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.debex.co.nz

Investment Directions **27 December 2014**

"Analysis to action. Opportunities to outcomes"

In this Issue

1. **Overview** – US sharemarkets rebound from mid-December lows as US Fed confirms low interest rate outlook. OCR rates on hold in NZ and Australia, with possibility of reduced OCR from RBA in 2015. Asset price inflation rampant as consumer price inflation slumps. Fundamentals point to a solid start for sharemarkets in the New Year, but always with the proviso of shock from a Black Swan.

2. **Equities** – Australian banks recover after release of Murray Report. APA Group makes special entitlement offer to help fund major new pipeline acquisition. NZX registers prospectus for two new exchange traded funds.

3. **Interest rates, bonds and debentures** – Best fixed term deposit rates from major finance companies. UDC Finance lowers longer term rates up to 0.40%.

4. **Strategy** – Some portfolio activity in the equities asset class resulting from special opportunities including an entitlement issue in Australia. Local bond issues looking less attractive as terms go out to 7 years and coupon rates fall. Portfolio unit values slip marginally in November on back of rising NZD/AUD and mediocre sharemarkets but recover in December. Portfolio income streams growing.

1. Overview

"Living within your means has somehow become relabelled as austerity". *Vern Gowdie, The Daily Reckoning, Australia*

US share markets rebounded from a 16 December low on statements from the Fed that the target US Federal Funds Rate would remain low. Earlier in December US equities fell sharply on uncertainty over declining oil prices, Ukraine and the tumbling Russian Rouble. US manufacturing recorded its largest increase in 9 months in November with capacity utilisation exceeding 80% for the first time since pre-crash 2008. Unemployment again declined. A number of commentators have quoted falling crude oil prices and their impact on the US energy fracking industry as a major risk to the US and world economies. This narrative says many new companies will default on "junk bonds" issued to fund expensive fracking operations as crude oil prices fall, creating a new "sub-prime bond" crisis. While true that many recently created US jobs have been related to the fracking industry and hence job growth could stall, the high risk of fracking company sub-investment grade bonds was widely known by purchasers – in contrast to the sub-prime mortgage bonds issued by major institutions in 2007-08. Also unlike the sub-prime mortgage crisis, issuers and buyers of the bonds are clearly identifiable. This doesn't look like a smoking gun.

The Reserve Bank of New Zealand kept its OCR at 3.50% on 11 December with Governor Wheeler giving sparse guidance, only saying that an increase will be required "at some stage". [Consumer] inflation remains low and the economic expansion can be maintained longer than previously thought, leading to a more gradual rise in interest rates. Some economists are now reportedly deferring their expectations of the next OCR rise out to 2016.

I add [Consumer] inflation in square brackets because RBNZ Governor Wheeler doesn't seem to distinguish between very low consumer price inflation and rampant asset price inflation. Westpac has doubled its expectation of house price increases in 2015 from 3.5% to 7%, with Auckland likely to "outperform". Unable to raise local interest rates in the face of plentiful and cheap global money, for fear of boosting the dollar and hampering business, the RBNZ is likely to turn to more prescriptive methods in its attempts to rein in house prices – such as increased LVR ratios and increased capital requirements for bank lending on housing investment. Government may well weigh in with a register of overseas buyers, followed by tougher tax treatment of property investors, possibly ring fencing losses on negatively geared properties and imposing even stricter depreciation rules. "Populist policy" may see overseas buyers limited to construction of new properties. Calls to free up more land, restrict "land banking" and hasten building approvals should all gain traction. The effects are likely to be only marginal. Money is still cheap.

New Zealand's Balance of Payments deficit, the difference between exports and imports, rose to $2.5B in the September quarter, the highest since 2008. Apart from living beyond our means (always ignored), falling dairy prices were fingered as a major cause. Fonterra reduced its farmgate milk price forecast for this season to $4.70/kg, down from the earlier forecast of $5.30/kg. Dairy makes up 47% of the ANZ New Zealand Commodity Price Index which fell 8% in NZD terms from November 2013 to November 2014. Increases in export prices for meat, hides and wool, comprising 24% of the index, offset dairy falls to some extent during the year.

In Australia, despite market expectations of a lower OCR in 2015, the RBA indicated in December that interest rates should remain stable. The RBA held its OCR at 2.50% on 2 December. National income from falling commodity prices is, so far, being offset to a large degree by increased production. Lower oil prices are expected to boost global growth and decrease consumer inflation but the RBA is still trying to talk down the Australian dollar further. The RBA hopes increasing residential construction and improving consumer demand will support the economy, replacing the falling level of engineering construction in the mining industry.

