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Investment Directions **30 March 2016**

"Analysis to action; opportunities to outcomes"

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1. **Overview** – US equity markets continue rebound as US Fed forecasts more caution on raising interest rates. European markets rally on major new ECB stimulus measures but fall back again on confusing announcement soon after. Possible election likely to have short term impact on equities in Australia. Data table suggests short term top in equities may have been reached.

2. **Equities** – BHP Billiton expected oil to be first of its commodities to recover but iron ore makes greater headway. Australian banks marked down on concern over increasing bad and doubtful debts but selling looks overdone with high dividends on offer.

3. **Interest rates, bonds and debentures** – Fisher and Paykel Finance may repay depositors early and seek alternative funding to issue of debentures. Rush of corporate bonds to market indicates CFOs believe interest rate cycle is near the bottom. Deposit rates for major S&P-rated finance companies.

4. **Strategy** – Portfolio values rebound in March. Income on savings, after tax and fees, heads for 7.1% and 6.0% respectively for income and growth portfolios during Financial Year 2015/16.

Space Exploration News

Bright spots in Occator Crater on Ceres shown in remarkable detail from Dawn spacecraft during lowest mapping orbit to date. See http://dawn.jpl.nasa.gov

Surface ice found in Oxo crater on Ceres surprises as the dwarf planet is warm enough for natural ice to sublimate into space. See report at
https://www.newscientist.com/article/2082050-ceres-surprises-with-water-ice-and-colourful-bright-spots

Low neutron counts indicate hydrogen abundance with potential for water ice within one metre of Ceres' surface near the poles. See http://www.jpl.nasa.gov/spaceimages/details.php?id=PIA20353

1. Overview

US markets continued their strong rebound during March, returning index levels to start of year values and appearing to form a near term top. Previous US Fed guidance indicating that just two additional 0.25% Federal Fund Target Rate rises may occur during 2016 rather than the four forecast in late 2015 appeared to be confirmed when Fed Chair, Janet Yellen, speaking on 29 March said caution in lifting rates is especially warranted as the global economy presents heightened risks. However, she was still confident US inflation would gradually return to the Fed's 2% goal. The expectation of even two hikes should put a limit on any near-term equities recovery but a reported negligible rise in US consumer spending and a retreat in inflation during February may yet force the US Federal Reserve to reconsider its target rate intentions yet again.

Major investment management firm PIMCO expects US growth in 2016 of 2.0% - 2.5% with inflation of 1.5% - 2.0%. European growth of about 1.5% is expected with very low inflation. For China, 6% growth and 2% inflation is predicted with Japan forecast to have 1% growth and 1% inflation. PIMCO sees no sign of a US recession quoting no over-consumption, no over-investment and no "overkill" by the Federal Reserve.

The RBNZ unexpectedly cut its OCR by 0.25% to 2.25% on 10 March, sparking a sharp NZD fall against the AUD just as the Australian currency was rising on higher commodity prices and the RBA decision on 1 March to leave its own OCR at 2.00%. Little strategy appeared to justify the RBNZ move – appearing more like reaction to banks' expectation of an OCR cut later in the year and pressure from the Minister of Finance.

New Zealand recorded an unexpected trade surplus of $8.1m in January c.f. -$245.5m expected, mainly due to higher than expected exports of wood, dairy and fruit. Apart from dairy, New Zealand's major export sectors are strong, helping support the NZD. A budget surplus of $934m for 7 months to the end of January was $724m above Treasury forecasts, due mainly to higher tax revenue and delays in some Treaty settlements.

Prime Minister John Key, fresh from humiliating defeat over his self-promoted flag referendum, looks to be suffering loss of political capital having committed the basic error of offending a large swathe of his own traditional voter base. Support for National dropped to 46% in the latest Roy Morgan poll, just 4 points ahead of a potential Labour/Greens coalition. Winston Peters was the big winner with NZ First up 3% to 9%, meaning Winston could yet be in a strong position to demand the Deputy Prime Ministership when offering Key his only chance of Prime Ministerial survival late in 2017.

