of that goes to the Midwest, though more flows will reach the Gulf Coast.

BHP Billiton may be forced to slash its planned $4 billion spending this year on U.S. shale wells and book writedowns on its shale assets as it battles plunging prices for its biggest earners iron ore, oil and copper. The mining giant, which has cut capital spending for the past two years, needs further savings to have enough cash to meet a promise not to reduce its dividend. U.S. onshore drilling, the biggest single item in the company's capital budget, is seen as the easiest target. Other candidates for cuts in its $14.2 billion capital and exploration spending plan could be its longer-dated projects like BHP's Canadian Jansen potash project and Australian Olympic Dam copper expansion study. Shale drilling is much easier to shut than conventional oil and gas wells as individual wells are smaller, making it a logical target for cuts. It is not expected to cut spending on its conventional wells in the Gulf of Mexico. As of June 30, 2014, the company valued its onshore U.S. business at $26.95 billion, after taking a $2.8 billion writedown on some of its shale gas assets in 2012.

Pacific Rubiales joined Canadian oil and gas producers in cutting capital budgets, citing falling oil prices amid a supply glut and the OPEC's refusal to curb production. The company cut its 2015 capital budget to a range of $1.1 billion to $1.3 billion, from $1.5 billion. The Toronto-based company said it expects to produce 150 million to 160 million barrels of oil equivalent per day (mboe/d) in 2015. Pacific Rubiales denied market rumors regarding its debt obligations that briefly halted trading and sent shares to a five-year low on Wednesday. An analyst report warned that the company might breach an incurrence test requiring the ratio between its consolidated debt and its earnings before interest, tax, depreciation and amortization (EBITDA) to be below 3.5:1.0. The company said the ratio was currently 1.8:1.0.

Suncor – Canada's largest oil and gas company Suncor Energy Inc announced it would cut about 1,000 employees and contractors, freeze hiring and slash C$1 billion (US$837 million) in capital spending in response to falling crude oil prices. Suncor said it would also defer some capital projects that have not yet been sanctioned, such as MacKay River 2 in northern Alberta and the White Rose Extension offshore Atlantic Canada. Production outlook for 2015 remained unchanged at 540,000 to 585,000 barrels per day. Suncor's revision of its 2015 capital budget to between C$6.2 billion to C$6.8 million, from $7.2 billion to $7.8 billion when it was presented in November, brings it in line with other Canadian oil producers that have cut spending as oil prices fell.

Royal Dutch Shell had announced it would cut between 5% and 10% of the positions at its Albian Sands mining project. The company employs 3000 people at that site. Canadian Natural Resources, which on Monday reduced its capital spending and deferred an oil sands project, also has a hiring freeze.

Financial Sector

Bank of America: Core EPS was $0.32 (ex. market-related net interest income adjustments and FVA/DVA) vs. consensus of $0.31. Results also included $0.02 EPS drag from legal expense, but also a $0.04 benefit from reserve release. Core trading decreased 21% Y-Y, but note gains in 4Q13 that made for more difficult comparisons. This compares to JPM down 5% Y-Y on a core basis (ex. the impact of business simplification) and Citi down 14%. I-banking fees increased $0.2B Q-Q to $1.6B, as advisory, equity underwriting, and debt underwriting were all up. Reported Net Interest Income decreased $0.6B Q-Q to $9.9B and the reported Net Interest Margin decreased 11bp to 2.18%. Ex. market-related adjustments, core Net Interest Income decreased slightly to $10.4B, and core Net Interest Margin increased 1bp to 2.31%. Loan balances were somewhat disappointing once again, with balances down 1.1% Q-Q. The discretionary mortgage portfolio continues to decline, though U.S. commercial balances were positive Q-Q. Core expenses [ex. legal costs and Legacy Asset Servicing (LAS)] were $12.7B in 4Q vs.

$12.8B in 3Q. The decline was driven by lower compensation costs. LAS expense (ex. legal) declined $0.2B Q-Q to $1.1B, hitting BAC's target of $1.1B by 1Q15. Litigation expense declined meaningfully from 3Q ($0.4B vs. $6.0B), and we believe it should remain at a more reasonable level going forward absent new developments on the legal front. Provision expense was lower-than-expected at $220mm, resulting in a reserve release of $660mm. Non Conforming Obligations were $0.9B, down from the $1.2B core level in 3Q. The Basel III Tier 1 common ratio (under the advanced approach) ended the quarter at 9.6% (flat vs. 3Q) and the holding company Supplemental Leverage Ratio (SLR) is estimated to be at 5.9% (up 20bp Q-Q). Tangible book value was $14.43 vs. $14.09 last quarter.

Barclays : has appointed Jonathan Moulds, former head of Europe at Bank of America Merrill lynch, as Chief Operating Officer to help separate its UK bank network from rest of the group and separately capitalize its US activities.

