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Investment Directions **23 December 2015**

"Analysis to action; opportunities to outcomes"

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2. **Equities** – Shares not necessarily hit by higher interest rates. Currently oil prices are the main driver. Fletcher Building could turn from this year's loser to next year's winner. AFT Pharmaceuticals jumps on listing despite poor IPO.

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Space Exploration News

Astounding success of private company SpaceX in launching 11 satellites and re-landing main booster stage for reuse sets a whole new standard of skills and technology in space exploration, paving the way to much lower orbital launching and space travel costs. See the replay here http://www.spacex.com/webcast/ or a shorter version on YouTube at https://www.youtube.com/watch?v=3G8GJQumBFs

Latest data from Dawn indicates the bright spots on dwarf planet Ceres comprise mainly salts but detection of water vapour near Occator crater by the Herschel Space Observatory suggests water may be sublimating from lower levels as Ceres nears the Sun. Dawn has now reached its closest orbit of Ceres, about 385 km above the surface. We await data and close-up images from the lower orbit.
See http://dawn.jpl.nasa.gov/news/news-detail.html?id=4785

1. Overview

The US Federal Reserve finally delivered on its own guidance by raising the Federal Funds target rate by 0.25% from a range of 0 – 0.25% to 0.25% - 0.50% on 17 December (NZ Time). Because the move was so

widely expected, interest centred mainly on the accompanying commentary which forecast a gradual target rate rise in future provided employment and inflation continue to improve as projected. Also as expected, interest rate and share markets largely took the announcement in stride with both exhibiting a small measure of "buy rumour, sell fact" reaction after the event. Benchmark 10 yr US T-Note yields retreated from 2.31% to 2.24% (prices rose) over the next two days while the S&P 500 share index came off 1.5%. Higher prices (lower yields) in the US Treasury bond markets have been attributed to increased foreign buying on higher yields being available coupled with the expectation of a rising US dollar. Major bond fund PIMCO expects the Fed to raise its target Federal Funds rate four times per year, 0.25% per time, for two years, reaching 2%-3% in 2018.

Crude oil continued to fall in December as the number of US oil rigs increased by 35 to 541 and stockpiles grew. OPEC abandoned production limits on 4 December. The spread between WTI crude and Brent crude is narrowing as the US plans to allow export of its domestic crude. The S&P 500 fell and US T-bonds rose (yields fell) as US inflation expectations weakened yet again. Adding to equities weakness were renewed concerns over China and doubts that some US fracking companies - oil explorers and producers - will be able to refinance maturing "junk" bonds used to commence exploration in the first place. Crude oil needs to be much higher for many US fracking companies to be profitable or even remain solvent. Already two high yield bond funds have failed – one in liquidation and another barring withdrawals until assets can be realised - which will be difficult. However, the possibility of widespread default does not become a major problem until 2017, with only a relatively small amount (US$5b) of the bonds becoming due for repayment in 2016.

China's "Beige Book" (prepared by a New York private survey) shows China's economy still slowing, in contrast to official Chinese figures which claim the slowdown is stabilising. The NY survey found a range of company activities declined in November including sales revenue, volumes, prices, profits, hiring, borrowing and capital expenditure. China reported a lower trade balance in November of 343.10B Yuan surplus vs 407.5B Yuan surplus expected and down from a surplus of 393.2B Yuan in October. Both imports and exports declined.

The Chinese Yuan will join the USD, Yen, GBP and Euro as an SDR component following an IMF vote. The inclusion is a big victory for China as it pursues its goal of full convertibility and acceptance of the Yuan as a global reserve currency.

New Zealand's Reserve Bank reduced its OCR to 2.50% on 10 December from 2.75% but surprised some economists by indicating the decrease is likely to be the last in this cycle. The NZ dollar rose on the news vs both the USD and AUD. Company CFOs appear to have been right in rushing bond issues to market at low coupons and long terms (and we have been right in not buying them). Swap rates across the board have trended upwards since the announcement. Correlation is very high between long term US interest rates and those in NZ and Australia.

The New Zealand economy grew faster than expected in 3Q15 with GDP up 0.9% for the 3 months to 30 September 2015, compared to 0.8% expected and just 0.3% in 2Q15. Positive contributions came from food manufacturing and tourism services. Transport, postal and warehousing expanded 2.6%. In contrast the commodity export sector was flat, including agriculture, fishing and forestry. News that the World Trade Organisation (WTO) has agreed to end global export subsidies is highly positive for New Zealand's agricultural sector.

