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Investment Directions **27 February 2017**

"Analysis to action; opportunities to outcomes"

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1. **Overview** – High expectations for President Trump's tax package push US equities to new heights. Expected tariffs may be aimed at cheap labour countries rather than commodity exporters. Trump equities rally bypasses Australasia. RBNZ indicates OCR may stay on 1.75% until 2019. Australia has run of large trade surpluses. French presidential election could be crucial for Euro and European Union. Germany reclaims its gold. Short term data says equities still "overbought" – not a good time to invest.

2. **Equities** – Comments on some of our portfolio shares after interim reports released: Macquarie, Transurban, BHP Billiton, Fletcher Building, Tourism Holdings and APA Group.

3. **Interest rates, bonds and debentures** – Fisher and Paykel Finance being rebranded as Flexi Cards. ANZ selling UDC, secured deposit program could be discontinued. UDC rating lowered. Deposit rates for major S&P-rated finance companies.

4. **Strategy** – Risk to share markets high as expectations for business-friendly Trump tax policy soar. Bond yields up slightly but still not attractive. Good time to accumulate cash in portfolios. Published portfolios gain over 1% in February to date.

Space Exploration News

SpaceX dragon resupply craft docks with International Space Station on second attempt.

http://www.news4jax.com/news/spacex-waves-off-docking-with-international-space-station

Seven earth-sized planets discovered orbiting dwarf star

https://www.theguardian.com/science/2017/feb/22/thrilling-discovery-of-seven-earth-sized-planets-discovered-orbiting-trappist-1-star

1. Overview

US equity markets surged on high expectations for a US business-friendly Trump taxation package, supposedly to be released as early as this week or next. Market enthusiasm has been built up on expectations that the following factors will be largely included:

- A major headline corporate tax rate reduction from 35% to the 15%-20% range.
- Immediate write-off of all capital expenditure.
- Elimination of tax deductibility on interest paid.
- A new low tax rate, possibly 10%, on repatriation of US corporate profits held overseas. This move alone could encourage repatriation of up to US$2 trillion.
- Major reduction in regulations seen as an impediment to business.
- Some level of tariffs on imported goods to help pay for tax cuts while boosting US manufacturing and jobs.

Ultimate success of his plan relies on achieving all this without overly pushing up interest rates and boosting the US dollar.

President Trump can probably muster sufficient support in both houses to implement the first five points – or a close approximation to them. The sixth point is controversial even within his own party. House Republicans are generally opposed to tariffs but want to introduce a scheme whereby imported goods are not tax deductible while US-produced goods are. Trump needs tariffs to pay for the tax cuts but imposition at the necessary level is likely to trigger higher inflation through higher retail prices and wages while pushing up interest rates and the US dollar.

If Trump cannot come up with a workable scheme likely to gain approval in both houses of Congress, equity market reaction will be harsh. Even if he succeeds in putting together an acceptable proposal, the recent market sharp rise is likely to reverse - following the "buy rumour, sell fact" adage. Only a Congress-acceptable package, significantly exceeding current market expectations, could boost equities further.

Trump's tax plan will undoubtedly influence Federal Reserve interest rate intentions. The more inflationary his plan appears, the sooner a federal rate rise is likely with mid-March a possibility but by no means a certainty. US CPI is on the rise and initial jobless claims (seasonally adjusted) have been at the historically low rate of under 250k for six of the seven latest months. An early rate rise would compound the negative pressures building up on equities.

Imposition of tariffs may hold significant implication for exporting nations – including New Zealand and Australia, both of which list the US as a major trading partner. No analysis of potential effects is possible without the unveiling of more details. However, if US tariffs primarily take aim at manufactured goods from cheap labour countries, New Zealand and Australian commodity exports may not be greatly harmed. A major reduction in US corporate tax rates could not help but put high pressure on other OECD governments, including New Zealand and Australia, to respond in kind. Bill English may be forced into a much larger corporate tax cut than the miserly one or two percent talked about to date.

The RBNZ kept New Zealand's OCR at 1.75% on 9 February with Governor Wheeler indicating there may be no rate rise until 2019 despite rising inflation and growing inflation expectations, but many economists still pick a first rate rise in 2018. BNZ currency strategist, Jason Wong, expects the OCR to track well below market rates as the RBNZ believes the NZ dollar is too high for balanced growth to occur, meaning we could see negative tradables (export and import) inflation while CPI inflation moves back into the target 1% - 3% band.

The RBNZ predicts 1.5% inflation during 2017, falling to 1.3% in 2018 and rising again to 2% by mid-2019. GDP growth of +3.5% is expected for the year to 31 March 2017, rising to +3.9% to 31 March2018.

