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Investment Directions

27 June 2015

"Analysis to action; opportunities to outcomes"

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- 2. Equities** – Benefit of direct shareholdings by portfolio owners again highlighted by special offer from Westpac. Barramundi makes free issue of warrants to existing shareholders. Contact Energy pays special 50 cps dividend after reversing offshore investment intentions. Power company shares weak, awaiting Tiwai Point decision and possible revival of Labour Party nationalisation intentions.
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Spectacular higher resolution images show bright spots on dwarf planet Ceres as spacecraft Dawn spirals into lower orbit <http://dawn.jpl.nasa.gov/news/news-detail.html?id=4619> Latest images, June 10 2015. So far the bright spots remain a mystery and unique in our solar system. After descending to a lower orbit of altitude 1450 kilometres in early August, Dawn will be in a better position to analyse the bright spots in an attempt to determine their source.

1. Overview

Global share markets marked time towards the end of June as European and Greek negotiators failed to agree on a deal that would release €7.2B needed by Greece to avoid technical default on a €1.6B loan repayment due to the IMF on Tuesday, 30 June. Technically a country does not "default" when failing to meet payments due to the IMF but goes "into arrears". Unlike other deadlines, come and gone, IMF policy is not to reschedule payment dates. The sides are still far apart with Greece having the most to lose but creditors would

also face a severe haircut. Depositors, fearing overnight conversion to a relatively worthless new Drachma if their country does get forced out of the common-currency zone, continue their massive run on Greek banks, withdrawing Euros pumped in by the European Central Bank. This emergency funding would cease on a “Grexit”, leaving Greek banks to sink or swim with just the penniless Greek government in support. Strict capital controls would be unavoidable. Hopes of hard left Greek Prime Minister Tsipras and Finance Minister Varoufakis to bring a Russian threat card to the table were dashed when Moscow declined to intervene. Mr Putin would love to gain a financial foothold in the soft underbelly of Europe but the world’s toughest and smartest politician is an expert at picking limits if not friends.

Although the departure of Greece seems imminent, even at this late stage it’s not certain. Both sides want Greece to stay and keeping the full Euro zone intact may be just a face-saving deal away—but time to implement is rapidly running out. Latest reports say Greece has rejected as too harsh a proposal to extend its bailout programme by five months and €2B.

In the longer term though, Greece’s loan burden is unsustainable and must eventually be addressed by default or loan write-off.

Hope for a near term deal remains, so any sudden “Grexit” will catch out optimistic traders and probably impact negatively on European equity and bond markets in the short term. However a “pleased to see the back of them” reaction by those not directly affected could soon prove positive again.

In the US, Fed Chair Janet Yellen left the target Federal Funds rate at 0 - 0.25% on 19 June, saying further labour market improvement and 2% inflation are the triggers for a start to higher rates. Many analysts believe the conditions for “lift-off” of US interest rates will be met by September with some expecting two rises this calendar year. US bond yields retain upwards momentum in anticipation and expectation.

With an opposite bias, the RBNZ reduced its OCR from 3.50% to 3.25% on 11 June, producing forecasts of sharp reversals in immigration, consumer demand and even Auckland property demand to make the case for further cuts based on falling export receipts and rising fuel prices. The RBNZ says a lower NZ dollar is needed to put New Zealand’s current account balance on a more sustainable path.

Against this background the New Zealand yield curve continues to steepen, with short term rates following the OCR trend lower but longer term rates taking an upwards lead from US markets. If RBNZ forecasts of sharp turning points in immigration and demand turn out to be wrong (yes, we’ve seen it before) we should see the New Zealand yield curve start to rise right across the board.

The NZ dollar is lower against both the AUD and USD on news of the lower OCR, expectations of more cuts to come, lower export prices and GDP growth of just 0.2% in the March quarter c.f. 0.6% expected. However, New Zealand recorded its first quarterly current account surplus for five years to the end of March, +\$0.66B cf -\$3.19B for the December 2014 quarter.

China is pressing ahead with its “Qualified Domestic Individual Investor, part 2” (QDII2) trial under which residents of six cities, each having assets of more than US\$160,000, will be allowed to invest half their assets abroad c.f. the previous US\$50k limit. Economists expect most of the new money will head for property in the US, Canada, UK, Australia and New Zealand. However, the “Anglo” equity markets should also receive a share. The potential in just this initial stage is for the movement of many billions of dollars into the target markets.

