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Investment Directions **30 January 2016**

"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – Falling crude oil and Chinese central bank moves hit equity markets to start the year. Bank of Japan throws curved ball into global currency, bond and equity markets by adopting negative interest rates on last day of month. Equities regain some losses. New Zealand's credit rating under threat as forecast dairy payout falls but tourism and other sectors strong as Kiwi declines.

2. **Equities** – BHP Billiton writes down US shale oil and gas holdings, major dividend cut likely. Fletcher Building should benefit from new government infrastructure initiatives. High risk of companies relying on acquisitions and debt for growth.

3. **Interest rates, bonds and debentures** – Deposit rates stable for January 2016.

4. **Strategy** – Selective buying of Australasian blue chips and international equities warranted.

Space Exploration News

Data from Dawn's lowest orbit indicates bright spots on dwarf planet Ceres could comprise mainly salts or ammonia-rich clays. The wide dispersion of many bright spots on Ceres' surface suggests the dwarf planet has a subsurface layer containing briny water ice.
See http://dawn.jpl.nasa.gov/news/news-detail.html?id=4785

1. Overview

Global equity markets got off to a rough start in 2016 with the S&P 500 losing 9.5% to 1859.33 in just 12 trading days to 20 January '16 as crude oil prices plummeted further (Brent crude US$26.01 on 16 Jan '16) and Chinese shares gave up all their gains and more since the start of 2015. On top of that, concern over credit markets added pressure to equities. The last trading day of January though, saw a 2.48% recovery take the S&P 500 out of "correction" territory, limiting losses for the month to -5.07% at 1940.24.

The Bank of Japan's surprise adoption of European style negative interest rates on 29 January is credited with the late S&P 500 surge. With this action the BoJ has effectively rejoined the global currency war – the "race to the bottom" – in yet another attempt to spur growth in the moribund Japanese economy. The BoJ hopes to force banks to increase business lending rather than pay for the privilege of depositing excess reserves with the central bank. Its asset-buying quantitative easing program remains in place. From an American perspective

a lower Yen and expected unwanted attraction of yet more global cash into the US dollar will make it even harder for the US Federal Reserve to pursue its goal of stepping up the federal funds target rate during 2016. Futures markets are now pricing in a federal funds rate of just 0.55% for the end of 2016, implying just one more US rate rise at most during the year compared to four being touted by FOMC members themselves late in 2015.

The US Federal Open Market Committee maintained its target federal funds rate at 0.25% - 0.50% on 27 January, saying that while employment, household spending, the housing sector and business fixed investment had all increased moderately over the past few months, net exports had been soft and inventory investment had slowed. Inflation is expected to remain low in the near term and then rise to the Fed's target of 2% as the transitory effects of lower energy and import prices dissipate and the labour market strengthens further. In determining the size and timing of future adjustments the FOMC will assess the implications of global economic and financial developments on the US labour market and inflation. Only a gradual increase in the federal funds rate is expected to be warranted.

The FOMC is maintaining its current policy of reinvesting maturing agency debt and agency mortgage backed securities back into agency MBSs and rolling over maturing Treasury securities. Retaining high levels of long term securities should help maintain accommodative financial conditions - including market liquidity. Although stock market weakness indicates investors are sceptical of the Fed's ability to maintain high liquidity, extreme fear appears to be unjustified. Fundamentals are vastly different from 2008 – banks are now better capitalised and not nearly so vulnerable to huge unknown liabilities. Globally, large institutions are not holding enormous amounts of worthless sub-prime mortgage debt.

S&P 500 corporate earnings for 4Q15 are now being reported. As at 22 January '16 the blended earnings (actual plus estimated results) decline was -6.0% (YOY), giving the first three consecutive quarters of year on year earnings declines since 2009. Analysts expect revenue growth to resume in 1Q16 and earnings growth to return in 2Q16. Hence the "Bank of Japan rally" may have little follow through in the short term.