OPEC's decision on 27 November not to curb crude oil production hit oil and energy companies hard, especially US shale oil and gas services, explorers and producers, as shale production is relatively expensive. Since the OPEC decision, (Brent) crude oil has fallen 25% to US$58.31 per barrel. Gold and silver fell along with any expectations of consumer price inflation with the metals viewed as not needed as an inflation hedge. Copper is down but is seen as one hard commodity where demand is expected to outstrip supply in years to come as upgrading of Asian housing expands. BHP is to concentrate on copper production, giving the diversified big miner an advantage over its less diversified competitors.

In the 30 November referendum, Swiss voters rejected a proposal that would have obliged the Swiss National Bank to hold 20% of its assets in gold, up from 7% at present. The decision was clearly negative for gold. India has relaxed import restrictions on gold but the import duty of 10% remains in place.

Russia has been forced to sell foreign currency reserves and explode its benchmark interest rate up to 17% (from 10.50%) in an attempt to halt a dramatic slide in the Rouble. From a high (low value) of 68 to the USD on 16 December, the Rouble has regained a measure of strength, back to 52 to the USD, but still down 63% for the year. Russia may be selling gold to help finance its currency intervention. In a classic reaction to hyper-inflation, Russians are reportedly rushing stores to purchase high value consumer items such as furniture and cars, before the currency in their pockets devalues further.

In the current world of rampant asset price inflation, gold apparently has little appeal as a hedging product to astute investors - who would much rather place their faith in productive assets such as shares, property and even low-yielding bonds.

Japan's ruling coalition, led by Prime Minister Shinzo Abe, comfortably won re-election on 15 December meaning the huge Quantitative Easing (Japanese Yen money creation) program of "Abenomics" is set to continue. Numbers showing Japan has slipped back into recession forced the Japanese Government to defer a second sales tax rise, making the task of addressing Japan's enormous public debt even more difficult and cementing in more QE.

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

	Latest	Nov 14	Oct 14	Sep 14	Aug 14	Jul 14	Jun 14
3 month LIBOR (end of month)	.25660	.23435	.23210	.23510	.23360	.23960	.23460
TED Spread (points)	.22	.21	.22	.23	.20	.20	.19
VIX equity volatility	14.37	13.33	14.03	16.31	12.09	16.95	11.57
US LEI		+0.6%	+0.6%	+0.8%	+0.0%	+1.1%	+0.7%
Japan LEI			+0.4%	+0.8%	+0.3%	-0.9%	-0.8%
Eurozone LEI		+0.4%	-0.3%	+0.0%	-0.6%	+0.3%	-0.1%
Australia LEI			-0.2%	-0.6%	-0.3%	+0.6%	+0.2%
United Kingdom LEI			-0.3%	-0.3%	+0.4%	+0.1%	+0.7%
China LEI		+0.9%	+0.8%	+1.0%	+0.7%	+1.3%	+1.3%
New Zealand CLI (Amp adj. OECD)			+0.0%	+0.0%	+0.0%	-0.1%	-0.2%
US Money Market Funds $T	2.713	2.688	2.629	2.614	2.595	2.554	2.570
US Gov. 10 year T-Bond (%)	2.264	2.194	2.34	2.51	2.343	2.556	2.516
Foreign holdings of US T-Bonds $B			6058.9	6060.4	6066.6	5998.0	6013.2
Margin debt, NYSE (US$ millions)		457,106	453,841	463,878	463,018	460,231	464,311
US M2 Money Stock (US$B)		11,562	11,511	11,473	11,439	11,414	11,343
Velocity of Money US M2				1.5384			1.535
Forward P/E S&P 500 (12 month)	17.25	17.15	16.25	16.85	16.75	16.55	16.60
Trailing P/E S&P 500 (12 month)	19.67	19.27	18.43	19.36	19.16	19.51	19.34
Total Put/Call options ratio CBOE	0.89	0.99	0.775	1.29	0.82	0.99	0.85
S&P 500 Share Index	2081.88	2067.56	2018.05	1972.29	2003.37	1930.67	1960.23

The 10 day moving average of Put/Call options ratio (not recorded in our table) has been a reasonably consistent indicator of S&P 500 direction over the past year, moving up before or during index retreats and declining as the S&P 500 rises. A steady rise in the 10 day m.av. during the second half of November, with individual levels mostly above 1.0, preceded and then coincided with the sharp index fall to mid-December. Since then the m.av and individual readings have fallen sharply indicating expert traders see less need to insure portfolios as we head into the New Year.

