Canopus Investments Limited

Investment Advice Sharebroking Managed Funds Fixed Interest Property Company Formations Trade Mark Registration

P O Box 101 662
North Shore Mail Centre
Auckland
New Zealand

Phone: +64 9 444 8055
+64 9 444 8056
Fax: +64 9 444 8059
Websites: www.canopus.co.nz
www.international-equities.com

Unsolicited Electronic Messages Act 2007. If you do not wish to receive further issues of "Investment Directions" or other investment messages from Canopus, please reply to this message with "Remove" in the subject line.

Investment Directions **30 August 2016**

"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – Little useful Fed interest rate guidance from Yellen at Jackson Hole. Mid December first practical opportunity for Fed to raise rates but data remains inconclusive. Outside the US, central banks plough on with quantitative easing. New Zealand and Australian reserve banks lower OCRs with more expected – more so in Australia than New Zealand. Dairy prices respond upwards as increased demand starts meeting reduced supply. NZD set to stay strong.

2. **Equities** – Marlin warrants flop. Commentary on some portfolio holdings – Fletcher Building, Infratil, BHP and power companies.

3. **Interest rates, bonds and debentures** – Deposit rates stable during August but UDC makes small increase in some term rates. Deposit rates for major S&P-rated finance companies.

4. **Strategy** – Portfolios hold on to gains from July. Forthcoming US presidential election added to traditional equities weakness during September and October should hold back sharemarkets for 2-3 months. But all financial predictions now made are against an unprecedented background of massive money creation – with unforeseen consequences still unfolding.

Space Exploration News

Earth-sized planet found orbiting our nearest stellar neighbour, Proxima Centauri, possibly at right distance from its sun to hold liquid water http://www.skyandtelescope.com/astronomy-news/exoplanet-found-around-proxima-centauri-2408201623

1. Overview

Despite eight of the US Federal banks now reported as being in favour of an increase in the discount rate - the rate the US Fed charges banks for emergency loans (up from 6 in June) - the US Fed is unlikely to raise its federal funds target rate in September. Firstly because the data is not yet strong enough and secondly because the Fed would be very reluctant to raise rates during a presidential election campaign. Ten of the 17 Federal policy makers have votes on the rate-setting committee at any one time, so the growing numbers in favour of higher rates does indicate higher rates are coming – but not just yet.

Election Day is Tuesday, 8 November, which would seem to rule out a rise at the US Fed's November meeting to be held on 1 and 2 November. That leaves only the 13 and 14 December Fed meeting as holding a

real possibility of producing a rise this year. The Federal funds current target range is 0.25% - 0.50%, the introduction of which caused a brief but sharp downturn in equity markets when set in January 2016.

Fed Chair, Janet Yellen's speech to the Jackson Hole central bankers meeting on 26 August gave little additional guidance as to when the next rate rise would come, other than to state that the case for a rise is strengthening and repeat that a rise in 2016 is still on the table. However, the meeting of world central bankers declined to consider seriously any radical proposals to provide additional economic stimulus such as raising inflation targets, retaining permanently large balance sheets or even the abolition of cash. Although not mentioned in reports, radical proposals would include "helicopter money" – i.e. direct purchase by central banks of government bonds issued to raise funds for major infrastructure projects, seen as a means of pushing money out to workers who would spend instead of save or speculate. Nonetheless, regions such as Japan and Europe, with entrenched deflation, negative interest rates and minimal growth, must now be getting desperate enough to place it on their own agendas.

As at the end of August, US equity markets look to have absorbed Janet Yellen's speech with little concern for a short term rate rise. But the possibility of one in December, coupled with the traditional weak months of September and October, should give equity markets cause for restraint.

US retail sales were unexpectedly flat in July. Producer prices fell as costs for services and energy goods declined. The sharp pickup in US economic growth expected in 3Q16 must now be in doubt, adding further argument against a near term interest rate rise. Mid-December remains the only realistic possibility for a rise in 2016.