Australasian investors have largely missed out on the Trump-led US stocks rally, with the NZX 50 index up just 1.2% since the start of the year and the S&P/ASX200 effectively flat. In contrast the S&P 500 is up 4.8% in two months, setting new records along the way. Australian small cap shares have fared particularly poorly, down 2.3% since the start of 2017 and off 6.3% since peaking in August last year.

Restriction on capital outflows from China is not expected to have much impact on interest rates and house prices in New Zealand and Australia while immigration remains so strong. Despite froth coming off the market, demand for Auckland housing is still high.

Australia recorded its largest trade surplus ever, in dollar terms, in December 2016 at A$3.5b, up 75% on November's unexpectedly large surplus of A$2b and far ahead of economists' expectations. Annual exports rose by 4.2% in 2016 to set a record of A$329b, led by large volume increases in LNG, coal, gold, iron ore and services including tourism and education. Price-wise, commodities remained relatively flat. More strong Australian trade surpluses should help protect Australia's coveted AAA credit rating and put further downward pressure on the NZD/AUD cross rate.

Chinese holdings of US Treasury stock actually increased during December 2016, reversing net sales since February of last year. Whether this marks the end of the trend or simply a blip remains to be seen – as China struggles to limit cash outflows and defend the Yuan.

In Europe, the forthcoming French presidential election adds more uncertainty for investors to ponder. A win by Marine Le Pen could well mark the start of disintegration of the EU and failure of the Euro common currency. But French politics differ in that alliances of left and right, for common cause, are not unknown and might well apply to the second round of voting on May 7. Both the conservative, Fillon, and socialist, Macron, favour retention of the Euro and continued French membership of the EU. A win by either should calm markets but success by Le Pen could take volatility of European equities to new highs and the Euro to new lows altogether.

Of good news, Germany's Bundesbank is reported to be on track to have half the country's gold back in its own vaults by the end of 2017. During 2016 111 tonnes were transferred from the US Federal Reserve and 105 tonnes from Paris. At the close of 2016 the Bundesbank claimed to own 3378 tonnes of gold, mostly accumulated during the 1950s and 60s and held abroad in case of invasion by the Soviet Union. Repatriation of half the gold allays some widely-held fears that some of Germany's gold may have vanished or been "lent out" to speculators and lost. Of the remaining half, 1236 tonnes will remain in the Federal Reserve and 432 tonnes in the Bank of England.

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

	Latest	Jan 17	Dec 16	Nov 16	Oct 16	Sep 16	Aug 16
3 month LIBOR (end of month) %	1.05400	1.03900	.99789	.93067	.88594	.84561	.83344
TED Spread (points)	.53	.51	.50	.45	.54	.57	.51
VIX equity volatility	11.47	11.99	14.04	13.33	17.06	13.29	13.12
US LEI		+0.6%	+0.5%	+0.2%	+0.2%	+0.3%	-0.2%
Japan LEI			-1.3%	+0.4%	+1.6%	+0.0%	-0.8%
Eurozone LEI		+0.6%	+0.7%	+0.1%	+0.3%	-0.1%	+0.5%
Australia LEI			-0.1%	+0.5%	-0.4%	+0.3%	-0.1%
United Kingdom LEI			+0.0%	+0.0%	+0.0%	-0.2%	0.0%
China LEI		+1.1%	+0.8%	+1.3%	+1.0%	+1.0%	+0.5%
US Money Market Funds $T	2.680	2.680	2.729	2.719	2.677	2.680	2.724
US Gov. 10 year T-Bond (%)	2.317	2.451	2.446	2.368	1.834	1.6080	1.5680
US 5 yr inflation expectations %	2.16	2.16	2.19	2.11	1.87	1.75	1.64
US high yield-treasury spread 3-5yr %	3.77	4.00	4.21	4.67	4.91	4.97	5.10
Foreign holdings of US T-Bonds $B			6003.9	5944.7	6041.9	6154.9	6196.4
Margin debt, NYSE (US$ millions)			489,523	500,442	483,978	501,125	471,231
US M2 Money Stock (US$B)	13291.3	13282.5	13249.2	13223.2	13137.5	13060.9	12986.9
Velocity of Money US M2			1.436			1.439	
CNN Fear and Greed Index	68	59	66	70	43	50	63
AAII sentiment survey (% bullish)	38.5	32.8	45.6	43.8	23.6	24.0	28.6
US retail & food service sales US$B		472.142	470.461	466.028	465.321	462.284	457.722
Insider Buy/Sell ratio (US) %	24	26	34	36	32	31	29
Brent crude oil spot price USD/barrel	56.34	55.25	54.96	47.95	46.2	48.24	47.94
Forward P/E S&P 500 (12 month)	18.22	17.45	19.04	18.45	18.02	18.43	18.59
Trailing P/E S&P 500 (12 month)	24.80	24.71	24.95	24.35	24.31	24.81	24.71
Total Put/Call options ratio CBOE	0.830	1.025	.975	0.90	1.06	1.02	1.01
S&P 500 Share Index	2367.34	2278.87	2238.83	2198.81	2126.15	2168.27	2170.95

Our data table is saying loud and clear that investors are placing a lot of faith in President Trump to deliver on his promises to create more US jobs, higher wages and greater US manufacturing output through lower taxes, tariffs and less regulation. Any failure to meet high investor expectations will be treated harshly. Even "meeting expectations" is likely to see equity markets sell off in the short term.