Citigroup reported EPS of $0.06 vs. consensus of $0.10. 4Q results included legal and repositioning charges of $3.5B pre-tax, or about $1.00-$1.05 per share. This miss vs. consensus was largely driven by lower trading results (down 14% Y-Y), as advisory, equity underwriting, and debt underwriting were all lower. Firm-wide Citigroup revenues of $17.8B were slightly lower, largely due to lower trading results. Net interest income decreased 0.7% Q-Q to $12.1B and Net Interest Margin was essentially flat at 2.92%. Earning asset yields were 2bp lower vs. 3Q, but lower funding costs (particularly long-term debt) offset. Earning assets were down slightly Q-Q, and Citigroup loans were flat Q-Q ex. the impact of FX translation. Reported expenses of $14.4B included $3.5B of legal and repositioning charges. Ex. these items, core expenses of $10.9B were down $0.1B vs. 3Q. Citicorp's core 4Q efficiency ratio (ex. CVA/DVA and legal/repositioning charges) is about 62%, i.e. above management's '15 target in the mid-50's range. Provision expense increased $263mm Q-Q to $2,013mm. Charge-offs were higher Q-Q at $2.2B driven by higher ICG and Holdings losses. Firm-wide reserve release was smaller vs. 3Q at $367mm. The Basel III Tier 1 common ratio ended the quarter at 10.5% vs. 10.7% in 3Q. The holding company Supplemental Leverage Ratio (SLR) was estimated to be 6.0% (flat with 3Q). Citi utilized an additional $0.2B of deferred tax assets in 4Q ($3.1B for FY15). Tangible book value ended the quarter at $56.83, down 1.2% vs. last quarter.

JPMorgan reported a 6.6% drop in quarterly profit as legal costs exceeded $1bn in the wake of government probes, leading CEO Jamie Dimon to claim banks were "under assault." JPM agreed in November to pay $1bn in penalties over its conduct in foreign exchange markets. Investigations into that and other areas of the bank's business, including alleged manipulation of Libor interest rates, are continuing. "Banks are under assault," Dimon said on a call with reporters, responding to a question about legal costs. Also, CFO Marianne Lake said there's no reason to undertake "major surgery" on the company, which benefits from its size. Lake was responding to a question about a Goldman Sachs research report that said New York-based JPMorgan might be worth more to shareholders if it was broken into pieces (personally i believe a the clearest benefactor of such a carve up would be Goldman Sachs!).

Reported EPS was $1.19, but core EPS (ex. legal) looks to be around $1.30. Results are below consensus ($1.31), which would have included some legal expense. Overall, total core trading results (fixed income plus equities) were in line with expectations (down 13% Y-Y all-in, down 5% Y-Y core). Investment-banking fees increased $0.3B to $1.8B largely due to higher debt underwriting fees. The Corporate & Investment Bank (CIB) posted a 11% core ROE ex. legal expense (vs. the longer-term target of 15%) and the compensation ratio was low at 27%, below the 30%-35% historical range (full-year was 30%). Period-end loans increased 2% Q-Q. Growth in credit card, auto, and commercial categories was slightly offset by residential real estate-related run-off (JPM is selling some card loans too). The net interest margin declined 5bp to 2.14% and Net Interest Income declined slightly Q-Q to $11.3B. Total deposits were up 2% Q-Q on a period-end basis, and average interest-bearing deposit growth was also up 2%. Core fees were down vs. 3Q, largely due to seasonally softer trading fees. Otherwise, asset mgmt. revenues were strong, but card fees were below expectations, driven in part by card portfolio sales. For mortgage, production revenues were up 2% Q-Q on an 8% increase in originations. Mortgage Servicing Rights hedging results were lower for the quarter (-$41mm vs. $76mm last quarter) and there was more putback reserve release (at $131mm vs. $62mm). Core costs (ex. $1,114mm pre-tax of firm-wide litigation expense) were $14.3B vs. $14.7B in 3Q. The 4Q result was largely in-line with expectations and likely reflects the Q-Q decline in trading results. Capital ratios: The Basel III Tier 1 common ratio was stable Q-Q at 10.1%, but the Supplemental Leverage Ratio (SLR) ended the quarter at 5.6% (up 10bp) at the firm-level and 5.9% (up 20bp) at the bank. Tangible book value was up 1.3% to $44.69 and the bank repurchased $1.5B of common equity ($2B remaining).