Clinton remains ahead in the polls. A late attempt by Trump to become "more presidential" looks ineffective. Any reversal in fortunes would be viewed negatively by equity markets – but two months is a very long time in politics. The real surprise is that Clinton is still only 6% ahead of Trump in the polls and that, theoretically at least, still leaves him within striking distance.

New Zealand's dairy market auction overnight on 18 August produced higher prices than expected, driving the New Zealand dollar up against major currencies. New Zealand's single largest export, whole milk powder, increased 19% to US$2695 per tonne as global demand reacted to falling global supply. Fonterra increased its forecast 2016/17 farmgate milk price by 50 cents to $4.75 per kg of milk solids. Unemployment fell to 5.1% in the June quarter, down from 5.2% in the 3 months to 31 March.

The RBNZ cut its New Zealand's OCR by 0.25% to 2.00% on 11 August, following a similar sized cut by the RBA in Australia to 1.50% on 2 August. Although the RBNZ gave guidance of another cut to come in 2017, the narrative was less "dovish" than many economists had expected – some of whom had been expecting a 0.50% cut at the August release. RBNZ Governor Wheeler followed up with a speech released on 22 August stating he doesn't see the need for a "slash and burn" approach to interest rates and reiterating his confidence in the New Zealand economy – expecting annual growth of 3.5%. Wheeler is concerned that a rapid decrease in interest rates would further inflame the surging property market and exhaust the bank's capacity to respond to future financial shocks – putting at risk the Reserve Bank's ability "to avoid unnecessary instability in output, interest rates and the exchange rate".

Consequently hopes for a lower NZ dollar were once again frustrated with the kiwi currency rising against those of its major trading partners and the broader trade weighted index.

Governor Wheeler's commentary, a growing economy and the attraction of relatively high yields all point to the New Zealand dollar remaining high or higher against all comers in the months ahead.

As in Australia, New Zealand banks did not pass on the full 0.25% OCR cut to borrowers but spread a portion of the benefit as higher deposit rates for savers. However, banks stand to gain from slightly higher margins overall from the exercise since deposits are only a small fraction of banking business compared to mortgages. Deposits are said to be only 16% of mortgages by value.

In the UK, the BoE cut its base interest rate by 0.25% to 0.25% on 4 August and announced further stimulus through an intention to purchase £10B of UK corporate debt as well as expanding its UK government bond buying program by £60B. Larger than expected, the new stimulus put downward pressure on the pound and

boosted the FTSE. The pound is liable to be hit further once "Article 50" is triggered – an announcement of the UK's notification to leave the EU. PM Theresa May is thought to be considering April 2017 at the latest.

In the EU, more confirmation of "lower for longer" comes with news that Bank of Ireland will start charging 0.1% on deposits of €10m or more from 10 October, blaming the European Central Bank's introduction of negative interest rates (-0.4% overnight) earlier in 2016. Bank of Ireland thus joins Royal Bank of Scotland (its parent) and a growing number of other European banks in charging negative interest rates on deposits. Through negative interest rates the ECB and European banks hope to push huge quantities of recently created money out of their (electronic) vaults and into the real economy to spur investment, inflation and jobs, but demand for loans remains depressed despite all efforts. Major Dutch bank ABN Ambro is also reported to have advised business clients that new terms and conditions will allow the bank to charge negative interest rates on deposits. So negative interest rates, already the rule for European government bonds and making an appearance in corporate bonds too, are now spreading to bank deposits.

Japan's central bank kept its policy rate at -0.1% but almost doubled the amount of stimulus to be injected via purchase of exchange traded funds (ETFs) to 6T Yen. However, the measure was actually below market expectations, leading to a rise in the Yen vs the USD – not a welcome outcome from the Japanese point of view.

