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Investment Directions

29 September 2015

"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – US Fed passes on interest rate rise in September but reaffirms guidance for a rise this year as negative consequences of ultra-low rate environment compound. Fed intends to keep highly accommodative monetary conditions through retention of massive balance sheet. New Australian PM expected to provide stronger economic leadership. OCR on hold in Australia while NZ has downward bias.

2. **Equities** – Expectations of poor third quarter earnings by US corporates could depress equity prices further. Blue chip shares in Australia and New Zealand offering good value but patience required.

3. **Interest rates, bonds and debentures** – Deposit rates still falling. Latest investment rates from major deposit taking institutions.

4. **Strategy** – Looking for opportunities to pick up bargains in blue chip equities and listed property over the next couple of months but wary of likely weakness in global equities during October, triggered by expectation of weak US reporting season.

Space News

NASA confirms evidence of flowing water on Mars, news release 29 September 2015 (NZ time) http://www.nasa.gov/press-release/nasa-confirms-evidence-that-liquid-water-flows-on-today-s-mars

Bright spots in Occator crater on Ceres seen in ever more detail as Dawn moves closer. Truly striking images now of a minor planet that was, until just a few months ago, nothing but a fuzzy spot in the biggest telescopes. "Soon, the scientific analysis will reveal the geological and chemical nature of this mysterious and mesmerizing extraterrestrial scenery". See http://dawn.jpl.nasa.gov/news/news-detail.html?id=4714

1. Overview

The US Fed Federal Open Market Committee (FOMC) gave little new guidance in its 17 September statement in which the target federal funds rate was held at 0 – 0.25%. Overall the Fed simply restated its known position of wanting to see more progress towards its twin goals of maximum employment and price stability (2% inflation) before making a first move towards higher rates. The Fed believes recent global financial developments are likely to put downward pressure on inflation rates in the near term. US equity markets responded by quickly settling back into their five-month negative channel. The Dow Jones Industrial Average is now down 11% since its peak in May and off 8.5% for the 2015 calendar year. Equity markets interpreted the Fed's commentary as revealing a lack of confidence in the US economic recovery. Although traditionally weak September is largely gone, awareness of October as the producer of crashes (1929, 1987, 2008) should keep equity investors away from the "buy" side for now. Equities could well move up once the first Fed rates rise is announced.

Negative effects of holding US short term interest rates at ultra-low levels since 2008 are compounding. "Lift-off" seems just a matter of time with markets still expecting a first move this year, probably December, but October remains a possibility. To recap, while undoubtedly assisting a US economic recovery, excessively low short term rates have, on the downside:

- Encouraged irresponsible borrowing, both private and business, especially in emerging economies where defaults and bankruptcies are now reported to be growing swiftly.
- Steepened the US yield curve, attracting US dollar buying at the expense of emerging economy currencies, massively increasing unhedged US dollar denominated debt burdens.
- Encouraged build-up of debt for speculation in assets - particularly property and equities (through margin trading).
- Promoted "moral hazard" in business management such as buying back company shares with cheap borrowed money, artificially boosting returns per share and hence management bonuses.
- Pushed retirees and other "low risk" investors into much riskier investments in search of yield as incomes decline.
- Distorted financial institution profits with ability to borrow at next to nothing and lend at 3% - 4% in the US.

Furthermore, persistence with near zero interest rates means the US Fed has no interest rate ammunition left to help counter any future financial crisis.

The Fed intends to continue reinvesting principal repayments from its existing huge holdings of US agency mortgage-backed securities and agency debt back into more agency mortgage-backed securities while, at the same time, rolling over maturing US Treasury securities at auction. Thus "highly accommodative" monetary conditions will be maintained but the Fed is forgoing the opportunity to reduce its bloated balance sheet while it has the chance. For now, demand for US Treasury securities is still high from offshore buyers, allowing the Fed to reduce purchases, and the size of its balance sheet, if it so wishes.

The US Commerce Department has revised upwards its estimate of US growth to an annual rate of 3.9% in the second quarter of 2015, further boosting chances the Fed will start raising interest rates this year.

In Australia, Malcolm Turnbull gathered enough support to roll Tony Abbott as Prime Minister as poll after poll clearly indicated that a Tony Abbott-led Liberal/National Party coalition would be out at the next election. Turnbull is expected to provide clearer economic leadership and adopt a more consensus-style approach when it comes to policy formation although a commitment to continuation of some major Abbot principles was apparently the price of sufficient support for a successful coup. Initially, at least, the move appears to have been met with public approval, putting the Government back in a contestable position. Turnbull will have just one chance to consolidate his "honey moon" into an election win.

The RBA kept its OCR at 2% on 15 September, noting that although a weakening economy and financial markets in China had led to a sharp decline in global equity markets, functioning of other financial markets had not been impaired and funding remained readily available to creditworthy borrowers. Low interest rates and the lower AUD are expected to support growth in the non-mining sectors. Resource exports had grown strongly over the past year and further growth was expected from liquefied natural gas. Holding the Australian OCR at 2% for a long time appears likely.

