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

Investment Directions 29 December 2016

"Analysis to action; opportunities to outcomes"

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Space Exploration News

Spacex aims to return to flight with Falcon 9 launch in January 2017(although item says December2016)

https://www.nasaspaceflight.com/2016/11/spacex-rockets-december-return

1. Overview

The strong US equity market "Trump Jump" looks to be topping out as visions of higher infrastructure spending, lower corporate taxes, fewer regulations and more US jobs become countered by views of possible negative consequences from a higher US dollar plus Trump's plans to renegotiate major trade pacts and impose import duties – especially on goods manufactured overseas by US companies. Some analysts believe such moves could see the US dollar up another 15%, hitting S&P 500 companies with a 3% negative impact on earnings for each 5% USD rise and a -0.5% hit on US GDP growth. Further, import duties could trigger foreign retaliation against US exports around the world. But, analysts' forecasts have been known to be wrong.

S&P 500 earnings for 2017 have already been forecast to rise a high 12.5% - hence expectations are vulnerable to even a slight disappointment. Nevertheless, US consumer confidence, a major input to the US economy, is at its highest since 2001.

The US Federal Reserve finally raised its target federal funds rate by 0.25% to the 0.5% - 0.75% band as expected on 14 December. So long expected and outshone by the Trump Jump, the new target caused scarcely a ripple on equity markets. Accompanying commentary garnered more attention, shifting the Fed's own expectations to three further rate increases during 2017 rather than the two envisaged earlier. Reasoning included Trump's expected fiscal spending increase, strong job growth, improving manufacturing output and faster inflation expectations. In reaction, US bond rates hit a high of 2.62% on 15 December before easing off again for the remainder of the month. Investors though, need to be mindful that the Fed member's record of forecasting their own future action is abysmal. Time and again, Fed members' expectations of future fed funds target rate movements, as expressed through the famous "Dot Plot", have turned out to be wrong. Even though Fed and market expectations look to be more aligned for 2017 than 2016, three 0.25% fed fund target rate rises during the year would appear to be on the high side given the persistence of negative global influences.

Trump's election win brought an early Christmas present for US equity investors **-** but swamped any New Year rally before it even began. The S&P 500 is currently up 8.81% from its pre-election low on November 4 and +3.19% for December. To date, yearly gain has been 11.0%.

Australia's central bank kept its OCR at 1.5% on 6 December as widely expected. Australia's mid-year budget forecast improved enough for Australia to maintain its coveted AAA credit rating which had been seen as under threat. After a strong recovery, miners weakened after rising Chinese interbank interest rates, imposition of pollution control measures in Hebei Province and slowing home price growth in major Chinese cities evoked declining iron ore futures' prices. Current outlook for the Australian OCR during 2017 is for no change although a further cut cannot be ruled out. Odds are firmly against any rise.

The Australian economy shrank 0.5% in the September quarter and may shrink further to the end of December but the RBA expects growth to resume in 2017.

Australian equities managed to follow the US lead, the S&P/ASX 200 gaining 10.15% from the 9 November presidential election low, and +4.4% in December to give an overall gain to date of 7.34% for 2016.

In New Zealand, accession of Bill English to the Prime Ministership, after John Key's surprise resignation, engendered no such share market enthusiasm. For New Zealand equities 2016 has certainly been a year of two "halves", the S&P/NZX50 Gross reaching a peak of 7571.11 on 7 September, up 19.72% since the start of the year, only to fall back sharply and out of step with US and Australian markets over the last four months for a yearly gain of 8.7%. Explanations would have to centre around changing interest rate expectations and change of Prime Minister – although a more "steady as she goes" handover than Key to English could hardly be imagined. Withdrawal of foreign cash following the 14 November Kaikoura earthquake may have played some part but the record shows no sudden flight of "scared" money. Withdrawal of foreign cash is more likely a global investor desire to switch into the strengthening US dollar. Overall, New Zealand's economy remains on track as one of the best OECD performers – boosted by recovering dairy prices and high immigration. RBNZ Governor Wheeler believes "CPI inflation is probably past its low point.." and the Government's half year economic update projected economic growth of 3% p.a. over the next 5 years, giving a higher tax take and allowing for increased infrastructure spending.

New Zealand's OCR stayed at 1.75% during December after a reduction from 2.00% on 10 November with the RBNZ projecting an easing bias if anything as "numerous uncertainties remain..". The NZD/AUD exchange rate continues to trade in a high band about 0.94 -0.97. Belief that Australia will be more adversely affected by the declining Yuan than New Zealand means the NZD/AUD is likely to move even higher in the short term. Against the US dollar both the NZD and AUD have declined sharply, around 7%, following Trump's unexpected win. A short term reversal or steadying of comparative rates is quite likely as US interest rates, equities and US dollar all come off their "over-reaction" highs.