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

	Latest	Jul 16	Jun 16	May 16	Apr 16	Mar 16	Feb 16
3 month LIBOR (end of month) %	.82544	.75150	.6311	.67305	.63835	.62820	.63310
TED Spread (points)	.53	.49	.39	.35	.42	.42	.30
VIX equity volatility	13.65	11.87	15.63	14.19	15.70	13.95	20.55
US LEI		+0.4	+0.3%	-0.2%	+0.5%	+0.1%	-0.5%
Japan LEI			+1.1%	-0.8%	-0.8%	+0.1%	-0.3%
Eurozone LEI		-0.1%	-0.1%	+0.2%	+0.0%	+0.3%	-0.2%
Australia LEI			+0.1%	+0.1%	+0.5%	+0.1%	-0.5%
United Kingdom LEI			-0.3%	-0.2%	-0.1%	-0.1%	+0.1%
China LEI		+0.7%	+0.5%	+0.4%	-0.1%	+0.4%	+0.3%
US Money Market Funds $T	2.735	2.715	2.718	2.733	2.709	2.765	2.807
US Gov. 10 year T-Bond (%)	1.635	1.458	1.488	1.834	1.819	1.786	1.740
US 5 yr inflation expectations %	1.65	1.67	1.42	1.61	1.82	1.75	1.61
US high yield-treasury spread 3-5yr %	5.13	5.69	6.21	5.97	6.24	7.05	7.75
Foreign holdings of US T-Bonds $B			6281.0	6209.9	6238.5	6287.0	6236.2
Margin debt, NYSE (US$ millions)			447,337	451,094	455,646	445,846	435,814
US M2 Money Stock (US$B)		12891.8	12811.4	12733.5	12654.2	12572.9	12485.2
Velocity of Money US M2			1.448			1.463	
CNN Fear and Greed Index	63	82	44	77	72	64	51
AAII sentiment survey (% bullish)	29.4	31.3	29.0	17.8	27.4	27.2	32.0
US retail & food service sales US$B		457.727	457.901	454.135	453.397		
Insider Buy/Sell ratio (US) %	31	34	45	44	41	58	65
Forward P/E S&P 500 (12 month)	18.59	18.93	17.99	17.75	17.80	17.55	15.75
Trailing P/E S&P 500 (12 month)	24.71	24.87	24.22	24.04	24.11	23.53	21.82
Total Put/Call options ratio CBOE	1.04	1.20	1.23	0.93	1.15	1.08	1.20
S&P 500 Share Index	2169.04	2173.60	2098.86	2096.95	2065.30	2059.74	1932.23

This month we received another reading of "velocity of money" i.e. a measure of the rate at which a dollar is used for transactions in the US economy. This important series of figures continues downwards, setting ever new lows since the record began in 1959. Clearly the vast amounts of money created through US (and other) quantitative easing programs have still not provided the economic stimulus intended, with new money largely being held either in commercial banks' accounts with the Federal Reserve or being used by those with access to the funds for speculative purchase of assets – mainly property and shares and even bonds. Speculators are becoming hoarders as asset buyers around the world seek to protect themselves from potential massive

debasement of currencies at some unknown time in the future. The continuing decline in velocity of money effectively locks in “lower for longer” interest rates for longer still.
Free flow of huge quantities of newly created capital around the world means economies avoiding domestic QE programs, including New Zealand, do not escape the effects. Irrespective of whether new money comes directly from overseas or channelled through local banks to resident buyers, the effect is to push up house prices at hyper-inflationary rates in Auckland – just as in Sydney, London, New York or wherever.

Central banks have no scope to use higher interest rates as a lever against asset price inflation while consumer inflation remains ultra-low or even negative. Broader measures to rein in rising house prices – in NZ and elsewhere – such as higher deposit ratios and loan to income limits, tend to protect bank balance sheets rather than assist first time buyers onto the property ladder. Eventually populist political pressure will likely force governments to implement Muldoonist-style control of housing markets but equity markets, not viewed as a vital “social good”, should be left largely alone. Expect more “macro-prudential” tools aimed at house prices from both government and reserve bank as current moves are found wanting.