The Reserve Bank of New Zealand again lowered its OCR on 9 September by 0.25%, to 2.75%, citing as reasons a lower economic growth outlook due to the sharp decline in export prices, plateauing of construction activity in Christchurch and a weakening in business and consumer confidence. However, economic growth is around 2% supported by robust tourism, strong immigration, a large pipeline of construction projects and depreciation of the NZ dollar. Auckland housing construction is increasing but will take some time to correct the supply and demand imbalance. Headline inflation remains below the 1% – 3% target range but is expected to return within the range in early 2016 as the earlier petrol price decline drops out of the CPI calculation and the lower exchange rate passes into higher priced imports. The RBNZ believes further easing of the OCR seems likely but will depend on the data.

In Europe, revelation of emission-standards cheating by giant car maker Volkswagen was sufficient to roil international equity markets – a genuine "unknown unknown' on the Rumsfeld scale. Possible extension of the scandal to other manufacturers, so far denied, saw a nascent recovery from the 11% S&P 500 drop in August snuffed out.

Tsipras won the Greek elections on 20 September, falling just short of an outright majority. His Syriza party, having seen its hard core left depart and erratic former finance minister Yanis Varoufakis gone, should be able to bring a more competent team to negotiations with Greece's creditors – something Europe badly needs.

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

	Latest	Aug 15	Jul 15	Jun 15	May 15	Apr 15	Mar 15
3 month LIBOR (end of month) %	.32610	.32900	.30860	.28175	.28275	.27875	.27075
TED Spread (points)	.33	.27	.23	.27	.27	.27	.24
VIX equity volatility	23.62	28.43	12.12	18.23	13.84	14.55	15.29
US LEI		+0.1%	0.0%	+0.6%	+0.6%	+0.6%	+0.4%
Japan LEI			-0.1%	+0.8%	+0.1%	+0.0%	-0.4%
Eurozone LEI		+0.3%	+0.3%	+0.5%	+0.3%	+0.5%	+0.6%
Australia LEI			+0.3%	-0.3%	-0.2%	-0.3%	+0.0%
United Kingdom LEI			-0.3%	-0.3%	-0.5%	+0.3%	+0.2%
China LEI		+1.0%	+0.9%	+0.5%	+1.1%	+1.5%	+0.2%
US Money Market Funds $T	2.660	2.694	2.648	2.618	2.615	2.582	2.634
US Gov. 10 year T-Bond (%)	2.168	2.200	2.205	2.335	2.095	2.046	1.93
Foreign holdings of US T-Bonds $B			6076.6	6175.2	6134.8	6137.3	6175.9
Margin debt, NYSE (US$ millions)		473,412	487,345	504,975	499,143	507,153	476,381
US M2 Money Stock (US$B)		12,138	12,059	11,982	11,938	11,895	11,846
Velocity of Money US M2				1.501			1.497
CNN Fear and Greed Index	18	3	9				
Insider Buy/Sell ratio (US) %	70	68	38	39	38	32	32
Forward P/E S&P 500 (12 month)	16.45	17.42	17.82	17.81	17.89	18.05	17.62
Trailing P/E S&P 500 (12 month)	20.59	21.63	21.18	21.52	21.47	20.98	20.52
Total Put/Call options ratio CBOE	1.30	1.20	1.00	1.10	1.15	1.05	1.13
S&P 500 Share Index	1931.34	1972.18	2103.84	2063.11	2107.39	2085.51	2067.89

Margin debt on the NYSE retreated to US$473B at the end of August, down as expected but not nearly as far as would be expected under more "normal" monetary conditions. But US monetary conditions are far from normal and the US Fed intends to keep it that way for an extended time. Enormous amounts of cash remain available to speculators, throwing the usual contraction and correlation scenario into doubt. Nevertheless, the credit balance of US margin traders (including cash account balances) is hugely negative and must serve as a warning that further weakness in US equities lies ahead.

Another sharp rise in the Put/Call options ratio gives a further negative sign while, at 18, the "Fear and Greed" Index is still in "extreme fear" territory.

After a sharp spike to 40.74, just *after* to the August equities slump, VIX volatility has returned to calmer levels. VIX volatility failed to provide any degree of foresight into the sharp market correction over 18 to 24 August.

2. Equities

Analysts have been downgrading S&P 500 profit forecasts for the US third quarter earnings season which ends on 30 September. An overall decline of 3.9%, year on year, is predicted owing to lower oil prices, the strong US dollar and weak global demand – especially China's falling commodity needs. Energy sector profitability is expected to be the big negative, falling 64.7 percent. Omitting energy is calculated to result in a forecast profit increase of 3.7% for the other sectors. Should lower profit forecasts be confirmed as the reporting season unfolds, forward S&P 500 P/E ratio, currently at 16.45, could undershoot on the downside producing another weak October for equity prices. Although a majority of companies usually end up reporting results better than forecast, the significant potential for yet lower US equity prices gives cause to pause when considering purchases over the next few weeks.