The US dollar and US Government bonds remain strongly supported by foreign buyers with Russia the exception, as it sells overseas reserves to support its own currency and avoid western sanctions.

Margin debt on the NYSE has remained high but quite consistent for six months, an unsurprising result in light of the US Fed's decision to maintain its huge balance sheet and ultra-low interest rates.

Overall none of our indicators are flashing danger signals and, barring a major black swan event out of left field, we could well see yet another solid S&P performance into the New Year. Important short term indicators to watch for are any strong reversal to an expanding Put/Call options ratio, any significant movement in NYSE margin debt and a sharply rising US Government 10 year bond rate. The US Municipal Bond Market has not reacted negatively to the Stockton exit-of bankruptcy decision (covered by Investment Directions last month) but that index deserves watching. Franklin Templeton is to appeal the judgement allowing Stockton to exit bankruptcy with a reorganisation of the City's debt that effectively overturns the priority of creditors in favour of unsecured pension obligations. The appeal could take years to litigate.

Don't expect rampant asset price inflation to be reined in anytime soon.

2. Equities

Australian banks were sold off early in December on fears of harsh new capital requirements being imposed but, on release of the Murray Report, proposed conditions turned out to be not as harsh as expected and bank share prices rallied, outpacing the overall market. Morgan Stanley estimates the big four Australian banks could require A$39B of new equity by the end of 2017 to meet the new objective of cushioning the Australian banking system from the effects of any new banking crisis. Australian Treasurer, Joe Hockey, says a decision on new capital requirements will probably be made after 1Q 2015. Australian banks are already regarded as well capitalised having added A$52.3B in new capital between 2008 to September 2014 from share issues and retained profits. The big four banks are likely to raise the new capital required through dividend reinvestment schemes, restricted payout ratios and the issue of new shares.

Kiwi Income Property Trust has changed its name to **Kiwi Property Group (NZX:KPG)** after restructuring as a company. The listed bonds will now be found with the code **KPG010** (from KIP010) with terms and conditions remaining the same.

Telstra (ASX:TLS) is set to benefit from a new National Broadband Network agreement whereby TLS can sell its copper network to NBN Co. The copper network can then be used to connect houses to the National Broadband Network. The new agreement restricts NBN Co's ability to re-sell ex-TLS assets to competitors and opens the likelihood that TLS will win the contract to maintain the copper network that it knows so well but no longer owns. This looks like a win-win-win for Telstra. No wonder the share price has jumped up to hit A$6.00.

More info concerning the 1:4 Kingfish Warrants covered in this section last month. **The Kingfish Limited Warrants (NZX:KFLWC)** exercise price will be adjusted downwards from $1.29 for any dividends declared up to the exercise date of 6 November 2015. Kingfish normally declares quarterly dividends in March, June, September and December. Hence there is likely to be an adjustment to the exercise price from three dividends, each amounting to 2% of NTA per share. On the latest NTA of $1.35 the adjustment would be about 8 cents (6%) giving an exercise price of around $1.21. The final exercise price will be announced in October 2015.

Major Australian gas pipeline operator **APA Group (ASX:APA)** is to pay A$5.41B to acquire 542 km of new LNG pipeline between Surat Basin and the QCLNG project export terminal on Curtis Island. APA claims to be on track to achieve 2014/15 earnings guidance of between A$1.17B and A$1.19B, excluding the new acquisition. Net interest is expected to be between A$315m and A$325m. APA Group is raising A$1.839B of the required funding through a 1:3 entitlement offer to existing security holders at A$6.60 per stapled security. The new securities are not eligible for the interim dividend of 17.5 cps with a record date of 24 December 2014 but will rank pari-passu for the for the final FY2015 distribution expected to be at least 18.75 cps. The offer is fully underwritten so APA is assured of raising the amount sought. The additional funds required will come from a US$4.1B two year bridging facility. The QCLNG pipeline is expected to generate additional EBITDA of A$78m and A$118m while adding interest cost of A$13m to A$29m. The entitlements are non-transferable and are not listed so existing security holders effectively face a "use it or lose it situation". Although there is provision for those taking no action to receive a payout after securities not initially taken up are sold to institutions later via book build, the payout is of unknown quantity and will likely be subject to administration fees. Already the listed stapled securities have suffered a steep sell off against the market trend as some existing holders will have been selling old securities to take up the new. With the offer closing on 15 January 2015, more weakness in the early New Year is likely. There are risks to APA from this major new pipeline investment. Anyone considering taking up the offer needs to study the offer document carefully.

