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Investment Directions **29 January 2015**

"Analysis to action. Opportunities to outcomes"

In this Issue

1. **Overview** – High volatility on US equity markets with negative sentiment dominating after oil falls again, some poor corporate results and renewed market expectations of higher interest rates. ECB introduces huge QE forcing Swiss to break cap of 1.2 Swiss Francs to the Euro. Syriza wins Greek election, promises renegotiation of bail-out debt but creditors unimpressed. China's clampdown on margin trading pushes Shanghai down. US dollar overwhelmingly most sought-after currency but AUD may have been over-sold.

2. **Equities** – Infratil looks set to benefit from purchase of Australian retirement village operator; offers access to high growth retirement sector with dividend income.

3. **Interest rates, bonds and debentures** – Best fixed term deposit rates from major finance companies. Fisher and Paykel Finance lowers rates across the board, up to 0.45% for the 5 year term.

4. **Strategy** – High NZ/AUD rate makes some ASX purchases attractive. APA Group entitlement issue taken up. Bond yields have fallen but could well go lower yet. Portfolio unit values recover in December and look strong for January.

1. Overview

Wall Street fell on 28 January on declining oil prices and poor results from some major companies as the rising US dollar hurts those dependent on exports and indirectly on commodity prices. Amongst large decliners were Microsoft, Caterpillar, Proctor and Gamble and Du Pont. A sharp fall in durable goods orders in December added to negative sentiment. However, US consumer confidence remains high and Apple and Yahoo both surged in late trading after releasing positive announcements. The falls reversed strong gains the previous week on the back of planned ECB QE. US GDP recorded growth of 5% annualised in 3Q14, higher than the 3.9% expected, with consumption spending up +3.2%.

In Europe the ECB intends to inject €1.1T into the European economy to fight off deflation. It appears risk will be contained through each sovereign state central bank purchasing its own government's bonds. Global equity markets surged on the ECB announcement. In a move that caught many currency traders by surprise the

Swiss National Bank removed its 1.20 cap on the CHF/EUR exchange rate, which it had been defending with its own QE money creation programme – buying Euros with newly created Swiss Francs. The SNB came to realise the policy was untenable in the face of a severely-declining Euro. Swiss exporters will suffer but, as one observer remarked, the buyers of Rolex watches aren't really going to be worried about higher prices. The SNB move proved to be an ugly duckling for traders facing huge losses with some brokers being forced into closure, but no "Black Swan" event as far as world financial markets were concerned.

Effects of the Syriza left wing party win in the Greek elections have yet to be felt. New PM Alexis Tsipras wants Greek Government creditors to forego 50% of their debt value while the lending "Troika" of ECB, European Union and IMF say no, fearing a contagion of any relaxed terms to other "anti-austerity" parties throughout Europe. This fight is just beginning.

In China reported growth exceeded many forecasters' expectations at 7.4% for 2014 but opinion is still divided over the outlook. No "hard landing" appears imminent and, in real US dollar or Yuan terms, 7.4% of China's economy today is much greater than 10% of a much smaller economy a decade ago. As in the US, margin trading on China's stock exchanges is an asset price inflation problem. Margin trading on the Shanghai Stock Exchange rose from US$64B to US$177B in just seven months from June 2014 to January 2015 helpin boost the Shanghai 300 Composite Index up 64%. China's stocks trade on an average forward P/E reportedly of > 44, compared to the S&P 500 of <17. Correlation between margin trading in China and the Shanghai Composite Index is said to be virtually "1 for 1". In mid-January China's securities regulator, the CSRC, severely restricted the ability of investors to open and operate margin trading accounts, causing the Shanghai Composite Index to plunge 7.7% in one day.

I continue to monitor margin trading on the NYSE as an indicator of future direction. In February 1929 the US Federal Reserve banned margin trading to rein in speculation. The Great Wall Street Crash hit in earnest eight months later although markets had started to shake as early as March. However, enormous QE in major economies today plus the improving US economy mean comparisons between now and 1929 are otherwise largely irrelevant.

