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Investment Directions **26 February 2015**

"Analysis to action. Opportunities to outcomes"

In this Issue

1. **Overview** – Global economic indicators still favourable and supportive of equity, bond and listed property valuations. Wary eye needs to be kept on US interest rates for any sign of market divergence from official low target rates after sharp move in US 10 year T-Bond rate.

2. **Equities** – Commentary on some of our portfolio shares from the latest reporting rounds in Australia and New Zealand.

3. **Interest rates, bonds and debentures** – Best fixed term deposit rates from major deposit takers. Deposit rates still falling. UDC lowers longer term rates by up to 0.8%.

4. **Strategy** – Low interest rate environment encouraging promotion of high risk, low quality issues on basis of marginal yield advantage. Not a good time to be seeking small advantage in yield at the expense of quality and security. Strong performance of portfolios pleasing but finding new quality investments difficult.

"It annoys me when someone says "What do you actually do?". All I think is "How can you be so ignorant that you don't know"." Kim Kardashian-West

1. Overview

US Stocks received a further boost to new highs on 25 February after two months of negative volatility in December and January as US Fed Reserve Chair Janet Yellen told Congress that any future rates rise would be considered on a meeting by meeting basis. Markets interpreted the statement as indicating the first Federal Reserve rate increase would be deferred still further – later than the June 2015 date expected by many economists and observers.

Data shows the US economy continuing to improve erratically: house prices are rising across the major cities, the services sector is expanding at an increasing rate and employment is expected to increase slowly. On the negative side consumer confidence fell more than expected in February, corporate earnings growth is limited and wage growth is slow.

The US 10 year bond rate slipped back below 2.00% (1.99% at the time of writing) but remains significantly above the sharp low of 1.67% reached on 2 February. The next three weeks should provide a good indication as to whether the sharp rise in February is just a blip or possibly marks a reversal of trend to higher US interest rates later this year. Such a market reversal, irrespective of when the US Fed moves on the target Federal

Funds rate or not, should put negative pressure on share indices and bonds.

In New Zealand, the interest rate pattern is similar. Lack of movement on interest rates from the US Fed provides yet more influence on the RBNZ to refrain from raising the OCR here, following low export commodity prices, the high NZ Dollar, low inflation and a lower OCR in Australia. The NZ swaps market is currently pricing in a 70% chance of an OCR reduction by February 2016 but such sentiment can change quickly. When asked recently, two NZ fund managers believed the recent longer term interest rate jumps in both the US and NZ were just blips. Most NZ fund managers and economists were wrong at the beginning of 2014 when they expected steady rises in the NZ OCR during the year. Maybe wrong again?

Dairy prices climbed another 10% at the auction on 17 February, the 5th consecutive rise, spurred on by drought limiting production in parts of the North and South Island East Coasts. Whole milk rose to $3272 per tonne but Fonterra says $3500 per tonne is needed to enable the forecast $4.70/kg payout to farmers (since confirmed) to be achieved. The whole milk price is a significant factor in the New Zealand economy. Another rapid rise, as in 2012, would be a strong incentive for higher interest rates.

Expectations of any rise in official interest rates (OCR in NZ and target Federal Funds Rate in the US) are now shifting out to 2016. However, market rates could pre-empt reserve bank moves in both countries, putting downward pressure on both equities and bonds even before the official moves occur.

Investors need to watch market interest rate movements rather than just relying on predicted OCR movements to gauge potential impacts on equity, bond and even property markets.