Velocity of money, together with US retail and food service sales, gives us an indication of whether QE created money is moving out into the real economy – to be used for the purchase of goods and services with the potential to push up long-stagnant consumer inflation as opposed to entrenched asset hyper-inflation. A sudden surge in velocity of money or retail and food service sales would demand quick reversal of central bank accommodative monetary policies. Highly leveraged speculators, forced to sell, would suffer a swift downturn in fortunes but fully funded asset holders would be well positioned to benefit from cheaper asset prices in future.

US retail and food service sales effectively capture the outcome of US employment trends. Job numbers may be up but overall reward through higher pay is showing little improvement.

For now though, we remain in a highly accommodative central bank climate with no indication that any move towards much stronger economic growth, significant increases in demand for goods and services or higher consumer inflation is imminent. The US Federal Reserve struggles to find data to support even the most minimal of interest rate rises back towards normalcy.

Hence holding sound assets remains justified on the dual bases of wealth protection and income production but using high leverage to acquire such assets, a profitable venture up to now, grows increasingly risky.

2. Equities

Marlin Global (NZX:MLN) saw only 1,419,270 warrants converted to ordinary shares out of a possible 27,546,716, adding just $1,149,609 to company capital out of a potential $22,312,840 on the exercise date of 5 August, at the new share price of 81 cents. On 5 August, MLN warrants traded “out of the money” with the head shares at 79 cents, making warrant holders reluctant to pay 81 cents for new shares they could buy cheaper on market. Questions will now be raised as to how Marlin will fund the 2% NTA per quarter distribution to which the directors appear wedded. Sale of some assets could well be necessary if the dividend policy is to continue. Fisher Funds doesn’t have a good record of raising capital via the many issues of warrants the listed investment company manager has tried over several years – with only the New Zealand focused **Kingfish Limited (NZX:KFL)** having benefited to any appreciable extent. In future Fisher Funds should consider a straightforward entitlement issue, attaching more certainty to the receipt of new capital, rather than the uncertainty and likely failure of more and expensive warrant issues.

Fletcher Building (NZX:FBU) produced a strong performance for the year to 30 June 2016 with net earnings up 71% to $462m. Earnings per share, also up 71%, were 67.0 cps on revenue up 4% to $9.004B. Operating earnings (EBIT) are expected to be $720m - $760m in FY17 c.f. $682m for FY16. Total dividend for the year was up 5% at 39.0 cps, fully imputed and FBU expects the FY17 dividend to be fully imputed as well. Residential construction is gaining from immigration and an increase in consents which is expected to peak in 2018 – but peak construction should lag peak consents. However, Australian consents are on the decline after peaking in December 2015. Debt/(debt + equity) is down from 32% to 27% but return on average funds is also down at 1.59% from 2.02% in FY15. At current share prices around $10.50, dividend yield is about 3.7%, but

is tipped to grow to 45 cps in FY18, giving a respectable cash yield of 4.3% with 100% imputation credits attached.
New Zealand retail power companies such as **Contact Energy (NZX:CEN), Meridian Energy (NZX:MEL), Mercury Energy (NZX:MCY) and Trustpower (NZX:TPW)** are finally seeing a measure of share price appreciation as electricity consumption projections move into positive territory – after years of constant or declining demand predictions. Higher usage is expected to result from the growing New Zealand population and greater manufacturing demand. Ongoing cold weather snaps should help. Although representing an unhealthy heavy weighting of large-cap NZX-listed companies, the "gentailers" have come to provide a reliable source of dividends from a relatively stable utilities sector at a time when bond and bank deposit yields have fallen dramatically. An improved prospect of dividend increases with addition of some capital growth is long overdue. Weakness in power company share prices over the next few months, along with a general market decline, could offer opportunities to add good income yield to portfolios at reasonable cost.

