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Investment Directions **29 March 2015**

"Analysis to action. Opportunities to outcomes"

In this Issue

1. **Overview** – confusing statements from US Federal Reserve lead to equities and interest rate volatility. Negative pressure from rising US interest rates may be offset by inflow of new QE money from Europe and Japan. New Zealand and Australian OCR rates more likely to remain steady for longer – maybe out to 2017. Leading economic indicators all positive but equities weakness probable in short term.

2. **Equities** – Japan Post pays 50% premium over market for Toll Holdings. BHP Billiton carves off South32 to hold less profitable divisions. Fletcher Building participates in huge building projects in Wynyard precinct. Medibank Private joins S&P/ASX 50 and 100. Fliway Group IPO follows familiar pattern of enriching existing shareholders but some positives could emerge after listing. Fonterra Shareholders' Fund unit holders milked again.

3. **Interest rates, bonds and debentures** – Best fixed term deposit rates from major deposit takers. Virtually no movement in deposit rates during March.

4. **Strategy** – Opposing forces set to pressure equity markets over the coming months but which one dominates remains to be seen. Short term weakness looks most likely. Introductions of options trading on NZX may offer portfolio hedging possibilities. New issues of shares, bonds and notes demand close scrutiny as quality highly variable. Rampant New Zealand dollar restricts portfolio gains.

This month we just have to start with spacecraft Dawn's arrival at the dwarf planet Ceres. With Dawn poised to start transmitting pictures and data back to Earth in April are we on the verge of discovering the first major extra-terrestrial reservoir of water in the inner Solar System? Just what are those mysterious bright spots on Ceres filmed by Dawn during its approach? My pick is water ice – more valuable than gold out there. Visit NASA for more details http://dawn.jpl.nasa.gov *Even a salsa song has been produced to celebrate Dawn's visit to Vesta and Ceres* http://www.damuse.com/ThisFiestaCelebratesDawn/

Then it's back here for down to earth finance!

1. Overview

Equity and interest rate volatilities increased during March on confusing messages from the US Fed, growing conflicts in the Middle East and the ongoing Greek crisis.

After last month indicating a rise in US interest rates would be deferred still further, US Federal Reserve Chair Janet Yellen this month removed a commitment to “be patient” before raising rates, sparking speculation that the first Federal Funds rate rise was closer than the market had expected, possibly now as early as June. Later she attempted to mitigate the fallout by claiming ceasing to be “patient” didn’t mean the Fed would be “impatient” but left open the possibility that the rate may still be raised as early as June, saying “it all depends on the data”. The data itself has been contradictory, with wage growth slow but employment growing. Corporate profitability outlook is subdued but positive. Retail sales have been disappointing but are expected to expand as real incomes benefit from lower energy prices and higher consumer confidence. Two regional US Fed presidents have publicly stated lately that the Federal Funds rate should start to rise soon to avoid a drastic rise in inflation later on. Confusing guidance from the Fed simply serves to heighten equity and interest rate market volatility.

After dipping to 1.88% on March 24 the US 10 year Treasury Bond yield reversed sharply upwards again on US Fed uncertainty and after Saudi Arabia and friends entered the conflict in Yemen, attempting to save the Sunni President from Houthi rebels backed by Shiite Iran. On the news, commodities - oil, gold and copper all rose along with US interest rates. US T Bonds fell while US equities gave up gains made in mid-March to continue their high volatility pattern of 2015, but now a weakening bias looks to be developing. One study shows that of 16 US Federal Fund rate initial cycle hikes since 1946, 13 have seen US equity markets fall in the prior six months with a median drop of 10.1%. That would take the S&P 500 back to about 1900 from its current level of 2061, down from the high of 2117 in early March.

In pondering rises to the Federal Funds rate the US Fed has to be mindful of massive QE programmes in Japan and Europe weakening those currencies further with respect to the US dollar. A Federal Funds rate rise would exacerbate the situation further. Hence a likely scenario is for a very gradual rise in the Federal Funds rate once it does start. Equity markets though are likely to anticipate the move and over-react on the downside in the short term.

Rising US interest rates should give the RBNZ and RBA reason to pause on any thoughts they may have of lowering OCR rates on either side of the Tasman.

Europe’s new Quantitative Easing programme will see European State Central Banks purchase 1.1 T of Euros at a rate of 60B Euros per month at least until September 2015 in an attempt to stimulate a European economic revival. Many highly rated Euro bonds are already selling at near-zero or negative yields. At least some of the new cheap and plentiful money should make its way to the US and Australasia in search of positive yields. Similar reasoning applies to Japan and the latest Yen QE. Also much of the recent US dollar QE has yet to appear in circulation. Hence, longer term, it’s hard to see any significant fall in asset prices despite gradually rising US interest rates.