Everyone everywhere is bearish on the Australian dollar versus the US dollar. Such overwhelming sentiment means a sharp reversal is possible but the current direction looks to have some way to run yet, driven by continuing weakness in hard commodity prices and expectations that the Reserve Bank of Australia may follow Canada in lowering its Official Cash Rate. However, the declining AUD gives the RBA reason to hold off lowering its own 2.50% OCR for now. The lower AUD should assist business and job growth outside the mining sector, especially manufacturers, tourism operators, the rural sector and other exporters. New Free Trade Agreements with South Korea, Japan and (soon) China will help. In addition Australia has considerable potential for intellectual property export.

The New Zealand dollar fell again in January on release of a December quarterly CPI figure of -0.2%, "unexpectedly" below the RBNZ target of 1%-3% annually. The figure indicates RBNZ Governor Wheeler is still off track in giving guidance of an OCR rise in late 2015. RBNZ guidance and media predictions of inflation have been too high for over two years. Interest rate forward markets are now pricing in some possibility of an OCR cut by the RBNZ rather than a rise from the current 3.50%. But, as with Australia, the falling NZ dollar acts as a shock absorber for the economy. Latest auctions show a rise in lamb wool prices while export log prices hit a nine-month high in January, thanks to the lower NZ dollar, increasing demand from China and lower shipping costs. The ANZ Commodity Price Index fell 17% in 2014. Soft commodity prices could be on the turn. We may yet see an encore from the "Rock Star" economy.

RBNZ Governor Wheeler held the OCR at 3.50% on Thursday 29 January, saying that he expected the OCR to be on hold "for some time" and opening the possibility that the next move could be down rather than up.

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

	Latest	Dec 14	Nov 14	Oct 14	Sep 14	Aug 14	Jul 14
3 month LIBOR (end of month)	.25610	.25520	.23435	.23210	.23510	.23360	.23960
TED Spread (points)	.23	.22	.21	.22	.23	.20	.20
VIX equity volatility	17.22	19.20	13.33	14.03	16.31	12.09	16.95
US LEI		+0.5%	+0.4%	+0.6%	+0.8%	+0.0%	+1.1%
Japan LEI			+0.6%	+0.1%	+0.8%	+0.3%	-0.9%
Eurozone LEI			+0.4%	-0.3%	+0.0%	-0.6%	+0.3%
Australia LEI				-0.2%	-0.6%	-0.3%	+0.6%
United Kingdom LEI			-0.3%	-0.3%	-0.3%	+0.4%	+0.1%
China LEI			-0.3%	-0.3%	-0.3%	+0.7%	+1.3%
New Zealand CLI (Amp adj. OECD)				+0.2	+0.0%	+0.0%	-0.1%
US Money Market Funds $T	2.704	2.733	2.688	2.629	2.614	2.595	2.554
US Gov. 10 year T-Bond (%)	1.825	2.17	2.194	2.34	2.51	2.343	2.556
Foreign holdings of US T-Bonds $B			6112.4	6058.9	6060.4	6066.6	5998.0
Margin debt, NYSE (US$ millions)			457,106	453,841	463,878	463,018	460,231
US M2 Money Stock (US$B)		11.625	11,562	11,511	11,473	11,439	11,414
Velocity of Money US M2					1.5384		
Forward P/E S&P 500 (12 month)	17.01	17.25	17.15	16.25	16.85	16.75	16.55
Trailing P/E S&P 500 (12 month)	19.71	19.67	19.27	18.43	19.36	19.16	19.51
Total Put/Call options ratio CBOE	1.09	1.22	0.99	0.775	1.29	0.82	0.99
S&P 500 Share Index	2029.55	2058.90	2067.56	2018.05	1972.29	2003.37	1930.67

VIX equities volatility remains slightly elevated at over 17 but well below the 23.57 reached in mid-December, indicating market confidence is returning as 2015 progresses.

Note: China's LEI figures have been restated with respect to a benchmark revision where the base year is 2010 rather than 2004 as used previously. Hence the large positive figures we have become used to have disappeared for now at least.

After a 70% rise from October 2011 through to the end of November 2014, the S&P 500 has made no net gain over the past two months with high volatility dominating. The rising Put/Call Options ratio indicates professional traders are again moving to insure their portfolios against more sharemarket weakness in the immediate future. The ASX has made somewhat more progress, but still limited, over the same timeframe whereas the NZX has gained 6.35%, boosted by high dividend yields and a lower dollar.