But as in finance, in politics nothing is certain. Right on cue, Labour unintentionally rushed to John Key's rescue, "promoting discussion" on a "universal basic income", a simplistic "helicoptered money for all" idea locally attributed to former Clinton aide Robert Reich and media favourites such as Bernard Hickey and Gareth Morgan. In fact it's an old idea suggested by Milton Friedman nearly 50 years ago as part of a wider treatise. Various calculations have already put the cost in increased taxes as enormous.

It's no new idea that enabling large numbers of a growing world population to afford the benefits of technological revolution in both services and manufacturing is highly desirable from both a humanitarian point of view and as being essential to continued progress in advanced economies. Huge strides in productivity are pointless if markets for the output don't exist. Basic stuff.

But a cargo cult of free money for all is certainly not the answer. Reward for effort and engagement will remain essential, even as the collapse in traditional low skilled job numbers permeates further into the medium and even highly skilled work forces. Perhaps more realistic proposals such as extensive re-training programmes, shorter working hours, job sharing, entrepreneurship support and relocation assistance could all be joined with a gradual move towards equity sharing over a whole economy? The issue is too broad for detailed discussion here.

Our interest lies in assessing the impact of politics and policies on the future investment scene. If indeed Winston Peters does command a king-maker role after the 2017 election, we can expect substantially looser fiscal policy from government and forced relaxation of monetary policy from the Reserve Bank – to a lesser extent if Winston goes with National and a greater extent if he goes with Labour and Greens. Either way we should expect an initial surge in optimism and investment returns across the board quickly followed by devaluation of the New Zealand dollar favouring export industries at the expense of importers and the consumer. The impact should be particularly noticeable if, by that time, global interest rates have started to

follow the US lead higher.

In Australia politics are even more to the fore. Prime Minister Malcolm Turnbull has recalled parliament and threatened the Senate with a double dissolution if it fails to pass bills reconstituting the Australian Building and Construction Commission. The budget has been brought forward by a week to 3 May, paving the way for a possible winter election campaign with an election on 2 July. Given recent polls, an election could go either way. Turnbull says an election would be fought on economic management. Apart from an initial hiccup if Labour wins, the Australian investment scene seems unlikely to be significantly affected post the election. Any government will have to manage transition from a hard commodity export dependent economy to one much more diversified and service orientated. Until the issue of an election is decided late in April, expect high volatility in Australian equity markets with a downward trend.

Australia's Performance of Manufacturing Index (PMI) rose 0.2 to an expansionary 53.5 in February, the fastest rate of manufacturing growth in nearly six years but consumer confidence fell 2.6% for the week ending 26 February over concerns about the economy. MSM pushing the negative again?

The European Central Bank, on 10 March, announced major new anti-deflation moves comprising:

- Refinancing rate (lending rate to commercial banks) being lowered to 0% from +0.05%
- Deposit rate for commercial banks being lowered from -0.3% to -0.4%.
- Marginal lending facility (overnight credit rate to banks) being lowered from 0.3% to 0.25%.
- Monthly QE value of bond purchases being increased from €60B to €80B.
- ECB to start buying corporate bonds under its QE programme.
- An increase in financial system liquidity through another TLTRO (Targeted Long Term Refinancing Operation) offering cheap loans to banks.

European and global share markets initially reacted positively to the news but quickly fell back again to a negative close after the ECB indicated that it thought no further deposit rate cuts would be necessary. Then, on 18 March an interview with Peter Praet, Member of the ECB Executive Board, was published in which he said interest rates could go lower yet – leaving markets as confused as ever. Perhaps the ECB has been taking guidance lessons from the RBNZ!