Australian energy and resource stocks have already been heavily discounted in expectation of lower earnings. Whether current prices fully reflect actual results remains to be seen.

New Zealand equity markets, even with much less exposure to resources and energy (local power companies excepted) would likely be dragged down in concert with any new bouts of weakness in the US and Australia. Quite exceptional opportunities may then arise in the local market to purchase non-resource related shares at attractive prices.

Fletcher Building (NZX:FBU) shares, knocked down to bargain basement levels under ongoing media commentary of a weakening Australian economy, wind down of the Christchurch rebuild and slowing growth in New Zealand, offers a prospective yield of over 6% for the 2015/16 year. The shares are currently trading ex a 19 cps final dividend payable to holders registered on 25 September. In addition to a high dividend yield, analysts forecast Fletcher Building to provide modest growth in profit and dividends with at least 50% dividend imputation over the next two years.

Still no word on any further capital-raising move by **Westpac Bank (ASX:WBC).** Many shareholders dislike a company asking for money, overlooking the advantage a well-priced issue can offer. Such concern would appear, in part at least, to be responsible for the current weak Westpac share price. To repeat last month's note:

Analysts estimate **Westpac Bank (ASX:WBC)** will need to raise another A$3B before 1 July 2016 to remain ranked in the top quartile of its global peers on a tier-1 equity basis. Additional capital is then expected to be needed before the end of FY 2018, expected to be derived from dividend reinvestment, profit retention and/or additional asset sales. 2016 capital raising options include a special share purchase plan, an institutional placement, dividend reinvestment plan and asset sales. In this exercise Westpac will be following the lead of the other Australian big four. Reaction to negative press coverage of capital requirements and likely lower dividend growth has helped push bank share prices down 25% in just four months. After the latest global market sell-off, Westpac sits on a dividend yield of nearly 6% and P/E near 13. Westpac has missed the boat somewhat if it chooses to raise capital via a special share purchase plan or pro-rata cash issue to existing shareholders and will have to offer a generous discount in order to ensure success of the issue. The result could be a special opportunity for existing Westpac shareholders to add to holdings at a particularly attractive price. The high dividend yield appears sustainable for the mid-term future at least.

Although forecast growth is very modest, increased capital solidifies the big Australian banks as core portfolio holdings.

At current prices Westpac offers a cash yield of over 6%. Analysts still forecast modest earnings per share growth as well as increasing dividends.

3. Interest rates, bonds and debentures

Deposit rates keep falling with F&P Finance, Heartland and UDC all lowering rates during September. Again, the rate reductions are large, up to 0.30% p.a. for a number of terms.

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	3.60*	3.05	3.50	3.50	3.70	3.65	3.70	3.75	3.80	3.90
Heartland Bnk	20,000	3.60*	3.15	3.50	3.60	3.70	3.75	3.75	3.85	3.90	4.00
Liberty Fin.	5,000		3.95	4.55	4.85	5.20	5.55	5.80	6.40	6.40	6.30
Liberty Fin.	20,000		4.10	4.70	5.00	5.35	5.70	5.95	6.55	6.55	6.45
Liberty Fin.	100,000		4.15	4.75	5.05	5.40	5.75	6.00	6.60	6.60	6.50
UDC Finance	5000	2.95	3.20	3.50	3.55	3.65	3.55	3.60	3.65	3.75	3.70
UDC Finance	100,000	3.45	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.

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

We will be looking for firmer guidance, if not action, from the US Fed on movement in the target federal funds rate, hopefully to coincide with a calm October. Late October and early November may present an opportunity to return to equity markets for blue chip shares at good prices, high yields and with a stronger outlook going into the New Year. After many months of slow declines, listed property companies and trusts in both New Zealand and Australia may well have bottomed out, offering high yields plus some degree of growth and high dividend yields in an investment sector regarded as one of the most reliable over the long term. Expectations of higher interest rates appear to be already built in to listed property prices and, in any case, may well be misplaced as reserve bank OCR intentions in both countries retain a neutral or negative bias.

The Fed's commitment to highly accommodative monetary conditions appears to be breaking down the traditional correlation between US equity indices and the level of margin debt. Only a minor decrease in margin debt accompanied the sharp 26 August market correction whereas, under more "normal" conditions, we could have expected a slump in outstanding margin account balances. Hence we are placing less emphasis on this data now than we normally would – but we still await the September figure with keen interest.

With an outlook of lower or neutral interest rate movements in Australia and New Zealand compared to higher US rates, the forecast must be for still lower AUD and NZD exchange rates versus the USD. In selecting equities to purchase, companies with strong US dollar earnings should command special attention.

Our income portfolio unit retreated 2.25% to $1.3295 in August while the growth portfolio unit lost 2.60% to $1.5090.

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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