NYSE margin debt increased in November. The total has remained very high since July '14 and, theoretically, poses a major threat to US and global equity markets. However, vast amounts of cheap and accessible QE money look to be suspending US indices at present levels.

The US dollar is becoming even more attractive as a repository for central bank reserves from around the world in the face of falling Yen, Euro and Yuan. Market expectations of a US interest rate rise in late 2015 make the Greenback pull even more support but such interest rate expectations may again be proven wrong, just as they have been over the past two years.

2. Equities

Infratil (NZX:IFT), in another shared deal with the New Zealand Superannuation Fund, has bought 50% of Australia's 4th largest retirement village operator, RetireAustralia. The full price was A$640 million, funded by A$215m cash from each partner with the balance being funded by acceptance of existing debt already held by RetireAustralia. Infratil recently bought a cornerstone shareholding in NZX-listed Metlifecare **(NZX:MET)** and so provides access to the high growth retirement sector through a vehicle paying a reasonable dividend - a high dividend if last year's special dividend is repeated. Listed retirement village operators tend to pay minimal dividends and so are generally unsuitable for our income-biased portfolios. Infratil has reaffirmed its March 2015 profit guidance of $475m - $500m (NPBITDA). Net interest is forecast to rise from a range of $165m - $175m to a range of $170m - $180m. Infratil sees the retirement sector as one offering significant opportunities to deploy capital in future. IFT has risen 49% over the past 12 months while returning 26.5 cps in dividends, including a 15 cps special dividend paid in December 2014. Without a special dividend in 2015, yield should be around 4% at the current share price of $3.13.

3. Interest rates, bonds and debentures

F&P Finance has reduced its debenture rates across the board from call to 5 years, with the 5 year term down a hefty 0.45%. Given the Reserve Bank's latest neutral stance, changed from a tightening bias, we can expect more deposit rate reductions.

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	4.35	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.

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 have done well over the past two years out of our belief that the Reserve Bank of New Zealand was on the wrong track with its tightening bias and predictions of a higher OCR – parroted by the media and frequently deferred. There is just too much cheap money flowing around the world from massive QE programs for New Zealand to hold out in the opposite direction. Now the RBNZ has been forced to adopt a neutral stance and markets are pricing in the possibility that the next move, when it comes, will be down rather than up. Bonds purchased over the past two years are providing above-market yields in addition to strong capital growth. We have backed off buying bonds over the past few months as yields have fallen further, but may be forced to review that strategy if market sentiment towards still lower rates grows. In any case, new bond issues are scarce.

Canopus portfolio owners holding securities in big Australian gas network owner and operator, APA Group, took the opportunity to add to holdings via the 1:3 non-transferable entitlement issue at A$6.60 per security. Projected dividend yield on the new securities is 5.5% at the issue price and APA has already rebounded to over A$8 after declining to around A$7.40 during the issue, providing an immediate 23% capital gain. Useful issues from quality companies are uncommon and should be taken up as the opportunity arises. The non-transferable nature of this offer meant investors effectively had to accept it on a "use it or lose it" basis.

The high New Zealand dollar during January also provided the opportunity to add just a few carefully selected Australian and international equities to portfolios. Blue chip equity prices everywhere are not cheap and so now is not the time to be chasing higher yields – in bonds or equities – at the expense of quality.

Our diversified income portfolio recovered to $1.2526 as at 31 December, with unit value hampered by the high NZD/AUD exchange rate reaching over 0.95. A retreat to the 0.93 level should help January results.
The portfolio owner is still holding a significant portion of assets as cash just now.

Our growth portfolio unit value increased 1.6% for the month of December to stand at $1.3748.

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

January unit values are looking strong at the moment but high volatility in US markets usually affects Australian and New Zealand markets as well. US markets have reacted negatively again to the latest statement from the US Fed in which stronger US economic growth is predicted. US equity markets seem to have interpreted the improved economic outlook and Fed language as meaning a rise in interest rates is looming closer.

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,

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

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