In New Zealand, the RBNZ on 12 March indicated the OCR was likely to stay on hold at 3.50% right out to 2017 - contrary to the reductions or downward bias expected by many market commentators. In a world of tiny and even negative interest rates the NZ dollar should retain strength on that basis.

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

	Latest	Feb 15	Jan 15	Dec 14	Nov 14	Oct 14	Sep 14
3 month LIBOR (end of month)	.26680	.26160	.25460	.25520	.23435	.23210	.23510
TED Spread (points)	.24	.25	.23	.22	.21	.22	.23
VIX equity volatility	15.80	13.34	20.97	19.20	13.33	14.03	16.31
US LEI		+0.2%	+0.2%	+0.4%	+0.3%	+0.6%	+0.8%
Japan LEI			+0.1%	+0.1%	+0.6%	+0.2%	+0.8%
Eurozone LEI			+0.3%	+0.3%	+0.2%	-0.1%	+0.0%
Australia LEI			+0.4%	+0.3%	+0.0%	-0.1%	-0.6%
United Kingdom LEI			+0.2%	+0.0%	-0.4%	-0.4%	-0.3%
China LEI		+1.5%	+0.5%	+0.9%	+0.8%	+0.8%	+1.09%
US Money Market Funds $T	2.688	2.692	2.702	2.733	2.688	2.629	2.614
US Gov. 10 year T-Bond (%)	2.01	2.00	1.68	2.17	2.194	2.34	2.51
Foreign holdings of US T-Bonds $B			6217.9	6153.7	6112.4	6058.9	6060.4
Margin debt, NYSE (US$ millions)			444,836	456,283	457,106	453,841	463,878
US M2 Money Stock (US$B)		11,820	11,701	11,625	11,562	11,511	11,473
Velocity of Money US M2				1.531			1.5384
Forward P/E S&P 500 (12 month)	17.62	17.55	17.01	17.25	17.15	16.25	16.85
Trailing P/E S&P 500 (12 month)	20.52	20.53	19.71	19.67	19.27	18.43	19.36
Total Put/Call options ratio CBOE	0.97	1.01	1.10	1.22	0.99	0.775	1.29
S&P 500 Share Index	2056.15	2104.50	1994.99	2058.90	2067.56	2018.05	1972.29

Leading economic indicators started the year positively in all regions with the world's two largest economies positive at the end of February. Strong foreign demand for US Treasury Bonds gives the US Federal Reserve room to increase rates when it deems the time right.

Margin debt on the New York Stock Exchange, historically strongly correlated with the S&P 500, was down again in January, this time by 2.5%, pointing to lower stock prices in the following months.

US interest rates are moving inexorably towards higher levels but the rate of increase in "target rates" from the Federal Reserve should be slow. Historically the start of the US interest rate cycle upwards has produced significant weakness in US and global equity markets. This time it's different (dare I say) in that huge quantities of new money from Europe and Japan could well move to inflate global asset prices further despite the negative effect of rising US interest rates. Whether one can cancel or overcome the other remains to be seen.

The likely 2015 outlook for global equity markets then, based on current information and still led by the US, is for short term weakness until mid-year or September as expectations of an increase in the Federal Funds Target Rate materialise, followed by a recovery towards year's end as the US economy continues to improve, and new QE money arrives in the US (and Australasia) seeking yield and growth.

2. Equities

Some New Zealand fund managers are reportedly moving to a higher cash weighting in portfolios, reducing exposure to high yielding sectors such as utilities and listed property companies in expectation of higher market interest rates where they expect rising bond yields to provide a more secure income opportunity - while higher yielding shares suffer. This attitude ignores the real possibility of offshore new QE money from Europe and Japan targeting Australasian higher yielding equities – keeping values up if not inflating them further.

Japan Post's bid for **Toll Holdings (ASX:TOL)** at nearly 50% above market price may prove symptomatic of huge quantities of cheap overseas money being used to seek growth and yield outside the buyer's home territory where near-zero or even negative market rates prevail.

Shareholders in **BHP Billiton (ASX:BHP)** will receive free shares in **South 32,** being spun off from BHP to hold the less attractive mining divisions including manganese, silver, base metals, aluminium, alumina and coal, together valued at about A$12 billion. Some are said to be good assets with mines where capital development has been neglected while the South African coal and manganese businesses are likely to be sold. South 32 will have little debt and expects to be able to fund essential development while paying generous dividends. BHP will retain the iron ore, petroleum, copper and metallurgical coal divisions which, together, account for 96% of BHP's profits.