Auckland house prices look set for a pause, possibly even a mild fall, following a clampdown on funds allowed out of China. The Chinese sharemarket slump will have deprived some wealthy Chinese of capital and new NZ buyer identification requirements including an IRD number and local bank account have come on top of stricter conditions for bank lending to investors. But the main driver is still demand which is far from being satisfied by new building as the city's population swells and mortgages remain cheap. Expect prices to remain firm after the market adjusts to the range of new conditions.

The outlook for New Zealand investors then has shifted slightly since the RBNZ's latest OCR reduction and commentary to one of continued NZ dollar strength vs the AUD and range trading around present levels vs the US dollar as we move into 2016. Overall, direction of the AUD should continue to be set by news out of China with the latest lower trade surplus figures helping edge the NZD/AUD up again. Planners of parity parties with the AUD though, are liable to be disappointed once again. Despite endless writing down of

Australia's economy by MSM based on falling commodity prices, other sectors are filling the employment gap left by declining resource investment and demand. The beaten down S&P/ASX 200, down 10% for 2015, holds promise for stock pickers in the New Year. Australian small caps, up 5% for the year, offer special opportunities.

The NZX50 (Gross) has risen nearly 10% since the start of 2015, one of the top stock exchange performances from a developed economy in the world. The index now looks "toppy" and chart watchers would see a definite "head and shoulders" pattern flashing warning signs. Fundamentally though, some of our top companies are selling on high and apparently sustainable dividend yields with modest P/E ratios and solid outlooks. For the immediate future though, expect the New Zealand share market to follow a US lead which is overwhelmingly, at present, being pressured by falling crude oil prices and concern over possible contagion to other markets from the dicey US oil fracking sector "junk bonds".

As far as interest rates are concerned, New Zealand and Australia could be about a year behind the US in moving towards higher official cash rates. Although a number of economists are still calling for further OCR cuts in NZ, company CFOs and even the RBNZ itself seem to believe the bottom has been reached. Interest rate markets are now pricing in rising rates across the board. Mortgage rates have already started to push up.

The Australian trade deficit blew out to A$3.3B in October as commodity prices and export volumes fell while imports remained flat. But on a broader view, the economy expanded 0.9% in 3Q15 and was up 2.5% year on year. High commodity export volumes, albeit at lower prices, helped offset lower imports and augmented growing services exports, rising household consumption and housing construction. Strong jobs growth saw unemployment decline to 5.8%. The RBA left its OCR at 2.00% on 1 December citing evidence that the Australian economy is growing. The offshore view remains one of concern over demand from China and the large trade deficit so a weak AUD is expected, at least during 1Q16.

Despite the US Fed move, ECB President Mario Draghi cut the ECB deposit rate further into negative territory on 4 December, dropping from -0.2% to -0.3% and extended Euro area QE to at least March 2017.

Keeping our finger on the pulse of major Leading Economic Indicators (LEI) and other leading data:

	Latest	Nov 15	Oct 15	Sep 15	Aug 15	Jul 15	Jun 15
3 month LIBOR (end of month) %	.53250	.41620	.33410	.32500	.32900	.30860	.28175
TED Spread (points)	.29	.20	.25	.34	.27	.23	.27
VIX equity volatility	20.70	16.13	15.07	24.5	28.43	12.12	18.23
US LEI		+0.4%	+0.6%	+0.0%	0.0%	0.0%	+0.6%
Japan LEI			-0.2%	-0.7%	-0.1%	-0.2%	+0.8%
Eurozone LEI			+0.4%	+0.0%	+0.1%	+0.3%	+0.5%
Australia LEI				-0.1%	-0.4%	+0.4%	-0.3%
United Kingdom LEI			-0.1%	-0.4%	+0.1%	-0.3%	-0.2%
China LEI			+0.6%	+1.6%	+0.9%	+0.9%	+0.5%
US Money Market Funds $T	2.734	2.741	2.717	2.669	2.694	2.648	2.618
US Gov. 10 year T-Bond (%)	2.199	2.218	2.151	2.060	2.200	2.205	2.335
US 5 yr inflation expectations %	1.73	1.88	1.86	1.75	2.00	2.12	2.13
US high yield-treasury spread 3-5yr %	7.01	6.40	5.90	6.62	5.70	5.36	5.00
Foreign holdings of US T-Bonds $B			6046.3	6101.7	6098.7	6116.5	6175.2
Margin debt, NYSE (US$ millions)			471,922	453,896	473,412	487,345	504,975
US M2 Money Stock (US$B)		12,288	12,201	12,187	12,138	12,059	11,982
Velocity of Money US M2				1.491			1.501
CNN Fear and Greed Index	29	53	69	18	3	9	
Insider Buy/Sell ratio (US) %	51	49	48	70	68	38	39
Forward P/E S&P 500 (12 month)	17.19	17.55	18.41	16.45	17.42	17.82	17.81
Trailing P/E S&P 500 (12 month)	22.65	23.18	22.07	20.59	21.63	21.18	21.52
Total Put/Call options ratio CBOE	1.03	1.07	0.95	0.97	1.20	1.00	1.10
S&P 500 Share Index	2005.55	2080.41	2079.36	1920.03	1972.18	2103.84	2063.11