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

	Latest	Feb 16	Jan 16	Dec 15	Nov 15	Oct 15	Sep 15
3 month LIBOR (end of month) %	.62835	.63310	.61560	.61270	.41620	.33410	.32500
TED Spread (points)	.33	.30	0.29	0.45	.20	.25	.34
VIX equity volatility	14.74	20.55	20.20	18.21	16.13	15.07	24.5
US LEI		+0.1%	-0.2%	-0.3%	+0.5%	+0.5%	+0.0%
Japan LEI			-1.1%	-0.5%	+0.1%	+0.0%	-0.8%
Eurozone LEI		-0.2%	+0.1%	+0.2%	+0.6%	+0.4%	-0.3%
Australia LEI			-0.4%	-0.3%	+0.2%	-0.1%	-0.4%
United Kingdom LEI			+0.2%	+0.3%	+0.4%	+0.4%	+0.1%
China LEI				n/a	+0.6%	+0.3%	+1.6%
US Money Market Funds $T	2.752	2.807	2.756	2.759	2.741	2.717	2.669
US Gov. 10 year T-Bond (%)	1.900	1.74	1.931	2.269	2.218	2.151	2.060
US 5 yr inflation expectations %	1.72	1.61	1.63	1.77	1.88	1.86	1.75
US high yield-treasury spread 3-5yr %	6.93	7.75	7.77	6.95	6.40	5.90	6.62
Foreign holdings of US T-Bonds $B			6183.1	6165.8	6125.7	6046.3	6101.7
Margin debt, NYSE (US$ millions)			447,681	461,200	472,772	471,922	453,896
US M2 Money Stock (US$B)	12,472.8	12,472.8	12,420.3	12,331	12,288	12,201	12,187
Velocity of Money US M2				1.483			1.493
CNN Fear and Greed Index	66	51	17	44	53	69	18
Insider Buy/Sell ratio (US) %	61	65	58	53	49	48	70
Forward P/E S&P 500 (12 month)	17.55	15.75	15.38	17.19	17.55	18.41	16.45
Trailing P/E S&P 500 (12 month)	23.53	21.82	20.69	22.65	23.18	22.07	20.59
Total Put/Call options ratio CBOE	1.06	1.20	0.91	1.00	1.07	0.95	0.97
S&P 500 Share Index	2035.94	1932.23	1940.24	2043.94	2080.41	2079.36	1920.03

The decline in high yield- US Treasury spread marks improving sentiment in US (and global) credit markets – a positive for equity markets. US inflation expectations are moving back towards the Fed target of 2%, making further rate rises more likely despite some short term data disappointments.

VIX equities volatility has fallen back to benign sentiment levels but other short term indicators point to a retreat from the latest peak lasting a month or so – taking us into the "sell in May and go away" period.

2. Equities

NZX settlement times have been reduced by one day to T+2, meaning for practical purposes, funds must be in a sharetrader's associated cash management account when a purchase order is placed. This is essential for purchase orders placed on the ASX. However, "buy" orders can still be offset with an equivalent "sell" order provided the sell trade occurs within T+2 days of the buy order being executed.

BHP Billiton (BHP:ASX), said it expected crude oil to be the first of its commodities to recover in price but iron ore has gained about 33% from the start of the year while crude oil, up 24% from its low in February, is just back to the price prevailing at the start of January of around US$38 per barrel. S&P has removed BHP from credit watch after introduction of the company's new dividend policy, saying BHP's financial flexibility had increased. Moodys, though, cut BHP's credit rating from A1 to A3 with a negative outlook.

The Samarco joint venture between Vale and BHP will pay US$2.3B over six years to reinstate damage from the broken dam in Brazil and pay compensation to those affected. The total settlement plan spans 15 years during which, the Brazilian Government says, US$5.1B will be paid. Some analysts believe Samarco will be largely able to self-fund the penalties with BHP and Vale having to make up any shortfall. Whether the JV will be able to continue production is in doubt.

The International Energy Agency believes crude oil prices may have bottomed in February owing to supply outages in Nigeria, Iraq and UAE plus signs that OPEC production may be falling faster than expected. Saudi-led efforts to squeeze out high cost US shale oil producers appear to be working with non-OPEC production expected to fall by 750,000 barrels per day in 2016. But world demand growth is expected to slow from 1.8m bpd in 2015 to 1.2m bpd in 2016 just as the Gulf of Mexico starts pumping increasing volumes, so the glut could resume, capping or even reversing recent gains.

Australian banks are again in the news. A highly negative report on Australian housing, predicting that a falling AUD would be disastrous for banks, insurers, mortgage brokers and real estate investment, was given front page billing by the Australian Financial Review on 24 February and credited with causing a sharp drop in bank share prices, wiping A$15B off market capitalisations in one day. The report was quickly picked up by would-be guru catastrophists as confirming their "end of Australia" predictions and the like. The report is now widely suspected as having been a blatant attempt to manipulate markets via unquestioning news media by a couple of fund managers engaging in long/short equity strategies. If so, it worked. Bank shares fell as intended. Short positions made handsome profits. Ordinary shareholders, panicked into selling, lost out.