Fletcher Building (NZX:FBU), through its subsidiary Fletcher Construction, is to build an $86.2m multi-level office block in Wynyard Quarter, near Auckland's waterfront, under a conditional agreement with Wynyard Precinct Holdings, a joint venture between NZX-listed Goodman Property Trust and Singapore's Sovereign Wealth Fund GIC. GIC manages over US$100 billion in assets in more than 40 countries. Fletcher Construction, through a joint venture with ASX-listed Goodman Group, is already building a $500 million office development in the same precinct which will house the new Fonterra Headquarters.

Medibank Private (ASX:MPL) has been added to the S&P/ASX Top 50 and Top 100 indices meaning managed funds tracking the index will be obliged to buy the shares while some international funds with restricted mandates may have the option to include MPL in their portfolios if they want to.

The **Fliway Group** IPO offers yet another example of a new NZX listing being brought to market, primarily benefiting existing shareholders rather than the Company. Prior to the float existing shareholders created for themselves approximately 38 million new shares via a massive share split, then offered 13.3 million of those shares in the IPO at the set offer price of $1.20 to pocket nearly $16 million of the $24.96 million publicly-subscribed money. Selling shareholders, Duncan and Gretchen Hawkesby, will retain 54.2% of the listed company and Duncan Hawkesby will keep his Managing Director's position. The Fliway Group itself, into which IPO subscribers are investing, will receive only about $9 million of the subscribed funds, most of which will go towards paying back a portion of existing debt and $2.6 million to meet organising broker and other issue expenses. Apparently nothing will be left to put towards developing new business opportunities although debt-funded capex in new vehicles was heavy in 2014 with more scheduled for 2015. NPAT earnings growth has been erratic over the past two years and is forecast to fall 11% for the year to 30 June 2015 but climb again for the year ending 31 December 2015. That the offer price of $1.20 was set at the low end of the indicative price range after the bookbuild process indicates that participating brokers and institutions were not impressed with the IPO.

Despite obvious drawbacks in the float from an investor's point of view, Fliway Group could be interesting to watch once listed. Several positives exist:

- The NZX transport and logistics sector has produced some excellent investments over the past few years, namely Freightways and Mainfreight.
- The issue price has been set at the low end of the indicative range, so listing price is likely to be low too.
- Remaining shares held by the Hawkesbys after the float will be subject to an Escrow Deed under which they may not sell any further shares until the Company releases its six month results to 31 December 2015. That could be in February 2016 or near to.
- An early dividend is expected to be paid in September 2015 in respect of the three months to 30 June 2015. Current dividend policy is to pay out 50% -70% NPAT which could result in a cash yield of between 4.13% and 5.78% based on the $1.20 issue price. Dividends of course, are not guaranteed, with payment being subject to many provisos.
- Projected P/E is modest, in the 12 – 14 range.
- The immediate outlook for equity markets is weak, potentially taking Fliway Group down with the market.

Anyone considering buying shares in the Fliway Group IPO is advised to read the Prospectus and Investment Statement carefully before investing.

Unit holders in the **Fonterra Shareholders' Fund (NZX:FSF)** received another sharp reminder of their lowly second class status when Fonterra dropped its dividend guidance for 2015 from 25 – 35 cents to 20 – 30 cents per unit. The units quickly dropped from $6.00 to $5.50, (-8.3%) on the news. Unit holders in FSF are compromised by the obvious conflict of interest between shareholding dairy farmers who, having sold their rights to dividend payments to unitholders, retain voting rights in Fonterra and a share of any increase in company value. In contrast, FSF unit holders are mere price takers, with dividends decided by a management in which they have no say and a unit price dependent mainly on that dividend. Farmers can exchange their Fonterra shares for FSF units and back again if they want to but others cannot. Worse still, with 121 million units on issue, a lot of dairy farmers must have cashed in their rights to dividends thus creating a major conflict of interest whereby many farmers would rather see Fonterra profits retained within the Company or, better still, paid out to themselves as an increased farmgate price for milk. Having received a pitiful 10 cents per unit in 2014, FSF unit holders could receive as little as 20 cpu for 2015, 30 cpu at best, 3.6% - 5.4% for one year or an average return over two years of 2.7% - 3.6% on the latest market price of $5.56.

After being issued at $5.50 cents and listing in December 2012, FSF Units reached a peak of $8.09 in May 2013 from where they have fallen 31%, nearly back to the original issue price. FSF unit holders have no security over the assets of Fonterra as the units are issued by a separate unit trust.