Rating agency Fitch has reaffirmed New Zealand's sovereign long term foreign currency credit rating as AA but lowered the outlook from positive to stable saying weaker growth prospects have translated into a slower-than-expected reduction in Crown debt. Weak dairy prices are weighing on New Zealand's banking sector as a second season of low milk product prices constrains farmers' abilities to meet their obligations. So far delinquent loans have remained low as banks have supported farmers but a prolonged period of low dairy prices could lead to a rise in non-performing loans and sharper cutbacks in production and investment. Standard and Poors and Moodys have maintained their equivalent New Zealand long term foreign currency ratings at AA (stable) and Aaa (stable) respectively.

The unexpected Fitch move on 26 January caught the market by surprise, resulting in a sharp little drop in the NZD/USD from a high of 0.6531 to a close of 0.6433 on 27 January. Any overall deterioration in New Zealand's credit rating would generally oblige the New Zealand Government to incur higher interest charges on sovereign debt.

The Kiwi was further pressured by a wider than expected 5 month Government deficit, a more dovish tone from the RBNZ as it held the OCR at 2.50% on 28 January and a forecast payout cut to $4.15 per kg of milk solids by Fonterra. As at the time of writing the NZD was buying 64.44 US cents. Many economists and fund managers expect the RBNZ to lower its OCR at least once more, by 0.25%, during 2016 in an attempt to push inflation back into the target mid-range of 2% but the lower NZD and stable or rising rates in the US could obviate the move by pushing up inflation a little in any case.

On the positive side the NZIER Quarterly Survey of Business Opinion found business confidence rising and hiring intentions up for 1H16, but inflation remains subdued and businesses are largely unable to pass on cost increases to customers. Retail, especially in Auckland, is reportedly strong. Tourism is booming with total guest nights up 4.6% to 3.11m in November '15 (year on year) as the lower NZD and cheaper petrol create tail winds for what has become New Zealand's largest foreign exchange earning industry.

Against the Australian dollar the Kiwi has been falling steadily during January with a sharp dip to 91.52 Australian cents at the close on the 27th after crude oil jumped 5% on news of Russia agreeing to discuss

supply issues with OPEC. Also, Australian inflation for the December quarter marginally beat expectations at 0.4% giving an annual rate of 1.7% with core inflation just meeting the RBA target of 2%. Improving employment and business conditions mean the RBA is unlikely to cut its OCR again in the near future despite the soft inflation figures.

There can be little doubt Chinese authorities compounded global sharemarket fears early in January when a very crude “circuit breaker” kicked in, halting trading on Chinese equity markets for 15 minutes after an initial 5% index fall - triggered at least in part by a sharp fall in the Yuan. When equity losses for the day reached 7% the circuit breaker halted trading for the rest of the day. The result of such a naïve attempt at market control should have been obvious from the start. Reopening the market after 15 minutes following the initial 5% plunge was virtually guaranteed to produce a rush in panic for the exits. After repeating the process within a few days – with the same result – the circuit breaker was abandoned just four days after it was introduced. However the China Regulatory Commission retains a number of levers intended to enable intervention in and manipulation of, China’s equity markets. Chinese regulators have not given up their attempts to underpin share markets but future efforts may well be as ineffective as past.