Undoubtedly the 30 November OPEC decision to lower crude oil production by 1.2 million barrels per day helped spur US and global equities as Brent Spot jumped from US$44.68 to US$52.28 over two days, standing now at around US$56 per barrel. US shale oil production was not wiped out by the excess flood from OPEC and non-OPEC producers alike. In fact, survivors are said to be more efficient than before and may gain support from a Trump administration. Saudi Arabia looks to have suffered more damage than the US by flooding crude oil markets – now having to reduce fuel subsidies and sell shares in state companies to avoid permanent budget damage.

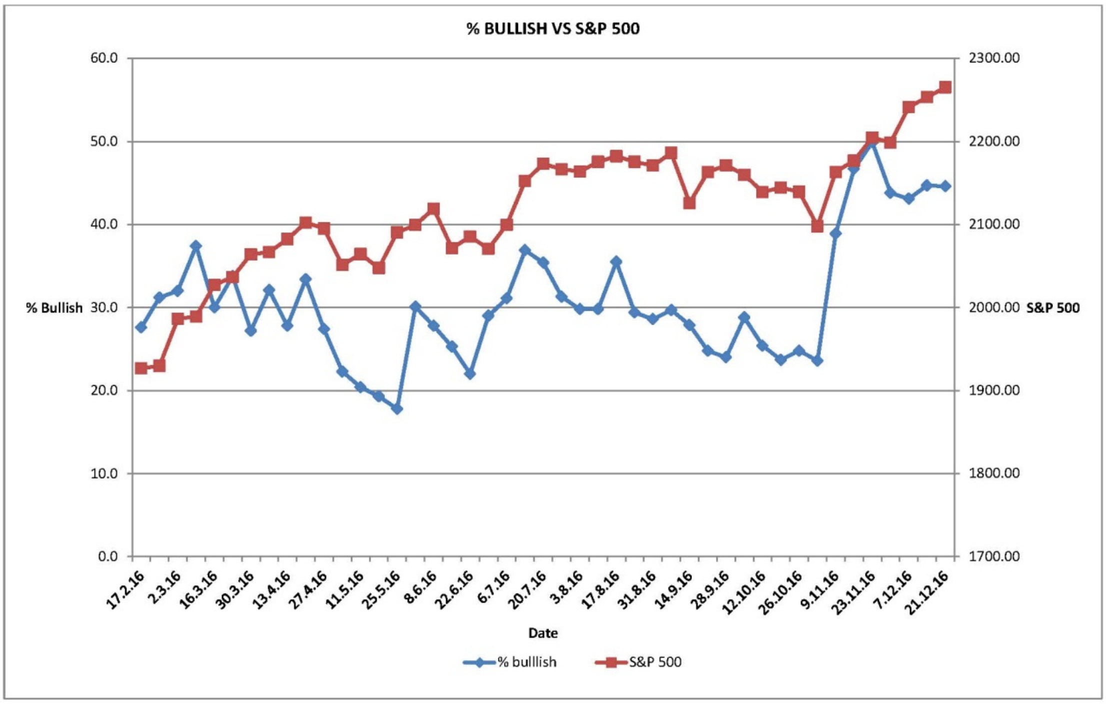
In Italy the Government's economic reform proposals were voted down on 4 December and Prime Minister Renzi handed in his resignation. The Euro weakened and the Italian referendum had no effect on US equities. The EU faces 16 separate state elections in 2017, at least some of which could well throw up anti-EU governments or presidents. Italian banks are still in crisis with Monte dei Paschi di Siena set to receive a huge government bail-out – accompanied by a bail-in handing large losses to pensioners and private savers. The ECB announced a 9 month extension to its asset purchase (quantitative easing) program on 8 December, although reducing purchases from €80B to €60B per month, but further pressuring the Euro. Europe is in a state of confusion, uncertainty and stress. Situation normal.