3. Interest rates, bonds and debentures

No movement in our tabled deposit rates this month.

Heartland Bank has a special 4.50% p.a. for 12 months.

Current deposit rates, % p.a.:

Issuer	$ min	Call	3mth	6mth	9mth	12mth	18mth	24mth	36mth	48mth	60mth
F&P Finance	1000	3.65	3.85	4.35	4.60	4.85	4.90	5.05	5.25	5.45	5.65
F&P Finance	25,000	3.65	4.00	4.50	4.75	5.00	5.05	5.20	5.40	5.60	5.80
Heartland Bnk	1000	3.75	3.80	4.40	4.35	4.50	4.55	4.65	4.90	5.00	5.15
Heartland Bnk	20,000	3.75	3.90	4.40	4.45	4.50	4.65	4.75	5.00	5.10	5.25
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
UDC Finance	5000	3.45	3.90	4.20	4.25	4.40	4.40	4.40	4.40	4.40	4.45
UDC Finance	100,000	3.95	4.00	4.30	4.35	4.50	4.50	4.50	4.50	4.50	4.55

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

Two major and opposing forces look set to pressure equity markets over the coming months – the more overt and negative being not if but when US interest rates move higher, possibly to be negated by the lesser recognised but asset-inflationary potential of huge new cash inflows seeking yield from European and Japanese QE programmes. US equity markets are already reacting with caution to the former while Australasian markets may already have seen a sample of the latter through the Japan Post/Toll deal.

Fundamentals, including positive global leading economic indicators and accelerating US M2 money supply, do not point to an equities meltdown in the near future although near term weakness appears likely with some degree of over-reaction possible.

Positioning portfolios to guard against a mid-term global equities retreat while retaining the potential to participate in an asset-inflationary upturn is problematic. The NZX will shortly introduce options trading for Spark, Fletcher Building and Trade Me, opening up some degree of portfolio insurance at a price, with options on more major companies to follow. A number of managed funds offer various options strategies claiming to protect capital and/or capitalise on market volatility to outperform the market. Many fail to do so. "Buy-write" strategy is particularly popular which, theoretically at least, should work well in a falling or even stable market but can quickly turn to mud when equities unexpectedly rise. Bare options trading is a high risk form of speculation, not suited to our long term investment portfolios.

We will check the cost of portfolio insurance using basic "Put" options once broadly available on the NZX.

In the present climate an extremely cautious approach towards purchase of suitable securities in the equities bond and listed property classes remains justified. Although we are heading into rougher waters, where value appears, we are still prepared to buy.

New equity and bond issues are being brought to market in New Zealand with quality varying dramatically from true junk to investment grade as far as bonds are concerned with equity IPOs often following a familiar pattern of enriching the original owners (and organising brokers) at the expense of new investors. Terms and conditions of new note and bond issues offering apparently high interest rates, even from banks, need to be examined closely. Such notes can place the holder in a deplorable position of deep subordination, unwanted convertibility or even complete cancellation of securities in the event of the issuer facing solvency issues. Conversion or cancellation may even be instigated at the demand of the regulator – for banks, the RBNZ. Amongst equity IPOs however, the occasional gem can still be found.

Now is not the time to be sacrificing security and quality of investment for a small margin in yield.

Please note that I cannot make application for new issues of bonds or shares, trade securities on your behalf or provide personal investment advice unless you have a sharebroking account opened through Canopus.

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

Our diversified income portfolio unit value eased a fraction in February as the New Zealand dollar gained 3.5% in one month against the AUD, cancelling out good gains in ASX-listed equities and pressuring Australian bonds in NZD terms. An unexpected intention by Contact Energy to apply new free cashflow to offshore thermal developments rather than increasing dividends didn't help either. Also, February is not a strong month for receipt of dividends and interest.

Our growth portfolio though managed a unit value gain of 1.82% during February even in the face of a surging NZD/AUD exchange rate.

Despite the ever-strengthening NZD and volatile but weaker equity markets in Australia and New Zealand, both portfolios are on track to record small gains in March as some individual equities do well and strong dividend and interest payments are received.

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

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.

Please note – Canopus does not pool investor funds. Each Canopus investor is treated as an individual with a personal customised investment portfolio being built to suit each individual's requirements. Investments are registered in your own name greatly enhancing returns, security and transparency while providing access to valuable special issues and minimising management fees. Individual voting rights attached to securities are retained by the investor. Uncommitted portfolio cash is held in the investor's own personal bank account with full online banking facilities. High liquidity of investments means the investor has ready access to funds if needed. Ultimately, the investor remains in control of the portfolio.

Regards,

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