China’s QDII2 trial is another step towards making the Yuan fully convertible, establishing the currency as an IMF-recognised global exchange currency and eventual rival to the US dollar. Allowing overseas investment by individuals also helps take heat off China’s domestic markets where investment opportunities are limited. In particular, high volatility in Chinese shares has led to massive margin trading speculation with margin loans reportedly reaching US\$358B – a figure comparable to the US\$507B speculating in the much deeper US equity markets.

In Australia the RBA kept its OCR at 2.00% on 2 June. Share prices of ASX – listed banks retreated as markets expect banks to benefit from lower interest rates but many economists are now picking the RBA has reached the bottom of its OCR cycle. In addition, Australian banks are expected to continue amassing capital,

driven by Basel III and comments from bank regulator APRA, leading some analysts to forecast a halt to growth in bank dividends. Conversely the AUD rose on expectations that relatively high Australian investment yields would remain in place. Just as main stream media (again) write down Australian banks as an investment, Warren Buffet announces that Berkshire Hathaway expects to add Australian banks to its portfolio as part of a US\$2B Australian investment programme, after buying 20% of IAG. Known for seeking to buy at low prices, Buffet may be waiting for Australian banks to fall below their long term average P/E of 11.9, compared to their present figure of 12.6. He could be in for a long wait.

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

| | Latest | May 15 | Apr 15 | Mar 15 | Feb 15 | Jan 15 | Dec 14 |
|------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| 3 month LIBOR (end of month) | .28200 | .28275 | .27875 | .27075 | .26160 | .25460 | .25520 |
| TED Spread (points) | .28 | .27 | .27 | .24 | .25 | .23 | .22 |
| VIX equity volatility | 14.02 | 13.84 | 14.55 | 15.29 | 13.34 | 20.97 | 19.20 |
| US LEI | | +0.7 | +0.7% | +0.4% | -0.2% | +0.2% | +0.4% |
| Japan LEI | | | +0.0% | -0.4% | -0.1% | -0.1% | +0.1% |
| Eurozone LEI | | +0.3% | +0.5% | +0.6% | +0.6% | +0.2% | +0.4% |
| Australia LEI | | | -0.3% | +0.0% | +0.7% | +0.4% | +0.3% |
| United Kingdom LEI | | | +0.4% | +0.3% | +0.7% | +0.2% | +0.0% |
| China LEI | | +1.1% | +1.4% | +0.2% | +1.4% | +0.6% | +0.9% |
| US Money Market Funds \$T | 2.602 | 2.615 | 2.582 | 2.634 | 2.692 | 2.702 | 2.733 |
| US Gov. 10 year T-Bond (%) | 2.476 | 2.095 | 2.046 | 1.93 | 2.00 | 1.68 | 2.17 |
| Foreign holdings of US T-Bonds \$B | | | 6137.3 | 6175.9 | 6162.8 | 6217.9 | 6153.7 |
| Margin debt, NYSE (US\$ millions) | | | 507,153 | 476,381 | 464,933 | 444,836 | 456,283 |
| US M2 Money Stock (US\$B) | | 11,938 | 11,895 | 11,846 | 11,820 | 11,701 | 11,625 |
| Velocity of Money US M2 | | | | 1.500 | | | 1.530 |
| Forward P/E S&P 500 (12 month) | 17.81 | 17.89 | 18.05 | 17.62 | 17.55 | 17.01 | 17.25 |
| Trailing P/E S&P 500 (12 month) | 21.52 | 21.47 | 20.98 | 20.52 | 20.53 | 19.71 | 19.67 |
| Total Put/Call options ratio CBOE | 1.06 | 1.15 | 1.05 | 1.13 | 1.01 | 1.10 | 1.22 |
| S&P 500 Share Index | 2101.49 | 2107.39 | 2085.51 | 2067.89 | 2104.50 | 1994.99 | 2058.90 |

As at the end of May the world's two biggest economies, US and China, both remained in solid LEI territory with the Eurozone and UK lending support. Australia and Japan continued to underperform in April. US 10 year T- Bonds retain their strong upward trend in expectation of the US Fed raising the target federal funds rate this year with many economists picking September for "lift-off". US debt markets set the direction of yields in the developed economies so RBNZ guidance of lower OCR rates in New Zealand could again be out of step with international trends, forcing another policy reversal later this year or early 2016.