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

	Latest	Dec 15	Nov 15	Oct 15	Sep 15	Aug 15	Jul 15
3 month LIBOR (end of month) %	.62110	.61270	.41620	.33410	.32500	.32900	.30860
TED Spread (points)	.36	0.45	.20	.25	.34	.27	.23
VIX equity volatility	22.50	18.21	16.13	15.07	24.5	28.43	12.12
US LEI		-0.2%	+0.5%	+0.5%	+0.0%	0.0%	0.0%
Japan LEI			+0.3%	-0.1%	-0.8%	-0.1%	-0.5%
Eurozone LEI		+0.2%	+0.6%	+0.5%	-0.3%	+0.3%	+0.2%
Australia LEI			+0.3%	-0.1%	-0.4%	-0.6%	+0.2%
United Kingdom LEI			+0.3%	+0.4%	+0.2%	+0.1%	+0.3%
China LEI			+0.6%	+0.3%	+1.6%	+0.9%	+0.9%
US Money Market Funds $T	2.743	2.759	2.741	2.717	2.669	2.694	2.648
US Gov. 10 year T-Bond (%)	2.001	2.269	2.218	2.151	2.060	2.200	2.205
US 5 yr inflation expectations %	1.55	1.77	1.88	1.86	1.75	2.00	2.12
US high yield-treasury spread 3-5yr %	7.85	6.95	6.40	5.90	6.62	5.70	5.36
Foreign holdings of US T-Bonds $B			6125.7	6046.3	6101.7	6098.7	6116.5
Margin debt, NYSE (US$ millions)		461,200	472,772	471,922	453,896	473,412	487,345
US M2 Money Stock (US$B)		12,331	12,288	12,201	12,187	12,138	12,059
Velocity of Money US M2					1.491		
CNN Fear and Greed Index	27	44	53	69	18	3	9
Insider Buy/Sell ratio (US) %	50	53	49	48	70	68	38
Forward P/E S&P 500 (12 month)	15.38	17.19	17.55	18.41	16.45	17.42	17.82
Trailing P/E S&P 500 (12 month)	20.69	22.65	23.18	22.07	20.59	21.63	21.18
Total Put/Call options ratio CBOE	0.95	1.00	1.07	0.95	0.97	1.20	1.00
S&P 500 Share Index	1940.24	2043.94	2080.41	2079.36	1920.03	1972.18	2103.84

LIBOR (London Interbank Offered Rate) and TED Spread remain at elevated levels with respect to their 2015 norms but have just moved down from highs in the last week of January, reflecting reduced credit risk concerns. Similarly VIX equity volatility is off 16% from its high of 27.59 on 20 January, providing at least temporary relief to concerned equities investors.

Market expectations for US inflation have fallen markedly since July 2015, implying falling expectations of further US federal fund rate rises by the Federal Open Market Committee (FOMC).

Margin debt reported by the NYSE has been surprisingly consistent now in the US$450B – US$510B range since June 2015. Although huge and therefore exposing US equity markets to the possibility of a sharp fall, there has been no sign at all of a sharp spike in US margin debt similar to that which fuelled China’s early 2015 share rally and then collapsed into the Chinese sharemarket rout of June the same year.

The CNN Fear and Greed index reached an extremely low value of 9 (“extreme fear”) on 21 January but has

since recovered to 27 – in the "fear" region. Historically periods of "extreme fear" have proven to be good buying points for true contrarian investors.

Our short term indicators point to January 20th as having set an intermediate S&P 500 low with investors taking a somewhat more relaxed attitude since then. At some point "selling into rises" will transform into sustained "buying the dips" – at which point the best buying opportunities will be over.

2. Equities

BHP Billiton (BHP:ASX) has written down the value of its US shale oil and gas resources by US$7.2B (A$10.17B) following extreme global weakness in crude oil and gas prices. The impairment charge against carrying value of US assets is stated as US$4.9B post-tax which will be recognised as an exceptional item in the annual accounts to 31 December 2015, reducing BHP's onshore US operating assets to a net US$16B (A$22.6B). Total BHP equity as at 30 June 2015 is recorded as A$91.855B. Given severe price weakness in BHP's other major resource products: coking coal, copper and iron ore, plus looming major fines and reinstatement costs for the Samarco dam failure in Brazil, retention of BHP's rising ("progressive") dividend policy looks impossible if the company is to hold onto its cherished A1 credit rating. Defending the balance sheet is a top priority according to Chairman Jac Nasser. The main avenues BHP has available to achieve that goal is further reduction in capital expenditure, lowered operating costs and retention within the company of potential dividend cash payments. All seem inevitable.