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

	Latest	Nov 16	Oct 16	Sep 16	Aug 16	Jul 16	Jun 16
3 month LIBOR (end of month) %	.99706	.93067	.88594	.84561	.83344	.75150	.6311
TED Spread (points)	.50	.45	.54	.57	.51	.49	.39
VIX equity volatility	11.44	13.33	17.06	13.29	13.12	11.87	15.63
US LEI		0.0	+0.1%	+0.3%	-0.2%	+0.5%	+0.2%
Japan LEI			+1.2%	+0.1%	-0.8%	-0.2%	-0.2%
Eurozone LEI		+0.3%	+0.3%	-0.1%	+0.5%	-0.6%	+0.2%
Australia LEI			-0.4%	+0.3%	-0.1%	+0.2%	-0.1%
United Kingdom LEI			+0.1%	0.0%	0.0%	-0.2%	-0.2%
China LEI		+1.0%	+0.8%	+1.0%	+0.5%	+0.2%	+0.3%
US Money Market Funds $T	2.712	2.719	2.677	2.680	2.724	2.715	2.718
US Gov. 10 year T-Bond (%)	2.543	2.368	1.834	1.6080	1.5680	1.458	1.488
US 5 yr inflation expectations %	2.04	2.11	1.87	1.75	1.64	1.67	1.42
US high yield-treasury spread 3-5yr %	4.19	4.67	4.91	4.97	5.10	5.69	6.21
Foreign holdings of US T-Bonds $B			6038.9	6154.9	6196.4	6247.3	6280.0
Margin debt, NYSE (US$ millions)			483,978	501,125	471,231	474,575	447,337
US M2 Money Stock (US$B)		13223.2	13137.5	13060.9	12986.9	12878.0	12803.6
Velocity of Money US M2				1.439			1.450
CNN Fear and Greed Index	66	70	43	50	63	82	44
AAII sentiment survey (% bullish)	44.6	43.8	23.6	24.0	28.6	31.3	29.0
US retail & food service sales US$B		465.513	465.135	462.284	457.722	457.849	457.409
Insider Buy/Sell ratio (US) %	35	36	32	31	29	34	45
Brent crude oil spot price USD/barrel	53.53	47.95	46.2	48.24	47.94	40.76	48.05
Forward P/E S&P 500 (12 month)	19.04	18.45	18.02	18.43	18.59	18.93	17.99
Trailing P/E S&P 500 (12 month)	24.95	24.35	24.31	24.81	24.71	24.87	24.22
Total Put/Call options ratio CBOE	0.86	0.90	1.06	1.02	1.01	1.20	1.23
S&P 500 Share Index	2263.79	2198.81	2126.15	2168.27	2170.95	2173.60	2098.86

Japan overtook China as the largest foreign holder of US Treasury securities during October. Economists report China is being forced to realize some of its foreign currency reserves to support the Yuan in the face of deteriorating loan quality held by Chinese banks and flight of capital out of the country. Chinese holdings of US Treasuries fell US$41.3B in October to US$1115.7B from US$1157B in September. Total foreign reserves are said to be falling rapidly towards US$3000B and China's central bank (PBOC) has little room to raise interest rates as a means of stemming the outflow. An interest rate rise would simply add to bank and bond market stresses. Strict exchange controls have recently been re-introduced, limiting the amount of yuan Chinese companies can remit abroad. Any further tightening would likely prove ineffective and run counter to China's ambition to see the Yuan as an international reserve currency, one day rivalling the US dollar. Although a formal devaluation of China's currency looks possible in the near future, for now Chinese authorities would much prefer to see the Yuan reach a natural "equilibrium" level against the US dollar through open market operation – which may require a broadening of the range in which the Chinese currency can trade against the US dollar on any one day. Any unexpected and significant official devaluation of the Yuan would have a negative impact on global equity markets with US, Australian and New Zealand share markets being hard hit.

Highly positive short term indicators are saying now is not a good time to be purchasing equities on market, i.e. markets are generally in "overbought" territory. On the charts, AAII % bullish sentiment has retreated, indicating a broad US investor belief that the S&P 500 is due for a correction. As at the time of writing, the S&P 500 has indeed retreated, led down by housing related stocks reacting, at least in part, to higher US interest rates.



2. Equities

US banks have been major beneficiaries of the unexpected presidential election outcome, based on a steepening of the yield curve and Trump's stated intention to repeal the Dodd-Frank Act which, amongst other things, severely restricts US banks' abilities to trade securities and derivatives on their own accounts (the Volcker Rule). Critics say the strict measures will limit lending to new and existing businesses, stifle job creation and reduce profitability of banks. With only a slim majority in the Senate Trump may not be able to implement his intention.

Australian banks have also been to the fore in market advances although drivers have a more regional focus.