The only indicator of real concern is the rapidly growing level of margin debt being used to speculate in stocks on the New York Stock exchange. This is sitting at 4.26% of the entire US M2 money supply. Clearly margin traders believe the Fed "has their backs". Although not recorded in our table, speculators in China are also running up huge margin account balances making both Chinese and US markets vulnerable to sharp reversals if a slide should start. We don't know if significant portions of margin trading accounts are used for short rather than long speculative positions but strong historic correlation between falling margin account balances and collapsing share indices in the past indicates a significant majority would be long positions.

2. Equities

As part of its capital raising programme, **Westpac Bank (ASX:WBC)** will sell down its 59% holding in well performed ASX-listed **BT Investment Management Limited (ASX:BTT)**, an investment management company it brought to market in 2007, to institutional investors and shareholders based in Australia and New Zealand. Westpac intends to retain 30% - 40% of BTT. Existing BTT shareholders will also receive the offer. Eligible shareholders will be able to apply for 600 or 1200 BTT shares at the offer price of A\$8.20, making an investment of A\$4920 or A\$9840.

At a discount of 7% to the latest market price, a forecast dividend yield of over 5% for 2016 and strong growth prospects, the offer looks attractive for our portfolios. Those considering taking up the offer should read the prospectus available at <https://events.miraqle.com/btim-share-offer/Validation/>.

The offer closes on 10 July 2015.

Application can be made online or by ordering a personalised application form by post from Westpac. As post can be a lengthy process between NZ and Australia, online applications are the preferred option. To apply online you will need your HIN number, a valid New Zealand or Australian address and access to BPay to make payment.

Eligible shareholders having a Canopus sharetrading account have access to the ASB Securities BPay facility. I am able to place an online application on your behalf and arrange payment via BPay for those wanting to accept the offer.

The offer is likely to prove popular and applications may be scaled.

Barramundi (NZX:BRM) announced a 1:4 issue of free warrants to shareholders on the register at 3 June 2015. The warrant exercise price will be \$0.68 per share less the amount of any dividends declared during the period leading up to the exercise date of 6 May 2016. Hence the final exercise price is likely to be around \$0.63 or less, a 7% discount to the latest market price of 68 cents. Dividend yield on the new shares is likely to be a very high 9%. The warrants will be issued automatically so shareholders need take no action to receive the issue.

New Zealand managed funds were quick to claim success in having **Contact Energy (NZX:CEN)** reverse its lately announced intention to seek new thermal energy investment opportunities overseas and, instead, return capital to investors as indicated earlier. There may be a measure of truth in the claim but, more likely, CEN directors got the message from 52% shareholder Origin Energy in Australia to forget about the new overseas ventures and pay out the accumulated capital. Origin is keen to de-lever its balance sheet and could use extra dividends from CEN to help pay interest. There is speculation in the market that Origin may sell its stake in CEN, allowing it to reduce debt by approximately A\$3.2B.

CEN paid a special 50 c.p.s. dividend on 23 June to shareholders on the register at the record date of 10 June 2015.

In a letter to shareholders dated 23 June, CEN advised that its new distribution policy would be to pay out approximately 100% of underlying earnings after tax cf the previous policy of an 80% payout. Furthermore, CEN expects free cash flow to exceed the 100% dividend level and will make additional distributions in the form of special dividends or share buybacks.

As noted in Investment Directions on previous occasions, special dividends are usually much more rewarding for ordinary shareholders than share buybacks.

NZX-listed power company shares have suffered from uncertainty over the future of Tiwai Point Aluminium Smelter and possible revival of Labour Party nationalisation intentions towards the whole electricity industry. Closure of Tiwai Point would leave a large excess of capacity in the New Zealand electricity grid. Smelter owners Rio Tinto and Sumitomo will advise Meridian Energy next week if they intent to terminate their electricity contract. Earlier reports indicated that cancellation of the contract would not have a major direct impact on Meridian because the contract supply price is already exceptionally low. However, cancellation of 13% of the country's electricity demand, currently taken by Tiwai Point, would impact all power companies. News of plans by Todd Corporation for a possible new 100 megawatt gas-fired power station didn't help and seem anomalous in a time of over-production.

High dividend yields should help underpin the power company share prices so long as these continue to appear sustainable.

3. Interest rates, bonds and debentures

Deposit taking institutions knocked up to 30 bps off deposit rates in response to the RBNZ 25 bps OCR cut on 11 June, making it even harder for investors to derive income from fixed term deposits.

Heartland Bank has current specials of 4.30% p.a. for 12 months or 4.15% p.a. for 6 months.