LIBOR and TED Spread are both up, reflecting the US Fed funds rate move. Equities volatility is up too but

money market funds have not benefitted from any large scale quitting of equities. Although the Fear and Greed index has fallen back to "extreme fear" levels, the total put/call options ratio is subdued, indicating professional traders are not expecting a serious equities downturn at this stage. The insider Buy/Sell ratio at 51 says directors, large shareholders and management are still happy to buy their own company's shares.

2. Equities

Theoretically, higher interest rates should be negative for equities as liquid funds move from shares to more stable bonds, but records indicate equity markets usually respond positively to rising interest rates – at least at the start of the cycle. In the recent era of ultra-low interest rates some high yielding shares such as banks and listed property entities have tended to become de facto bond alternatives for investors. Again, theoretically, these securities should be hit by rising interest rates but banks can increase profits from higher margins as interest rates rise and property companies can benefit from higher valuations and increased rents as inflation re-emerges – albeit at very low levels. Hence those waiting for a significant equities retreat before buying could well miss out and those selling in anticipation could do even worse by locking in today's low prices. Current equities volatility has much more to do with oil prices than interest rates.

Major New Zealand construction and building products provider **Fletcher Building (FBU:NZX)**, has frustrated shareholders with a pitiful share price performance in 2015, down 15% for the year to date against an NZX Top 10 rise of 1% and Top 50 (gross) surge of nearly 10%. Despite the strongest tail winds any listed company could hope for in its New Zealand home market, Fletcher Building languishes near its lowest share price since November 2013. Net profit for the year to 30 June 2015 fell 20% to NZ$270m against some forecasts of a rise up to NZ$390m. In the past Fletcher Building has been plagued by poorly timed and executed acquisitions, the impact of which continued into FY 2015 with impairments of NZ$150m from site closure costs and write-offs of goodwill. At the recent AGM, current CEO Mark Adamson observed that no new major acquisitions had been undertaken on his watch and there was even the possibility of write-backs being claimed next year in relation to some former impairments, but offered no details.

Fletcher Building says it has suffered from the Australian mining downturn where operating earnings before interest and tax fell 30.4%, cancelling out much of the 24% rise in New Zealand. FBU now derives approximately 35% of its revenue from Australia. Ongoing poor performance from this sector is likely but the worst earnings reductions should be over.

In New Zealand, Fletcher Building is the lead contractor for the Christchurch City earthquake rebuild. It stands to gain enormously from the housing construction boom in Auckland and regularly succeeds in gaining major new government infrastructure and private commercial construction projects. Fletcher Building boasts a huge contracted forward order book of NZ$3.4 billion. Locally, the company's light and heavy construction materials are in high demand and its program management skills are widely sought.

Eleven Reuters' analysts give Fletcher Building an overall "Outperform" recommendation. Three local recommendations range from "Hold" to "Overweight" and "Buy".

In addition to continued contraction in the Australian mining sector, a real risk to FBU's future profitability stems from a possible decrease in Auckland land and housing prices, depressing Fletcher's land bank value and forcing further write-offs. However, serious impact from this quarter looks unlikely with probable housing construction falling further behind demand.

Analysts' forecasts centre around 60 cents earnings per share in 2016, rising to about 64 cps in 2017. That gives modest P/E values of 11.85 and 11.11 respectively. Dividends are forecast at 41 cps in 2016 and 43 cps in 2017 giving high yields on the latest price of NZ$7.11 of 5.77% and 6.05%. Net debt to equity has been constant at around 47% for the past three years but is picked to fall substantially over the next three.

It would seem Fletcher Building simply has to deliver on its own forecasts to turn the company around from one of last year's losers to one of next year's winners.

AFT Pharmaceuticals (AFT:NZX) offered shares at $2.80 during November with the shares listing on 22 December at $3.10. The IPO had good points and bad.

Good:

- AFT is a mainly a distributor, not a high risk biotech company in the normal sense.
- Not a private equity divestment.
- Most IPO funds (90%) go towards growing the business, not into pockets of existing owners.
- International income growing although most revenue still comes from New Zealand.