To what extent further write-offs, fines and even lower commodity prices have already been built into the BHP share price is impossible to assess, given the large range of unknowns. What is known for sure is that if the last interim and final dividends were maintained, a cash dividend yield of around 11% on the current BHP share price would result – an untenable outcome for a company of such status. Current earnings will be nowhere near sufficient to cover a repeat of last year's dividend. A realistic yield can only re-emerge from either a massive short term rally in the BHP share price (highly unlikely) or a severe reduction in the dividend. Given BHP's priority to defend the balance sheet, the latter carries by far the higher probability. Most analysts seem to be picking the dividend will be cut in half but a few are calling for dividends to be suspended altogether.

Chartists watching the BHP share price action would be looking for a break out on the upside from the long downward channel, accompanied by high volume. They will almost certainly get it if BHP retains more than half its current dividend.

Shareholders of New Zealand's largest listed construction and building products provider **Fletcher Building (FBU:NZX)** should expect their company to be a major beneficiary of initiatives just announced by Prime Minister John Key to bring forward major infrastructure projects including Auckland's $2.5B city rail link, now timed for construction to start in 2018. Few other construction companies, either offshore or local, have the experience, associated knowledge networks and skills to undertake such a challenging engineering work within New Zealand. Fletcher Building could well take the role of lead project manager, utilising its own engineering resources and engaging a host of subsidiary contractors on specific tasks or at least participate as a major partner in any construction consortium.

The PM also announced that a $1B road connection from Onehunga to Mt. Wellington would be given a streamlined consenting process to allow construction to start in 2018. About $4.2B is expected to be invested in transport in and around Auckland over the next three years and up to $115m on four road projects in Taranaki, Gisborne and Blenheim. With opportunities like this, Fletcher Building should be able to add substantially to its already-announced forward order book of $3.4B.

These new opportunities should underwrite Fletcher Building's ability to meet analysts' forecasts of around 61 cents per share earnings in 2016 and 65 cents in 2017. Dividends are expected to rise from the current 37 cps to 40 in 2016 and 42 in 2017 giving cash yields of 5.76% and 6.05% respectively at the present price of $6.94.

Risks to future performance include the possibility that Fletcher Building is unable to derive a satisfactory return on its huge forward order book and that the company could potentially again be lured into one or more

ill-considered major acquisitions resulting in significant write-offs at a later date. Although current CEO Mark Adamson indicated to the last AGM that acquisitions are not a priority for his watch, Fletcher Building is now reported to be considering the purchase of civil construction and aggregates supplier Higgins Group for in excess of $100m. Higgins designs and builds infrastructure projects and provides road maintenance in New Zealand and Fiji. The company manufactures aggregates, concrete and bitumen based products, road signs and bitumen equipment. Fletcher Building apparently intends to fund the purchase with debt. With FBU equity of $3.71B as at 30 June 2015, the purchase would not be large in relation but shareholders will be wanting to see a much more carefully considered purchase and better executed acquisition than has been evident in the past.

At under $7.00, investors can add Fletcher Building as a core portfolio stock offering a high and apparently sustainable dividend yield at a modest P/E of around 11.4.

The danger of buying into companies relying on acquisitions for growth, especially when funded by high debt levels, has again been highlighted - this time by **Veritas Investments Limited (VIL:NZX).** The shares were pummelled after the company announced a profit forecast downgrade and no interim dividend for 2016 (c.f. 2.7 cps in IH15). After providing guidance in November 2015 that trading was in line with expectations, a forecast asset writedown of $5.4m and expected underlying profit reduction (pre one-off items) from a range of $5.3m - $5.4m to a revised range of $3m - $3.5m saw the shares drop 30% to 35 cents (price at time of writing is 30 cents). Veritas was formed in December 2011 with the intention of purchasing a portfolio of profitable New Zealand retail and food product supply businesses which now includes the Mad Butcher stores, Nosh Food Market and Kiwi Pacific Foods. The company was listed on the NZX via a back door listing through Salvus Strategic Investments Limited which returned its capital to shareholders and changed its name to Veritas in March 2012. As at 30 June 2015 total liabilities of $43.24m, including $37.32m in borrowings, exceeded equity of $13.175m by 228%. The great majority of assets, $30.75m, are classified as intangible meaning the company has a serious deficit when it comes to NTA per share.