Royal Bank of Scotland - According to The Economic Times, RBS is said to be considering scaling down its presence in India by giving up its branch status and operating as a representative office in the country following pressure from the UK government to support domestic growth. The bank is also in the process of exiting its $1bn non-core diamond, private banking and corporate banking businesses in the country. RBS is also accelerating its strategy of shedding non-UK operations by scaling back business in Asia. Some 2,000 employees in the Asia Pacific region could be affected. The Financial Times reports that RBS have been given a waiver by the US Federal Reserve over onerous new capital rules. The Fed are measuring banks assets over the 12 months to June but RBS will scale back US operations to below $50bn of assets by next year to allow the waiver. The US foreign banking organisation regime will require banks above the size threshold to set up separately capitalised holding companies and comply with tough local capital, leverage and corporate governance requirements. RBS plans this year to sell two more tranches of shares in Citizens, the retail bank it floated in September, to reduce its 75% below 30%. A lock-up preventing RBS from selling more Citizens shares expires on March 26th. A stake below 30% will enable RBS to argue it isn't in control and remove £60bn of RWAs from its balance sheet. Separately, Australia's ANZ Banking may be interested in RBS's Asian assets, the Australian Financial Review reports. According to the AFR, RBS has held talks to sell its corporate and institutional banking operations in Asia. However, ANZ may see roadblock in acquiring the assets under pressure to build up capital. In addition, Sky news reports that RBS are permanently eliminating annual cash bonuses for top executives. Sources at the bank tell Sky News that the policy, which was announced last year but had been assumed to apply only for 2014, means that CEO Ross McEwan and eight people on his senior management committee will not get any bonuses. Variable rewards will be paid in shares vesting over four or five years.

Standard Chartered - Bloomberg reports that Standard Chartered is close to selling private-equity investments valued at about $600mn, according to three people with knowledge of the talks. The bank has agreed with an investor to sell a bundle of stakes its principal investments unit had taken in companies across Africa, Asia and the Middle East, said one of the people. This is the second such transaction by Standard Chartered, which sold a $500mn portfolio to a group of investors led by Coller Capital Ltd. last year. The division made investments valued at about $1bn in 2014, while also selling parts of its portfolio as competition for assets by firms specializing in the secondary market for private-equity stakes drove up prices, one person said.

Swiss Banks - Following news of the removal of the swiss cap with Euro by its central bank and subsequent strengthening of swiss franc, revenue breakdown in annual reports of UBS and Credit Suisse suggests c.61% of revenues are international for UBS vs c.69% for CS. However, important to remember that large chunk of earnings come from US. For example UBS guides that only c.4% revenues come from Europe-ex UK. CHF has of course appreciated strongly thisweek but unlike vs EUR the move has only taken the CHFUSD rate back to the levels of mid-2014.

Wells Fargo reported EPS of $1.02 which was in line with consensus, but received some help from a lower-than-expected tax rate and a gain on the sale of student loans. Overall, revenue trends were OK in 4Q (solid loan and deposit growth again), but expenses were higher-than-expected (much is seasonal) and the efficiency ratio was at the high-end of management's 55%-59% target range. Net interest income increased $255mm Q-Q to $11.4B. Balance sheet growth (earning assets up 3% Q-Q) was driven by long-term debt issuance and strong deposit growth, which funded increases in cash balances, securities, and loans. Period-end loans increased 2.8% Q-Q, primarily driven by C&I growth. The net interest margin declined only 2bp Q-Q to 3.04% (and was not helped much by variable income). Core fees (ex. securities gains and the $217mm gain on sale of student loans) decreased $159mm Q-Q to $9.9B. Trust/investment fees (which includes Investment-banking fees) were robust, but service charges and equity investment gains were lower. Core mortgage production revenues decreased to $791mm (vs. $873mm in 3Q) and hedging results were fairly stable Q-Q. Mortgage origination volumes were 8% lower Q-Q and the gain-on-sale margin was stable. Expense increased $399mm Q-Q to $12.6B. Growth was driven by higher employee benefits expense, equipment expense, and outside professional services (at least some of which was typical of 4Q seasonality). The efficiency ratio increased to 59.0% (vs. 57.7% last quarter), which is at the very high-end of the bank's longer-term targeted range of 55%-59%. The firm expects to operate within this targeted efficiency ratio range for FY15. Provision expense increased $117mm Q-Q to $485mm. The increase was driven by smaller reserve release ($250mm vs. $300mm last quarter) and higher net charge-offs ($735mm vs. $668mm last quarter). Nonaccrual loans declined 5% Q-Q, which bodes well for future losses, although reserve release should continue to normalize lower. Capital: The Basel III Tier 1 common ratio ended the quarter at 10.4%. WFC's net payout ratio was 72% in 4Q (vs. the bank's longer-term target of 55%-75%), and buybacks drove the diluted share count 31mm lower.