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

	Latest	Jan 15	Dec 14	Nov 14	Oct 14	Sep 14	Aug 14
3 month LIBOR (end of month)	.26160	.25460	.25520	.23435	.23210	.23510	.23360
TED Spread (points)	.25	.23	.22	.21	.22	.23	.20
VIX equity volatility	13.69	20.97	19.20	13.33	14.03	16.31	12.09
US LEI		+0.2%	+0.4%	+0.3%	+0.6%	+0.8%	+0.0%
Japan LEI			-0.2%	+0.6%	+0.2%	+0.8%	+0.3%
Eurozone LEI			+0.2%	+0.2%	-0.1%	+0.0%	-0.6%
Australia LEI			+0.4%	+0.0%	-0.1%	-0.6%	-0.3%
United Kingdom LEI			+0.1%	-0.3%	-0.4%	-0.3%	+0.4%
China LEI (1)		+0.9%	+1.1%	+0.8%	+0.8%	+1.09%	+0.7%
New Zealand CLI (Amp adj. OECD)			+0.2%	+0.1%	+0.2%	+0.0%	+0.0%
US Money Market Funds $T	2.681	2.702	2.733	2.688	2.629	2.614	2.595
US Gov. 10 year T-Bond (%)	1.988	1.68	2.17	2.194	2.34	2.51	2.343
Foreign holdings of US T-Bonds $B			6153.7	6112.4	6058.9	6060.4	6066.6
Margin debt, NYSE (US$ millions)			456,283	457,106	453,841	463,878	463,018
US M2 Money Stock (US$B)		11,701	11,625	11,562	11,511	11,473	11,439
Velocity of Money US M2			1.531			1.5384	
Forward P/E S&P 500 (12 month)	17.55	17.01	17.25	17.15	16.25	16.85	16.75
Trailing P/E S&P 500 (12 month)	20.53	19.71	19.67	19.27	18.43	19.36	19.16
Total Put/Call options ratio CBOE	1.00	1.10	1.22	0.99	0.775	1.29	0.82
S&P 500 Share Index	2115.48	1994.99	2058.90	2067.56	2018.05	1972.29	2003.37

(1) Note: China's LEI figures have reverted to being stated with respect to a benchmark where the base year is 2004. The 2010 base used last month appears to have been dropped resulting in the negative figures in our table last month being revised.

TED Spread and 3 month LIBOR could be starting to show a reversal to upward trend in interest rates despite latest "dove-like" guidance from US Fed Chair Janet Yellen.

Growth in the US M2 money stock, often regarded as a harbinger of inflation, has been accelerating for six months now, reaching an expansion of US$76B in January, but a new reading shows the Velocity of Money (a measure of how often a dollar is used for a transaction), has declined again to just 1.531 for the last quarter of

2014, the lowest figure since the record began in the 1960s. Hence serious US inflation is unlikely to appear any time soon. Foreign demand for US Treasury Bonds is still growing as massive QE programs in Europe and Japan get underway, keeping downward pressure on US interest rates for now and underpinning US equity markets.

Australia's Leading Economic Indicators turned positive in December after a long stretch of negativity, indicating a greater depth to the economy exists than just the subsiding resources boom.

Total Put/Call options ratio is again heading back above 1.0, indicating expert traders are getting nervous about new highs in equities and are moving to insure recent gains against likely falls in the very near future. For some time this has been quite a good indicator of short term direction in the S&P 500.

2. Equities

The latest reporting rounds in both Australia and New Zealand have seen the froth blown off many over-exuberant share prices – especially where corporate results have failed to meet expectations. Even where expectations have been met, share prices have dipped on apparent market disappointment – characteristic of an expensive market. Notable in the former category have been Fletcher Building, Contact Energy and Spark. Nevertheless, relentless pressure from cheap overseas money could well see that over-exuberance soon return.

Contact Energy (NZX:CEN) announced an unexpected intention to pursue renewable energy projects overseas just when shareholders were hoping to derive some benefit at last from years of heavy capital expenditure and greatly enhanced free cash flow. The share price dropped 12% in a few days. Contact Energy has a history of wrong-footing shareholder expectations and potential benefits. This latest announcement has all the imprint of 51% shareholder Origin Energy (Australia) wanting to access Contact's cashflow to fund its own offshore expansion drive. Mighty River Power has just abandoned two geothermal development projects in Chile and Germany resulting in "non-cash impairments" of $83m and a huge plunge in half year profit from $116m to just $8m, indicating the path is not easy and no doubt adding to queasiness of Contact shareholders. At least Origin already has some experience in overseas renewable energy project development. Contact shareholders can be excused for preferring to see the cash.