Infratil (NZX:IFT), in a 50/50 joint venture with Australia's Commonwealth Superannuation Corporation, has paid A$82.5M for a 30 year contract to manage nine student accommodation facilities for the Australian National University in ACT, totalling about 3760 beds. The contract covers building maintenance and provision of utilities ("hard" facilities). The ANU purchase comes after Infratil paid A$392m for a 48% share of Canberra Data Centres in conjunction with the same partner (pending FIRB approval). Following its cash rich disposal of Z Energy and iSites, these purchases develop further Infratil's move to diversify into growing societal demand sectors such as renewable energy, data infrastructure and aged care which are expected to produce strong shareholder returns in future years. Infratil forecasts a big increase in capital expenditure in FY2017 of $785-$860m, up from $220.9m in FY16. Total ordinary dividend for the year ended 31 March 2016 was up 14% on FY15, based on EBITDAF from continuing operations up 2.5% to $462m and a record parent surplus of $438m. FY2017 guidance is for underlying EBITDAF to be in the range $485m - $525m with "continued growth" in dividends. Rather modest share price growth over the past 20 months belies the strong shareholder benefits from growing dividends with100% imputation credits, reasonably high yield and favourable outlook. Infratil remains one of our favoured core portfolio holdings.

BHP Billiton (ASX:BHP) recorded a loss of US$6.4B for the year to 30 June 2016, c.f. US$1.9B profit the previous year. The FY16 year result reflected lower commodity prices, especially oil and copper, as well as write-downs related to US assets (-US$4.9B) and the Brazilian Samarco Dam rupture (-US$2.2B). BHP paid global tax of US$570m.

BHP's underlying profit of US$1.2B was down 81% on FY15 but ahead of the average US$1.09B picked by analysts. Final dividend was cut to US$0.14 per share (US 62 cps last year) bringing total dividends for FY16 to just US$0.30 per share c.f. US$1.24 in FY15. BHP expects free cash flow in FY17 to grow to more than US$7.0B continuing the productivity gains in FY16 that generated US$3.4B in FY16. Longer term BHP believes the outlook for commodities is favourable, especially for oil and copper.

BHP's share price reacted favourably to the result being largely as expected but dividend yield is now only 1.5%.

BHP is still a big resource stock favoured by many analysts but unfinished business surrounding liability for Samarco and high net debt of US$26.1B means risk remains high.

3. Interest rates, bonds and debentures

Little movement in deposit rates during August. UDC has moved 12 month and 18 month rates up slightly.

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	2.50	2.95	3.65	3.70	3.75	3.80	3.85	3.90	3.95	4.05
F&P Finance	BB	25,000	2.50	3.10	3.80	3.85	3.90	3.95	4.00	4.05	4.10	4.20
Liberty Fin	BBB-	5,000		3.30	3.85	4.10	4.40	4.80	4.95	5.15	5.40	5.65
Liberty Fin	BBB-	20,000		3.40	3.95	4.15	4.65	4.85	5.00	5.40	5.55	5.75

Liberty Fin	BBB-	100,000		3.50	4.05	4.25	4.75	5.00	5.20	5.50	5.60	5.80
UDC Finance	AA-	5,000	2.20	2.70	3.20	3.50	3.55	3.65	3.30	3.30	3.30	3.40
UDC Finance	AA-	100,000	2.70	2.75	3.25	3.50	3.55	3.65	3.35	3.35	3.35	3.45

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

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

A sharp rise in longer term US T-bond rates, Libor and Ted spread towards the end of August, hinging on expectations for Janet Yellen's speech at Jackson Hole, gave impetus to a late sell-off in global equities on 26 August after a steady month for the S&P 500 up until then. Although no rate rise seems likely until mid-December, equities restraint should follow through at least until the US presidential election. A Trump victory against all odds after a campaign marked by Clinton leading in all polls, would certainly slam equity markets into reverse for a while. Also we must stay aware of traditional sharemarket weakness during September and October.

The next 2-3 months looks like a good time to spend on analysis while keeping powder dry.

But every financial prediction these days has to be made against the unprecedented background of massive money creation undertaken by central banks to fight deflation in major world economies over the past four years. These programs continue with unforeseen effects still unfolding. Main stream media bombard us daily with stories of property bubbles about to burst and our inboxes bulge with advice from "experts" repeating the same dire - and wrong - forecasts they've been pushing for years predicting the imminent share market crash and offering their expensive solution of how to avoid it! Almost without exception these "catastrophic" forecasts overlook the asset price hyperinflation produced by years of quantitative easing – and much of that new money still hasn't even reached circulation. Maybe, just maybe, much of that tremendous global debt we are told is about to bring the financial house of cards crashing down, will eventually be inflated away – just as in years gone by.