Listed NZX operator **NZX Limited (NZX:NZX)** has registered a prospectus for the launch of two new Exchange Traded Funds (ETFs) to be listed on the NZX and managed by Smartshares, the NZX's fund management business. The **Australian Property Index Trust (ASP)** will track the S&P/ASX 200 A-REIT Equal Weight Index through investment in 16 listed Australian property companies while the **Australian Dividend Trust (ASD)** will track the S&P/ASX Dividend Opportunities Index.

3. Interest rates, bonds and debentures

UDC has reduced rates for longer terms with the 5 year, $100,000+ deposit rate being reduced by 0.4% to 5.35% p.a. The 6 month rate for all deposit amounts has been increased by 0.10% p.a.

Current deposit rates, % p.a.:

Issuer	$ min	Call	3mth	6mth	9mth	12mth	18mth	24mth	36mth	48mth	60mth
F&P Finance	1000	3.75	4.10	4.60	4.85	4.95	5.10	5.35	5.60	5.85	6.10
F&P Finance	25,000	3.75	4.25	4.75	5.00	5.10	5.25	5.50	5.75	6.00	6.25
Heartland Bnk	1000	3.75	3.80	4.40	4.35	4.50	4.55	4.65	5.05	5.15	5.60
Heartland Bnk	20,000	3.75	3.90	4.40	4.45	4.50	4.65	4.75	5.15	5.25	5.70
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	3.50	4.35	4.40	4.50	4.75	4.80	5.00	5.10	5.25
UDC Finance	100,000	3.95	3.60	4.45	4.50	4.60	4.75	4.90	5.10	5.20	5.35

Heartland Bank occasionally offers existing depositors a small margin above normal rates for certain terms. Check with Canopus for their latest specials.

Fisher and Paykel Finance has had its long term credit rating of BB+ reaffirmed by Standard and Poors but the outlook has been changed to negative from stable.

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 took the opportunity to add Westpac, where this blue chip was lacking in portfolios, on release of the Murray Report, locking in a cash yield of 5.84% based on the expected 2015 distribution. Even if the payout ratio is reduced a little in response to increased capital requirements resulting from the Murray Report, the yield should be solid in today's low yield environment with the prospect of an increase in future. The high NZD/AUD helped although brokerage exchange rates are never flash and the cross rate could go a little higher yet.

Over the past few months there have been just a few 7 year senior bond issues coming to market at decreasing coupon rates from issuers getting in for a longer term at what they consider to be the low point in the interest rate cycle. This time they could be right. Swap rates, used as the base to which a margin is added to determine the coupon for these issues, have been falling since July this year. Although there is no sign yet that the downward trend has been broken, we are not keen on committing funds at the current low rates for a term of 7 years. We will always have a look at new bond issues but our taking them up and adding to our existing holdings is becoming increasingly unlikely. We gave the recent Precinct Properties 7 year senior bond issue a miss. The coupon rate was set at 5.54%.

The APA Group entitlement offer, covered in Section 2- Equities, looks attractive enough for us to participate. At A$6.60 the forecast dividend yield on the new securities should be about 5.7% once they rank pari-passu with existing securities. At the current market price of A$7.32 for existing securities the new securities are selling at a discount of 10%. Although further weakness can be expected as some investors sell old securities to take up new in the New Year, the fall should be temporary, giving us a useful capital gain in addition to good yield.

Our diversified income portfolio unit value retreated a little in November as the NZD/AUD cross rate surged and Australian banks fell in response to the possibility of harsh new capital requirements being imposed. Bank share prices are now moving up again as any requirements to raise new capital look quite manageable and should be some time off. The rising NZD/AUD rate is stunting our unit value recovery but income from the portfolio is strong. The portfolio owner is holding a significant portion of assets as cash just now.

Our growth portfolio unit value slipped marginally in November as the NZD/AUD rose and sharemarkets struggled. PIE Funds recovered as expected and bond values increased slightly in line with falling market yields. Portfolio income is growing from increasing dividends and new purchases coming on stream. Figures for December point to a month of good gains.

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.

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Regards,

Alan King
Authorised Financial Adviser
Canopus Investments Limited
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

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