Global Dividend Payers

Johnson & Johnson boosted its research efforts into battling Alzheimer's, striking a deal potentially worth more than $500 million to develop anti-tau vaccines with Swiss biotech firm AC Immune. Tau is a protein known for forming twisted fibres inside brain cells and is linked to cell death. It is one of two abnormal proteins tied to the memory-robbing disease. The hope is that therapeutic vaccines targeting tau will offer a way to treat Alzheimer's patients early in the disease. Unlisted AC Immune said on Monday it would receive an upfront sum and further payments based on scientific and commercial progress under the worldwide exclusive licence agreement and research collaboration with J&J's Janssen Pharmaceuticals unit. The deal is the fourth licensing agreement for AC Immune, which has another major tie-up with Roche for a beta amyloid-fighting drug called crenezumab.

Roche – Swiss drugmaker announced it had agreed to buy privately-held Trophos to gain access to an experimental drug to treat a debilitating genetic neuromuscular disease. The acquisition is the latest in a spate of deals by Roche as it uses its cash pile to expand its portfolio of medicines and invests in genomic data and tools to help in drug discovery and development. So far Roche has paid $1 billion for a stake in Foundation Medicine, signed a licensing deal for an antibiotic boosting drug for up to $750 million and partnered with Genome pioneer J. Craig Venter. Under the terms of the agreement with Trophos, the French firm's shareholders will receive an upfront payment of €120 million ($140 million), plus further payments based on certain predetermined milestones worth up to €350 million. The deal brings the Swiss drugmaker Trophos' investigational medicine olesoxime, which is being developed as a treatment for spinal muscular atrophy (SMA). SMA is a highly disabling genetic disease characterised by progressive muscle weakness and loss of motor functions, which affects one in 6,000 to one in 10,000 children. Roche has made a series of investments in treatments for genetic muscle-weakening diseases.

Economic Conditions

US – US retail sales dropped 0.9% in December, below the expected 0.1% correction, whilst November's 0.7% advance was adjusted downwards to 0.4%. Core retail sales, which excludes sales of motor vehicles and parts, were also lower by 1.0% in the month. Aside of the obvious drop in sales at gasoline stations, clothing, sporting goods, electronics and appliances, general merchandise and building materials, all suffered in the month. Thankfully, the consumer outlook, as measured by the University of Michigan'a sentiment index, jumped in January to a 98.2 points reading, the highest since 2004; which indicates a strong rebound in retail sales in subsequent months. Both the 'current conditions' and the 'expectations' component helped the advance. US inflation, meanwhile, diminished considerably, to 0.8% year on year change in the consumer price index (CPI), dragged lower by the steep decline in oil prices. The core CPI inflation, which excludes the most volatile price series, including food and energy, was also lower, to 1.6% in December, compared to November's 1.7% rate.

The US industrial production retreated 0.1% in December, affected mostly by lower utilities output as a result of warmer than usual weather and offset by growth in mining and manufacturing. Capacity utilization was also lower to 79.7%, from 80.0% in November.

Canada – Sales of existing homes in Canada fell by 5.8% in December, affected by a weaker Alberta market, while the Toronto market continues to be robust.

Global Growth - The World Bank have cut their global growth forecasts. The world economy is now expected to expand 3% in 2015 down from a projection of 3.4% in June. The lower revision is driven primarily by lower prospects in the eurozone, Japan, Brazil and Russia. The World Bank sees global growth at 3.3% in 2016 and 3.2% in 2017. The Washington-based lender cut its forecast for China, saying the world's second-biggest economy is undergoing a "managed slowdown," while also reducing its projections for the euro area and Japan.

Financial Conditions

Bank of England: Expectations for a BoE rate hike have been diminishing over the past six months or so, but with the release of the December CPI data, the possibilities have ebbed further. British inflation rose just 0.5% from year-ago levels, the slowest increase since May 2000. The Bank expects inflation to trend even lower in coming months, and does not expect the 2% target to be reached for another two years. That, along with slowing growth, suggests that the BoE will remain sidelined for most or all of the year.

Greece's central bank has moved to protect its banks from any fallout from the coming general election, asking the European Central Bank to approve a stand-by domestic emergency funding line, a Bank of Greece official said on Saturday. The move comes after two major banks applied to be able to tap an emergency liquidity assistance window on Friday as Greeks withdraw cash before the snap election on Jan. 25. (Source: Reuters)

Swiss Monetary Policy: The Swiss National Bank last Thursday removed the EUR cap at EURCHF 1.2 and lowered interest rates to -0.75% in a surprise move which triggered a massive move in the Swiss Franc which appreciated 33% at some stage (now +14.5%), and a sharp sell-off in Swiss equities with the SMI down -8.5%. The SNB's rationale for the move seems to be that being pegged to the EUR has meant the CHF has fallen too much against the US dollar. Noticeable, therefore, that the rally today has taken USDCHF back to where it was in June before the recent USD rally.

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 1.35% and the UK's 2 year/10 year treasury spread is 1.14% - 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 3.66% - (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 5.1 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 20.95 (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, KBW, BMO, Barclays

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

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