High gearing can greatly boost earnings per share for a profitable company but seriously magnify losses.

Examples of ill-considered and poorly executed acquisitions, resulting in massive loss of shareholder funds, abound amongst listed companies, right up to the very largest.

3. Interest rates, bonds and debentures

Deposit rates stabilised in January with just UDC Finance shaving minor amounts off its short term rates.

Current deposit rates, % p.a., quarterly interest payments:

Issuer	$ min	Call	3mth	6mth	9mth	12mth	18mth	24mth	36mth	48mth	60mth
F&P Finance	1000	2.85	3.15	3.65	3.75	3.85	3.95	4.10	4.25	4.35	4.45
F&P Finance	25,000	2.85	3.30	3.80	3.90	4.00	4.10	4.25	4.40	4.50	4.60
Heartland Bnk	1000	3.25*	2.90	3.40	3.30	3.55	3.45	3.50	3.60	3.65	3.70
Heartland Bnk	20,000	3.25*	3.00	3.40	3.40	3.55	3.55	3.60	3.70	3.75	3.80
Liberty Fin.	5,000		3.45	4.05	4.15	4.70	5.05	5.25	5.85	5.75	5.65
Liberty Fin.	20,000		4.60	4.20	4.30	4.85	5.20	5.40	6.00	5.90	5.80
Liberty Fin.	100,000		4.65	4.25	4.35	4.90	5.25	5.45	6.05	5.95	5.85
UDC Finance	5000	2.45	2.95	3.50	3.50	3.65	3.55	3.60	3.65	3.75	3.85
UDC Finance	100,000	2.95	2.95	3.55	3.55	3.70	3.60	3.65	3.70	3.80	3.90

*Heartland Direct Call Account

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4. Strategy

Now is an opportune time to be adding regional blue chips and international equities to portfolios currently light in weighting towards these sub-sectors. Blue chips paying high and sustainable dividends based on sound earnings forecasts should come in for special attention. International equities are often more difficult to analyse and can be expensive to purchase and hold for the individual investor. Gaining access to international equities through a locally listed international equities unit trust or listed investment company simplifies the process and provides ready liquidity. Each of these two types of entity have different characteristics which may or may not suit any particular investor so either do detailed research yourself or seek advice.

Have we reached the bottom yet? No-one knows. Markets usually over-react on both the upside and downside. To date in 2016 the downside has predominated. The worst strategy is to panic out in a downturn on advice from the barrage of would-be gurus bombarding our inboxes daily with never-ending predictions of imminent financial catastrophe – all aimed at acquiring your subscription money for their “indispensable” newsletter or string of other expensive publications. Remember the “ASX 90% collapse coming” just over three years ago?

A useful strategy is to recognise that current index levels may not be the bottom but purchases made now definitely will not comprise “buying in at the top”. Selective buying spread over the next month or two should enable some top quality shares to be added to a portfolio at reasonable prices and, with luck, purchases may just straddle a medium term market low.

Market value of NZDX listed bonds look to be moving upwards again as current ultra-low interest rates become more entrenched globally. But, despite renewed speculation of at least one more Reserve Bank cut to New Zealand’s OCR, purchasing bonds on market or via new issues appears risky right now. Fixed interest bonds purchased at today’s low yields would be expected to decline in value should market rates start moving up. Of course, one could hold to maturity in expectation of recovering the original investment but the investor may well have to endure several years of sub-market income to realise that original dollar. For now we are happy to sit on our current bond allocations, mostly purchased 18 months or more ago as rates were falling.

The S&P/ASX 200 is down 6% for the month of January 2016 with the NZX50 off about 3%. Our growth portfolio unit is down about 3% for the month with our more conservative income portfolio unit off 1.3%.

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,

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