Of interest is the latest velocity of M2 money, down yet again to another record low since records began in 1959. Coupled with a trend towards lower growth in M2 money supply the velocity figure indicates that serious inflation is still not of immediate concern and may push the US Fed to hold off on a March federal funds rate increase.

2. Equities

Macquarie Group (ASX:MQG) could gain immediately from Trump's planned US tax cuts but benefits from planned spending on new infrastructure projects would take longer to materialise. Macquarie generates 30% of its revenue in the US so a large tax cut would provide immediate gains. MQG's US activities already include waste management, roads and energy but adding new infrastructure investments would take time, not reflecting in the accounts for years. Macquarie says it is on course to meet full year guidance in line with 2016's A$2.1b profit despite a reduced contribution from its capital markets business resulting from less capital markets activity and timing of some transactions. Net profit from annuity-type businesses was up. MQG shares have risen by 33% over the past year, but remain essentially flat, even down a little, for calendar 2017 to date. Cash dividend is forecast to exceed 5% in 2018 based on a latest price of A$86.31. Any Trump-induced market pull-back could represent a buying opportunity.

Transurban Group (ASX:TCL) reported a profit up 42% to A$88m for the six months to 31 December 2016 as traffic surged on Brisbane and Sydney toll roads. Toll revenue of over A$1b has exceeded earlier guidance, allowing the board to increase expected 2016/17 dividend by 13% to 51.5 cps. At just over A$11, TCL shares have essentially gone nowhere since February 2016 and are well off their highs of over A$12.50 in August last year. However, TCL has shown a rise of 7.7% during calendar 2017 to date and projected cash dividend yield for 2016/17 at today's share price would be about 4.63%. Transurban is looking to expand its presence in the US although opportunities, as with Macquarie, from Trump's planned new infrastructure spending would take years to materialise. TCL already has two toll roads in northern Virginia.

Transurban says it has A$9b worth of projects under development, all of which are on time and within budget. The Company is negotiating with the Victorian Government over the A$5.5b Western Distributor project which would include a second bridge across Melbourne's Maribyrnong River. Transurban may have to raise capital if these negotiations reach their objectives. TCL is also intending to bid for part of the WestConnex project presently under construction and planned to be sold by the NSW Government. The project links Western Sydney to the CBD.

Expectations of a capital raising may have contributed to TCL's unexciting share price movement over the last year. Depending on how and when any capital raising is undertaken, a good opportunity may arise to add additional shares to portfolios of this high growth company.

BHP Billiton (ASX:BHP) reported a net profit of US$3.2b for 1H17, slightly exceeding analysts' forecasts and up dramatically from the loss of US$5.7b for the previous comparable period. BHP benefitted largely from steady commodity price rises in the second half of 2016 and a reduction in costs including iron ore production costs. Iron ore from Pilbara increased from US$43/wet metric tonne to US$55/wmt in 2H16. Over the full 2016 year iron ore prices more than doubled and crude oil recovered more than 40% from multi-year lows seen earlier in the year. Iron ore production was boosted to a record 118m tonnes during the six months but conventional crude oil production rose just 1% to 32 million barrels equivalent. An interim dividend of US$0.40 per share has been declared, 2.5 times the US$0.16 per share from the pcp but still well down on the A$0.808 interim dividend paid in 2014/15. During the latest six month period BHP recorded a charge of US$155m against the Samarco Dam failure in Brazil.

Revenue grew 20% to US$18.79b. BHP says the outlook is for moderating commodity prices but growth of global protectionism could pose a bigger challenge. A portion of BHP's strong cash position will be used to buy back some of the Company's US$2.5b bonds on issue, reducing debt and interest commitments.

BHP shares have recovered 57% over the past year but have made no progress during calendar year 2017 to date. Dividend yield should be about 3% if final dividend matches interim. High volatility of resource companies such as BHP and uncertainty of commodity prices mean rewards can be significant but risk is high. Hence we prefer to limit any portfolio holdings to modest levels.