A good case can be made for holding on to assets, especially shares and property.

Our published personalised portfolios held onto July's gains during August, despite weakness in Australian equities and a higher NZD/AUD exchange rate. Some dividend and interest payments for August are still to come. We declined to exercise Marlin warrants. Published returns are after fees and tax at the investor's prescribed rate on portfolio investments.

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

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 an ASB Securities sharebroking account opened through Canopus.

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.

Canopus does not cancel portfolio units to meet fees. In Canopus portfolios, fees are taken on the nose as a portfolio expense. Hence, if you start with 100,000 units of $1.00 and make no further contributions or withdrawals, you will still have 100,000 units years later. The number won't be whittled away and the current unit value times the original number of units will represent your true portfolio value.

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 the investor'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 portfolio owner remains in control of the portfolio.

Regards,

Alan King
Authorised Financial Adviser
Canopus Investments Limited FSP31002
Email: alan@canopus.co.nz
Mob: 0274 718 253
Tel: +649 444 8055

Postal address:
PO Box 101662
North Shore Mail Centre
Auckland 0745
New Zealand

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

Disclosure

Canopus Investments Limited, its directors, officers and associates, may hold or apply for investments referred to in this newsletter for their own investment purposes.

Canopus Investments Limited does not bank or hold investment monies received on behalf of clients unless by special request or arrangement. When held on behalf of clients through special request, client funds will be held on trust in a separate special purpose account. In the normal course of business, investment monies will be passed directly to the securities issuer. All Canopus sharetrading account holders are issued with an individual true bank account from which share purchases are funded and to which share sale proceeds are deposited. Canopus does not pool sharetrading account funds.

Disclaimer

This newsletter does not constitute personal investment advice. Information in this newsletter does not constitute a recommendation or advice to purchase any product or service referred to in this newsletter. Investment products or services referred to in this newsletter may not be suitable for individual investment objectives or individual financial circumstances. Information contained in this newsletter should not be relied on for making investment decisions. In compiling this newsletter, individual personal financial circumstances have not been taken into account. For personal investment advice contact Canopus Investments Limited to arrange an initial advisory interview.

To the maximum extent permitted by law, neither the owners, managers, employees nor associates of Canopus Investments Limited accept any liability whatsoever for any loss or damage resulting from reliance on, or consequent to, the use of information obtained from this communication or any other publication produced by the owners, managers, employees or associates of Canopus Investments Limited. Neither Canopus Investments Limited, nor its directors, officers and associates, guarantee the expected investment return, return of capital, or any other return from investments referred to in this newsletter. Neither Canopus Investments Limited, its directors, officers nor associates accept any liability whatsoever for financial losses that may be incurred as a result of reliance on, or consequent to, any information contained in this communication.

Information provided in this communication does not constitute an offer of securities as such offer is only made on receipt of a completed application form. Application for securities will only be accepted when made on the application form accompanying the formal offer document.

This newsletter is compiled from information believed to be accurate at the time of writing. However, no guarantee as to the accuracy of information contained in this newsletter is given, intended or implied.

Information contained in this newsletter is provided on a non-prejudicial basis only. Information contained in this newsletter is not intended to create, nor does it create, any legal obligation, responsibility or contract between Canopus Investments Limited, its officers and associates and any other party.

Copyright

Information contained in this newsletter may not be used for other than the purpose for which it is intended, that is, the obtaining of financial services information of a general or class nature only. International copyright to the material in this newsletter is held by Canopus Investments Limited. Unauthorised copying, forwarding or use of information obtained from this newsletter by any individual, entity (whether legally incorporated or not), corporate, state or representative of such entities in any manner whatsoever is prohibited and may be deemed to constitute breach of copyright.