



3Q results continue to reflect a recovery in financial conditions with signs of credit stabilization increasingly evident. Sentiment across the global credit markets has calmed with TED spreads (the rate at which banks lend to each other) at approximately 0.23% well off the highs of 4.6% witnessed late September/early October and back to pre-crisis normal levels. In addition, the U.S. 2 year/10 year treasury spread is 2.50% and the U.K.'s 2 year/10 year treasury spread is 2.78% - enabling financial services companies' assets booked at these levels, to be very profitable, so enabling them to absorb anticipated consumer credit losses.

Our concerns (recently borne out by 3Q results) are mostly focused around the later cycle issues facing financial services companies – particularly commercial real estate and unsecured consumer loans/credit card loans. However, commercial real estate exposure is more acutely held by US regional banks – rather than larger more diversified global financial services companies. The number of small U.S. banks failing continues to grow (106 year-to-date) but their franchises are being acquired/absorbed as convergence of the financial services industry accelerates – favouring we believe the stronger, better managed banks. A concern which remains is the extent to which loan modifications are an exercise in loss deferral but for the larger franchises the quantum of proactive provisioning continues to act as a differentiator of quality which we believe has still to be fully appreciated.

3Q results from credit card companies support their executives' earlier indications of improving trends in credit card / consumer loan delinquencies and stabilization in billing volumes.

Worldwide, the improvements in financial conditions are providing support for a rebound in the economic activity and an upgrade in the business conditions. Most purchasing managers indices (PMI) point towards a bottoming in the manufacturing activity with the spread between New Orders and Inventories (both ISM/PMI components) being the highest since 1976; the U.S. services sector is showing signs of expansion for the first time in a year. The U.S. leading economic indicators (LEI) have recorded the sixth consecutive month of improvement in August. We believe, three consecutive months of increases, or three consecutive months of decreases traditionally signal an upturn or a downturn in the economy within three to six months.

On the consumer side (ex Asia), despite a significant sentiment improvement, spending is lagging (most recently noted in the Fed's Beige Book) on weak fundamentals, in particular real income growth. U.S. Unemployment rate reached a 26 year high at 9.8% in September. Largely due to the lack of wage pressure, inflation is subdued, with core (ex food and energy) personal consumption expenditures (PCE) U.S. inflation reaching recent lows at 1.3%.

The U.S. 30 year mortgage market has remained low at 5.0% (it first dropped below the psychologically important 5% in late March before rising to 5.59% in June and has since been falling back). The Fed's decision to buy mortgage backed securities and the U.S. Department of Treasury's proposal to assist as many as 9 million homeowners to refinance and/or reschedule their mortgage payments have contributed to a significant pick up in refinancing activity – to the advantage of bank franchises with substantial mortgage operations... In a recent statement, the Fed reinforced its commitment to purchase US\$1.45 trillion of agencies' mortgage backed securities (MBSs) and debt (a significant part of it has yet to go through) by the end of Q1 2010. U.S. housing inventory is being slowly reduced (7.3 month supply of new houses and 7.8 month supply of existing houses). We believe it is premature to consider a recovery in house prices but a measure of stability from which to build is to be welcomed....particularly for those financial services companies holding structured assets in their portfolios.

The amended Federal Reserve Stats for large domestically chartered commercial banks in the US

shows that the quantum of net unrealized losses on available for sale securities peaked in December at -\$87.4 billion ...improving to -\$49.1 billion by end June and as at October 14 was reported as -\$10.2 billion – the pricing of these securities will in our view become increasingly volatile as liquidity now drives more normalized prices but the positive trend is much welcomed. The writing back up of these assets feeds through to the book value and endorses the strategy of many large financial services companies to hold rather than trade such assets.

The VIX (volatility index) is 22.7, below the levels experienced last August/September (and well off the highs of 70-80 witnessed late September/October) and while, by its characteristics, it will remain volatile, it is we believe further evidence of markets reacclimatizing to risk – typically we believe a VIX level below 25 augurs well for quality equities. And credit default swaps across most leading financial companies are trading in a gradually improving range of 1%-2% (compared to 5%-7% late September/early October).

We believe the largest impediment to a sustainable rally remains government intervention, not the global economy. We believe that as signs of stabilization gain traction the market will become more discerning, favouring quality franchises rather than the apparent recovery of weaker franchises. Quality is likely to embrace those franchises with attractive market footprints, stabilizing returns on equity (and credit in the case of financials), efficient operating platforms and robust net margins based on solid core franchises.

A handwritten signature in black ink, appearing to read "Chris Wain-Lowe". The signature is fluid and cursive, with a large, sweeping initial 'C'.

Chris Wain-Lowe  
Executive Vice President  
Portland Investment Counsel Inc.  
Phone: 905-331-4250 Ext. 4232  
Fax: 905-331-4368  
[www.portlandinvestmentcounsel.com](http://www.portlandinvestmentcounsel.com)