Sky City (NZX:SKC) made a cheeky but bumbling attempt to garner Government assistance to the tune of $70m - $130m for enlargement of the planned Auckland Conference Centre project. Cheeky because it had next to no chance of success and bumbling because it created widespread negative publicity that the Company doesn't need. Moreover, Sky City has ample options itself to raise the extra cash needed for the improved Conference Centre. Apart from a possible joint venture with Asian interests, a small cash issue of new shares to existing shareholders would easily cover the amount required. Some shareholders have already approached Sky City management asking for such an issue to be considered as a means by which they could participate in the Company's growth prospects. So far directors and management have chosen not to go down the cash issue route, apparently believing they already have a simpler, alternative means of raising the money.

Toll Holdings (ASX:TOL) is subject to a takeover offer at A$9.04 from Japan Post, nearly 50% above the pre-announcement market price of A$6.05. Directors have recommended acceptance of the bid. Apparently Japan Post is very eager to take over Toll's developing infrastructure in Asia. The Toll share price has gone nowhere for years despite favourable prospects and a relatively high dividend yield. Existing shareholders will be pleased to see the back of it.

Telstra (ASX:TLS) lifted 1H15 profit by 22% to A$2.08B and will raise interim dividend by 0.5 cps to 15.0 cps. Telstra has reactivated its Dividend Reinvestment Plan and reaffirmed its guidance of achieving "single digit" earnings growth for the full year. The Company is increasingly turning towards Asia for growth, including purchase of PACNET, owner of the world's biggest submarine cable network. Further opportunities in Australia are limited for such a large corporation. Revenues are sound, the Company is reported to have A$4B in cash and expected dividend yield is attractive in today's low yield environment at 4.5% to 5%.

Auckland International Airport (NZX:AIA), one of our very few new equity purchases in recent months, raised interim net profit by +8.1% to $92.8m for the six months to 31 December 2014. Passenger movements through the Airport grew 3.8% to 7.9m. An interim dividend of 7.3 cps will be paid on 2 April. Profit guidance for the full year has been raised to between $167m and $174m. The shares are up 13% since we purchased in August last year which, together with dividends already received, gives a useful gain of 15% in six months. Nevertheless the AIA share price has suffered the same negative movement as other majors meeting expectations in the current reporting round. Continued overall market strength should see upward momentum in AIA regained.

Genesis Energy (NZX:GNE) eased slightly even though earnings for 1H15 rose 15% (before expenses, gains and losses) at $172m and NPAT trebled to $68.2m. An interim dividend of 8 cps will be paid with a total dividend of 16 cps for the year expected, in line with the prospectus forecast. Eligible New Zealand shareholders, having held the shares for 12 months after participating in the IPO, will receive a 1:15 loyalty bonus in April 2015.

3. Interest rates, bonds and debentures

Heartland Bank and UDC have both reduced deposit rates during the month. The 5 year UDC rate has declined a whopping 0.8% p.a.

Heartland Bank has a special 4.75% p.a. for 9 months.

Current deposit rates, % p.a.:

Issuer	$ min	Call	3mth	6mth	9mth	12mth	18mth	24mth	36mth	48mth	60mth
F&P Finance	1000	3.65	3.85	4.35	4.60	4.85	4.90	5.05	5.25	5.45	5.65
F&P Finance	25,000	3.65	4.00	4.50	4.75	5.00	5.05	5.20	5.40	5.60	5.80
Heartland Bnk	1000	3.75	3.80	4.40	4.75	4.50	4.55	4.65	4.90	5.00	5.15
Heartland Bnk	20,000	3.75	3.90	4.40	4.75	4.50	4.65	4.75	5.00	5.10	5.25
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	3.90	4.20	4.25	4.40	4.40	4.40	4.40	4.40	4.45
UDC Finance	100,000	3.95	4.00	4.30	4.35	4.50	4.50	4.50	4.50	4.50	4.55