The banks are now being sold down on reports of increasing bad and doubtful debts. **ANZ** announced an increase in provisions of A$100m to A$900m, against a company with issued capital of over A$57B. **Westpac (ASX:WBC)** has flagged a likely 10% increase in housing related provisions to A$25m but says it may also need to increase provisions relating to five large corporate clients.

Morgan Stanley analysts believe increased bad and doubtful debts will create a headwind of about 4% per annum over the next two years providing the housing market does not weaken suddenly. Lower write-backs and non-recurrence of collective provision releases will lead to increased impairment charges from bottom-of-the-cycle levels according to Morgan Stanley. Westpac remains its preferred bank of the big four due to a stronger capital position and lower risk profile. Despite the negativity Westpac's current dividend appears sustainable and would provide a cash yield of 6.2% at the current share price of A$29.98. Current selling

looks overdone.

3. Interest rates, bonds and debentures

Options for fixed interest investors continue to narrow as deposit rates fall further and the number of issuers may possibly decrease again. Fisher and Paykel Finance has notified investors that it may cease to become a deposit taking institution now that ownership has changed. A review of funding sources could result in existing depositors being repaid early.

The recent rush of bonds to market indicates that corporate Chief Financial Officers think interest rates are near the bottom of the current cycle and so are moving to lock in cheap funding for up to eight years.

Current major S&P rated finance company deposit rates, % p.a., quarterly interest payments:

Issuer	S&P rating	$ min	Call	3m	6m	9m	12m	18m	24m	36m	48m	60m
F&P Finance	BB	1000	2.85	3.15	3.65	3.75	3.85	3.95	4.10	4.25	4.35	4.45
F&P Finance	BB	25,000	2.85	3.30	3.80	3.90	4.00	4.10	4.25	4.40	4.50	4.60
Liberty Fin	BBB-	5,000		3.45	4.05	4.15	4.70	5.05	5.25	5.85	5.75	5.65
Liberty Fin	BBB-	20,000		3.60	4.20	4.30	4.85	5.20	5.40	6.00	5.90	5.80
Liberty Fin	BBB-	100,000		3.65	4.25	4.35	4.90	5.25	5.45	6.05	5.95	5.85
UDC Finance	AA-	5,000	2.45	2.90	3.30	3.30	3.60	3.25	3.35	3.40	3.45	3.75
UDC Finance	AA-	100,000	2.95	2.95	3.35	3.35	3.60	3.30	3.40	3.45	3.50	3.55

Canopus advisory clients receive a full rebate of any brokerage paid on term deposits.

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4. Strategy

When seeking equities for our portfolios we need to consider dividends as well as growth prospects. Growing dividends tend to reduce portfolio volatility over time as well as providing increased income for portfolio owners. Buying in at a good price gives an investor the important psychological comfort of a deep cushion when the inevitable downturns occur from time to time, greatly reducing the age-old human urge to “panic out at the bottom”. By staying in for the long term our investors can enjoy growing income yields, much higher income than currently available from prevailing deposit rates or bond yields alone, while still seeing portfolio capital values rise. Finding a balance between growth and sustainable dividends inevitably requires compromise – highest dividend paying shares rarely coincide with good growth and visa-versa. Occasionally a portfolio component will need to be culled after failing to meet expectations or when forward looking risk for a particular share rises to an unacceptable level.

Both our published income and growth portfolios have made strong recoveries during March, erasing the brief but sharp capital value falls seen in the first six weeks of the year. Income on savings, after tax and after fees, for 2015/16 should be about 7.1% and 6.0% for the income and growth portfolios respectively.

Some reaction to the sharp equity market rises in late February and March should be expected, presenting an opportunity to add a small number of blue chips meeting our investment criteria to portfolios at reasonable prices. We may stand aside Australian share purchases until the election issue is sorted out. However, if an election does not eventuate, a short sharp rebound could well occur and we would want to be positioned to take advantage of such a move by having bought a few top shares at good prices.

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

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Regards,

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