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

| Issuer | \$ min | Call | 3mth | 6mth | 9mth | 12mth | 18mth | 24mth | 36mth | 48mth | 60mth |
|---------------|---------|-------|------|------|------|-------|-------|-------|-------|-------|-------|
| F&P Finance | 1000 | 3.65 | 3.85 | 4.35 | 4.60 | 4.70 | 4.80 | 4.85 | 4.95 | 5.05 | 5.15 |
| F&P Finance | 25,000 | 3.65 | 4.00 | 4.50 | 4.75 | 4.85 | 4.95 | 5.00 | 5.10 | 5.20 | 5.30 |
| Heartland Bnk | 1000 | 4.10* | 3.55 | 4.15 | 4.10 | 4.30 | 4.20 | 4.25 | 4.30 | 4.35 | 4.40 |
| Heartland Bnk | 20,000 | 4.10* | 3.65 | 4.15 | 4.20 | 4.30 | 4.30 | 4.35 | 4.40 | 4.45 | 4.50 |
| Liberty Fin. | 5,000 | | 4.05 | 4.65 | 4.85 | 5.35 | 5.80 | 6.05 | 6.55 | 6.70 | 6.75 |
| Liberty Fin. | 20,000 | | 4.20 | 4.80 | 5.00 | 5.50 | 5.95 | 6.20 | 6.70 | 6.85 | 6.90 |
| Liberty Fin. | 100,000 | | 4.25 | 4.85 | 5.05 | 5.55 | 6.00 | 6.25 | 6.75 | 6.90 | 6.95 |
| UDC Finance | 5000 | 3.45 | 3.55 | 3.90 | 3.95 | 3.95 | 3.95 | 4.00 | 4.00 | 4.10 | 4.25 |
| UDC Finance | 100,000 | 3.95 | 3.65 | 4.00 | 4.05 | 4.05 | 4.05 | 4.10 | 4.10 | 4.20 | 4.35 |

*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.

For the full range of debenture stock interest rates and credit ratings visit Debex at http://www.debentures.co.nz/debenture_stock.html

Canopus advisory clients receive a full rebate of any brokerage paid on term deposits. This can add up to 0.5% per year to the deposit rates tabulated above.

Contact me for copies of investment statements and application forms alan@canopus.co.nz or telephone 09 444 8055. No brokerage is payable by investors on applications made through Canopus.

4. Strategy

Although New Zealand news is of rate cuts to OCR, deposit rates and mortgages, it would be a mistake to rush into the raft of bonds being pushed to market at 7 year terms and low coupons. Leading US market rates are heading upwards at the mid to longer terms and New Zealand longer term rates are following, creating a steepening local yield curve. When the US Fed eventually starts to raise its target Federal Funds Target Rate, expect US yield curves to move up across the board. The New Zealand yield curve is likely to follow some time later, irrespective of NZRB guidance for lower OCRs. Buyers of new issue longer term New Zealand bonds will likely be left holding securities of relatively low yield and falling capital value.

We are happy to retain our existing portfolio bonds in light of a rolling maturity programme starting late this year and ramping up in 2016, going through to 2022. As bonds mature we will examine suitable reinvestment opportunities at the time.

As reported here last month, bonds of reasonable quality offering even a modest return are now almost unobtainable on the NZDX.

On the equities front share indices look vulnerable to further weakness so our on market purchases should remain minimal, but special offers to investors holding equities directly in their own names can still be very attractive. Investors relying on managed funds for access to blue chip shares will not personally receive these potentially valuable issues while those holding through platforms, nominee companies and independent trustees may or may not be able to participate in these special offers, depending on structure of the offer, vigilance of the actual holder and possibly the short time for acceptance.

The Westpac offer of BT Investment Management shares to ordinary Westpac shareholders looks likely to provide a useful addition to our client portfolios and we expect to take up the offer where possible.

Further out, in November, portfolio owners will have the opportunity to expand their holdings in NZX-listed investment company, Kingfish Limited, through exercise of free warrants awarded to shareholders last year, at a significant discount to the current market price.

We are unlikely to participate in the latest “hot” high risk investment schemes such as crowd funding, peer to peer lending and “Tier 1” deeply subordinated capital notes.

Both of our published diversified income and growth portfolios made good gains in May, with unit values increasing 1.85% and 3.13% respectively.

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

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Contact me if you would like to open an account alan@canopus.co.nz or telephone 09 444 8055.

To discuss building a diversified, low volatility personal investment portfolio designed to produce income, growth or a combination of both, contact me by email at alan@canopus.co.nz or telephone 09 444 8055.

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Regards,

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Financial Adviser Disclosure Statement available on request, free of charge.

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