The **Fletcher Building (NZX:FBU)** share price was hit hard by an unexpected write-down in the "tens of millions of dollars" on one major project and weak earnings from its construction division for the six months to 31 December 2016. Although reporting a profit rise of just 2% for the half, full year guidance of NZ$720m - $760m for the full 2016/17 FY was reaffirmed. The share price action epitomises harsh sharemarket treatment of any company not meeting expectations or revealing a nasty unexpected surprise. Fletcher Building claimed to be holding a record backlog of work at $2.7b but, as one shareholder succinctly put it from the AGM floor a few years ago " billions of dollars worth of backlog aren't worth squat if you're not going to make any money from it"…

An interim dividend of 20 cps has been declared, up from 19 cps for 1H16.

FBU shares have risen about 35% over the past 12 months but are well off their highs of over $11 in September last year. Fletcher Building is a company with everything going for it terms of demand, capabilities and market position. All the company has to do is meet basic expectations through effective allocation of capital to see the share price regain upward momentum. A frustrating investment. We will continue to hold.

Tourism Holdings Limited (NZX:THL) increased 1H17 net profit by 38% to NZ$11.3m and expects to deliver a full year profit of at least NZ$27m to 30 June 2017. Revenue increased 9% to NZ$146m and THL has set a profit target of $50m by 2020 with significant growth expected in its US operations. Hence THL provides a useful means of direct access to the US economy for New Zealand investors. An interim dividend of 10 cps has been declared. The shares have gained nearly 60% over the past year but still sell on a projected cash dividend yield of approximately 5.2%. THL should benefit from Trump's fiscal policies and prosper while the global economy improves.

Australian gas distribution pipeline operator **APA Group (ASX:APA)** is a core portfolio holding intended to provide steadily growing capital value and income from the relatively stable infrastructure sector. EBITDA increased by 13.8% (A$92.1m) for the six months ending 31 December 2016 to A$759.7m. An interim dividend of 20.5 cents per security has been declared, up 1.5 cents or 7.9% on the previous comparable period. Revenue grew by A$141.8m to A$954.3m, up 17% on 1H16. The share price has shown high volatility over the past year and now sits roughly where it began – reflecting investor concerns over increased regulation of the gas market and projected soft domestic gas demand. However, providing pipeline and storage facilities to big LNG exporters is a major opportunity. A cash dividend yield of over 5% is forecast for the next two years. A security to add to portfolios at the right price.

3. Interest rates, bonds and debentures

Fisher and Paykel Finance is now operating under the Flexi Cards brand, after the name of its Australian parent, FlexiGroup. The current Product Disclosure Statement still carries the Fisher and Paykel name.

ANZ is in the process of selling UDC finance to Chinese Group, HNA, for $660m, one of the world's largest asset financing and leasing companies. HNA does not currently operate in New Zealand. The sale is subject to certain closing steps and conditions, including replacement of the secured investments program. This could mean secured deposits may no longer be offered by UDC and existing deposits could be repaid early. S&P has lowered UDC's long term credit rating from A- to BBB-.

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	4.10	4.20	4.35	4.55	4.65
F&P Finance	BB	25,000	2.00	3.10	3.80	4.00	4.10	4.25	4.35	4.50	4.70	4.80
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	BBB-	5,000	1.85	2.70	3.45	3.75	3.80	3.75	3.75	3.85	4.05	4.15
UDC Finance	BBB-	100,000	2.35	2.75	3.50	3.75	3.80	3.80	3.80	3.90	4.10	4.20

Deposit rates are liable to change at short notice. Check before investing.

Canopus advisory clients receive a full rebate of any commission received by Canopus on term deposits used in portfolios.

Contact me for copies of product disclosure 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

Imminent release of the Trump tax policy, carrying high expectations from investors as shown in our data table, means we are unwilling to make open market share purchases at this time. Risk to equity markets is high when such a high level of expectation is built in. Repeating our earlier warning - any failure to meet high investor expectations will be treated harshly. Even "meeting expectations" is likely to see equity markets sell off in the short term. Chasing up prices in the current environment is unlikely to prove a winning strategy.

Although Australasian equity markets have missed out on the Trump rally, any US market reversal is almost certain to reverberate here to some extent.

Hence, on the equities side, little is to be done just now except, perhaps, to look at liquidating one or two holdings in the "failed to live up to expectations" category. Funds released would be put aside in cash. Overall, now is a good time to be monitoring watch lists, accumulating cash and just waiting. After all, sharemarkets do transfer wealth from the impatient to the patient.

Upward movement in fixed interest rates and bond yields has slowed but should regain some momentum later in the year – especially if the US Fed follows through on its stated intention to produce three rate rises in 2017. Hence open market bond purchases are not attractive just now either.

Preliminary results show our published portfolios as having gained just over 1% in February with just one day to go.

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

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Regards,

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