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

The risk to global equity, bond and even listed property markets will increase with any rise in US interest rates, whether that rise be driven by an increase in the Federal Funds Target Rate or by open market forces. For now though, NZ and Australian equity and bond markets are underpinned by already low market rates and expectations of lower official interest rates on both sides of the Tasman. But these low rates are high compared to major currency blocs outside the US, so overseas buyers help support bond and equity prices here despite the currency risk. We need to watch closely for any sign that market rates could react upwards in spite of reserve bank moves to lower or at least to hold steady the OCRs in both countries. Market rate divergence from official settings could well be led by the US where market rates may start to rise despite US Fed testimony indicating the target Federal Funds Rate is likely to remain on hold at the ultra-low level of near 0% - 0.25% for 2015.

We will continue to check out new bond and note issues coming to market but some issuers are now taking the opportunity offered by our low interest rate environment to promote very low quality issues at only modest yields. The latest issue from ANZ Bank, expected to carry a coupon of about 7.3%, is described as "Capital Notes, mandatory convertible (to ordinary shares), non-cumulative (missed interest payments will not be made up later), perpetual, subordinated and unsecured". Should another financial crisis hit, demanding new capital to preserve bank solvency, these notes can be quickly converted to ordinary shares or cancelled altogether. This is hardly the type of investment we want in portfolios. I suspect many investors, scrambling for yield, will still take up the offer without reading or understanding the complicated terms.

Similarly the NZX is likely to see up to 20 new share floats during 2015. On past experience many of these are likely to be low quality with initial investors paying good money for companies being brought to market after generous issues of new shares to existing owners and stripping of reserves by special dividends prior to the IPO. If past patterns repeat, some investors will get lucky but many will be left holding shares of dubious value and with little prospect of a useful dividend (or any dividend at all) for years to come. In selecting portfolio shares we prefer to look at those with an established history of market pricing, a known history of dividends and sound analysis of future prospects.

Proportionate (shared) ownership of commercial buildings is another relatively risky investment option with syndicators offering yields of around 8% p.a. for an investment with little, if any, liquidity. Large "units" of investment are often sought, being a minimum of $25,000 or more. The investor wanting to sell can be faced with no opportunity to sell or to sell only at a large discount to perceived value – and all that assumes the syndicated property ownership scheme is operating as planned. Risk is highly concentrated through the building being leased to a business (or maybe a few businesses) able to maintain its lease responsibilities for years. In the past, some proportionate ownership schemes have failed through improper related party lending, poor governance and tenant failure.

In contrast, listed property entities offer high liquidity, a wide spread of high quality properties and tenants, professional management, stock exchange scrutiny, market pricing, analyst opinions, good dividends and strong capital growth over time.

It's no contest as far as our portfolios are concerned.

Now is not the time to be sacrificing security and quality of investment for a small margin in yield.

Our diversified income portfolio unit value reached $1.2899 at the end of January 2015. The negative impact of a rising NZD/AUD exchange rate was more than offset by good performance from ASX-listed shares and acceptance of an ASX-listed cash issue at A$6.60, finishing the month at A$8.83. Market value of bonds continued to gain as market interest rates fell. The portfolio owner is still holding a significant portion of assets as cash just now.

Our diversified growth portfolio unit value increased 3.44% for the month of January to stand at $1.4249 at the end of the month. Again, the negative impact of a high NZD/AUD was offset by good performance from ASX-listed securities and acceptance of the A$6.60 special issue. Strong contributions also came from listed property and international equities to which this portfolio has access via certain managed funds. The growth portfolio also benefited from rising bond valuations.

The rising portfolio values are pleasing but finding suitable new investments is increasingly difficult.

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.

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 each individual'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 investor remains in control of the portfolio.

Regards,

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