A year ago, many analysts and fund managers had nothing good to say about Australian banks, forecasting lower profits, higher bad debts, reduced dividends, nil growth, probable need for more capital and lower share prices. Although already subject to strict regulation and higher capital ratio requirements than just a few years ago, Australian banks have generally managed to preserve dividends in the face of a low interest rate operating environment and now stand to benefit from the steepening yield curve (as in the US) and an ability to derive more funding from onshore deposits rather than the more expensive international markets. Share prices have been rising over the past two months, reflecting a renewed outlook for at least some profit growth from improved margins and growth in lending. Bad and doubtful debts, while still increasing from a very low base, should not reach worrisome levels. Bernard De Longevialle, a senior analytical manager at Standard and Poors, has pointed out that most banks don't need more capital – they just need more flexibility to use what they already have in times of stress to avoid breaching increased minimum regulatory requirements.

As for many years, Australian banks can still provide a core component for investment portfolios, offering a cash dividend yield of around 6% p.a. with still some measure, if not spectacular, of capital growth.

Similarly the unloved sector of Australian listed property has undergone a recent sharp recovery during November and December. After peaking at the end of July, the S&P/ASX 200 A-REIT Index fell sharply into early November as fears emerged over the degree to which rising interest rates would negatively impact distributions, property values and debt servicing ability of listed property entities. The market now seems to have decided that any significant rise in Australian interest rates and inflation is still a long way off and just as likely to have a positive impact on property prices as negative. Broadly, listed property entities have much stronger balance sheets than in 2008 so are in a better position to handle a slow rise in interest rates. So far, concern about the oversupply of apartments in major cities has not flowed into concern for other property sectors – even alternative residential sub-sectors including urban renewal projects. Diversified and sector-specific listed property entities – other than apartments – could benefit from a return to growth in the Australian economy during 2017, providing portfolios with both high dividend yields and growth. Of course, by the time confirmation is received, the best opportunities will have been long gone. This is a major sector well worth watching for any overall market-related weakness in the early New Year.

For New Zealand listed investment company **Kingfish Limited (NZX:KFL)** Sam Dickie will replace, as Portfolio Manager, Murray Brown who retired in October. Sam Dickie, a New Zealander and highly experienced professional analyst, will return from Hong Kong to take up the role. Kingfish has been the most successful of the Fisher Funds listed investment companies, providing sound returns through high PIE distributions rather than rapid share price growth. However, as with Barramundi and Marlin, Kingfish is forever asking shareholders for more cash through the issue of warrants. With the increase in shares on issue, some of those requests are becoming a significant imposition on shareholders. Tranche number 4 **(NZX:KFLWD)** is currently on market with the warrants exercisable on 5 May 2017. Although the exercise price is likely to be at an attractive discount to market price of the head shares, shareholders have little choice but to pay up if they want to avoid having their shareholdings diluted. Hopefully the new portfolio manager will be able to steer directors towards a new approach where growth can occur from astute investment decisions alone - without the need for more cash from shareholders.

3. Interest rates, bonds and debentures

Fisher and Paykel Finance has raised deposit rates up to 0.4% for 4 and 5 year terms, but reduced its on call rate to 2.00% from 2.50%.

UDC Finance has increased deposit rates by 0.20% for all terms 24 months and longer but reduced its call rate by 0.2%.

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	2.00	2.95	3.65	3.85	3.95	3.80	4.00	4.20	4.35	4.35
F&P Finance	BB	25,000	2.00	3.10	3.80	4.00	4.10	4.15	4.25	4.35	4.50	4.50
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	A-	5,000	1.85	2.70	3.30	3.60	3.60	3.65	3.50	3.50	3.50	3.60
UDC Finance	A-	100,000	2.35	2.75	3.35	3.60	3.60	3.65	3.55	3.55	3.55	3.65

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4. Strategy

Although New Zealand failed to participate in the US and Australian sharemarket surges of November and December we are unlikely to remain at odds by recording a surge as the others come off. With short term indicators still showing major equity markets as overbought we prefer to await more favourable buying conditions. On any significant weakness we would be looking to add to portfolios in cheap bond proxy sectors such as listed property, utilities and infrastructure – but limiting selections to securities offering high and sustainable dividends, limited debt and with a reasonable measure of projected growth. Despite some recoveries over the past two months, prices are still down and should retreat further in a general market reversal. A few opportunities may also arise in more popular sectors such as aged care and tourism but generally, these sectors are already highly priced with respect to growth and dividend prospects.

Preliminary results for December show both of our published portfolios, income and growth, as having made about 2% gains during the month. Some strong individual NZ share prices, higher listed Australian equities and receipt of substantial dividends boosted portfolio values but were held back by a relatively poor performance of New Zealand equities, a rising NZ dollar and slightly weaker bond values – which we mark to market.

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

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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 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

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