Bad:

- High debt.
- No dividend forecast.
- No financial information forecast.
- Substantial loss for FY 2015 and loss expected for 1H16.

The lack of dividend, high debt and failure to provide financial forecasts put us off applying but the shares have bolted to a good premium on listing. The company will have to deliver to justify such market confidence.

3. Interest rates, bonds and debentures

The US federal funds increase looks set to be reflected in higher New Zealand lending costs with little delay. Already the ASB Bank has raised 3 – 5 year fixed mortgage rates and other banks should soon follow. The new low OCR at 2.50% should keep short term and floating rates near current levels a little longer.

In contrast, deposit rates took another broad step down with the lower OCR after relative stability for a couple of months. Fixed term investors hoping for a boost in income could be waiting some time as deposit rates are unlikely to move up in unison with mortgages. Deposit taking institutions still have plenty of cash coming in at today's rates and quality lending opportunities are still hard to find. Liberty Financial took 0.65% p.a. off its longer term deposit rates during the month.

Current deposit rates, % p.a., quarterly interest payments:

Issuer	$ min	Call	3mth	6mth	9mth	12mth	18mth	24mth	36mth	48mth	60mth
F&P Finance	1000	2.85	3.15	3.65	3.75	3.85	3.95	4.10	4.25	4.35	4.45
F&P Finance	25,000	2.85	3.30	3.80	3.90	4.00	4.10	4.25	4.40	4.50	4.60
Heartland Bnk	1000	3.25*	2.90	3.40	3.30	3.55	3.45	3.50	3.75	3.80	3.70
Heartland Bnk	20,000	3.25*	3.00	3.40	3.40	3.55	3.55	3.60	3.60	3.65	3.80
Liberty Fin.	5,000		3.45	4.05	4.15	4.70	5.05	5.25	5.85	5.75	5.65
Liberty Fin.	20,000		4.60	4.20	4.30	4.85	5.20	5.40	6.00	5.90	5.80
Liberty Fin.	100,000		4.65	4.25	4.35	4.90	5.25	5.45	6.05	5.95	5.85
UDC Finance	5000	2.70	3.20	3.50	3.55	3.65	3.55	3.60	3.65	3.75	3.85
UDC Finance	100,000	3.20	3.20	3.55	3.60	3.70	3.60	3.65	3.70	3.80	3.90

*Heartland Direct Call Account

Heartland Bank occasionally offers existing depositors a small margin above normal rates for certain terms. Check with Canopus for their latest specials.

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4. Strategy

This could be an opportune time to reconsider banks - as interest rates rise, led by the US Fed. Australasian banks have been subject to extreme negativity during 2015 centred on exposure to "over-priced" housing markets, competition from alternative online services (e.g. peer to peer lending), low margins, concern over a potential rise in bad debts and low growth forecasts. Despite economists calling for a lower OCR in 2016, NZ and Australian interest rates should follow the US lead up – first at the longer terms and later for the short term and cash rates. Although Trans-Tasman rate moves may be up to a year behind the US, eventually Australasian banks should benefit from increasing margins. Property prices are pausing but a bust looks unlikely and the banks are capable of participating in the move towards online lending. Bad debts are still at low levels and should not rise to a level of concern while employment is strong. Analysts still predict low to modest growth for the banks and dividend yields remain high at around 6%.

Merchant bank Macquarie appears worthy of consideration too. At just under A$80, the shares are marginally above the recent Share Purchase Plan price of A$78.40. Analysts predict continuing strong growth with a dividend yield of around 5% for 2016, increasing to 5.5% for 2017. Macquarie derives much of its income offshore so should benefit from the expected weak AUD in 2016.

Bottoming of the interest rate cycle in NZ means we can no longer expect capital gains from the bond class of our portfolios. Income should not be affected with all our fixed and floating rate income issuers in good shape to meet their interest payment obligations. "Mark to Market" gains on bonds have been strong during the time of falling yields but taking profits and reinvesting in the same sector has not been a viable option as alternative worthwhile investments have simply not been available. We will look to reinvest maturing bonds over the next couple of years at rates above those currently available.

Both our published diversified income and growth portfolios added to October recoveries with strong performances in November. Our growth portfolio unit reached a new high of $1.5760, surpassing the previous high of $1.5502 set in July and giving a gain of 14.63% for the calendar year to date.

Click this link to see charts http://www.canopus.co.nz/investment_advice.html#returns

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Do have a great Christmas and take care during the holidays.

Regards,

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