

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.debex.co.nz

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Investment Directions

27 July 2016

"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – International equities rebound after Brexit vote shock. Buying opportunity short lived. RBNZ flags lower OCR to devalue NZ dollar, raises deposit requirement for housing investors. NZ manufacturing strong in June. US presidential election still anybody's guess but possible impacts vary widely. US Fed rate rise still possible in 2016.
2. **Equities** – Exercise of Marlin warrants a difficult decision.
3. **Interest rates, bonds and debentures** – Deposit rates stable during July. UDC has 9 month special at 3.50% p.a. Deposit rates for major S&P-rated finance companies.
4. **Strategy** – Portfolio values bounce back in July. International equities added to portfolios during brief Brexit vote opportunity. Fixed interest portion of portfolios even harder to manage as RBNZ flags more OCR cuts.

Space Exploration News

NASA's Juno exploration spacecraft entered orbit around Jupiter on 4 July, its mission to study the red planet and its system of moons. Keep up to date at http://www.nasa.gov/mission_pages/juno/where

1. Overview

Global equity markets rebounded quickly after Brexit failed to deliver the financial chaos and catastrophe predicted by ardent Euroists. Swift departure of David Cameron as British PM, to be replaced by Theresa May, lent an air of order to Britain's forthcoming EU departure. The British may yet have even more reason to celebrate being as far removed from the ECB, Euro and EU as possible in the months ahead as they watch Germany's mainstay Deutsche Bank join Italy's banks in suffocating under mounting mountains of bad debts. While Germany has ample resources to save its banks if needed, Italy does not. Shares in Italy's third largest bank, Banca Monte dei Paschi di Siena, are down to 31 Euro cents, off 96% from their peak just two years ago and down 75% from €1.23 at the start of 2016. The Italian government is reportedly now considering a bailout to save the bank, which would be in direct contravention of European Union rules. EU rules demand bond holders suffer losses via a bail-in before taxpayer funds are brought to the rescue. Who knows what goes on in Italian banking circles but a bail-in would definitely not be popular amongst the monied class – which has very long and strong arms in Italy! Also, many bank bonds are held by voting, retail investors. Forcing a bail-in could see PM Matteo Renzi quickly looking for a new job as Italy's Five Star Euro-skeptic movement gains further strength.

Post Brexit the GBP/USD rate has oscillated in the 1.28 to 1.34 range, well above the 1.20 collapse predicted by catastrophists and generally off about 8% from the 1.44 leading into the vote. After an initial intra-day shock loss of 9%, the FTSE is now trading well above its pre-Brexit vote level at around 6700, up about 8% on its pre-vote average near 6200 during May and June.

For investors, Brexit opened an opportunity to add international equities to portfolios but that opportunity proved to be short lived.

New Zealand manufacturing activity expanded again in June with the Performance of Manufacturing Index (PMI) rising to 57.7 from 57.2 May. A PMI above 50 indicates expansion and 57.7 is very high on a world scale. New Zealand's long term average is 53.1. Major OECD economies would give eye teeth to have such a high PMI with most struggling to exceed the 50 expansion point. All NZ regions reported growth. Clearly the country is no longer wedded to agricultural production alone although the various rural sectors combined still account for a major slice of exports.

The RBNZ is keen to retain competitiveness by lowering the New Zealand dollar – hence its firm guidance on 21 July that an OCR cut (0.25% expected) is solidly on the cards for August 11th. The guidance came after the Central Bank increased up-front deposit requirements for property investors to 40% when seeking loans from major banks. This way the RBNZ hopes to keep a lid on Auckland housing prices while devaluing the NZ dollar and boosting inflation – which remains well off its 2% target. Some economists are picking a further 0.25% OCR reduction later in the year. Already China's second largest bank, China Construction Bank, has announced a \$140m capital injection into its New Zealand subsidiary to fund further business and mortgage lending growth. The 40% rule doesn't apply outside the big local banks so offshore funding and non-bank local lenders have been handed a golden business opportunity.

Currency-wise the NZD took a quick 4% tumble against the USD after the new loan rules were announced with similar, but slightly lesser degrees, applying against the AUD and TWI.

Whether these latest loan restrictions will have any significant effect on house prices remains to be seen. The new rules won't decrease demand or increase supply. If they don't, expect even louder calls for more direct controls on prices, rents, interest rates, immigration, etc. with one just leading to another. Of course that's been tried before too. It became known as Muldoonism.

In Australia, the RBA now looks just as likely to reduce interest rates as the RBNZ rather than more so. Markets certainly have moved to price in the likelihood with the NZD/AUD cross rate retreating from a peak near 0.97 to around 0.935. Parity is off yet again it seems.

Australia's Prime Minister, Malcolm Turnbull, just managed to scrape home in the 2 July election, able to form a wafer thin majority government in the Lower House but having to rely on small parties and independents to pass any legislation in the Senate. Such a weak government will be in no position to pass meaningful legislation to impose a return to fiscal surplus.

In the US equity markets have been boosted by better-than-expected second quarter results and news that big bank loans to oil explorers were not as bad as were feared. JP Morgan Chase, Citicorp, and PNC Financial reported better-than-expected Q2 results although profits were down, assisted by higher oil prices staving off bankruptcies in the US oil exploration sector. Although oil prices are again on the decline, banks' exposure to the sector is nothing like it was to the housing mortgage market in 2008. Guidance from the Bank of England – that it was prepared to launch stimulus measures to help a UK recovery after Brexit, if necessary - added extra confidence to global equities.

The Brexit vote effectively put any further US Fed Target Rate rise on the back burner for now. The Fed's July meeting is out but September, or more likely December, is still a possibility. The Fed's inflation measure sits at 1.6% vs a target of 2% and jobs growth is robust but slowing global growth casts a shadow.

And just when you thought Trump could not possibly win the Presidency, there he goes and gets a big convention boost to put him ahead of Clinton in the polls. And just when Clinton needs her own convention boost the Democrats manage to put on an equally shambolic gathering as the Republicans – with Sanders

supporters discovering they were cheated and Chairwoman Debbie Wasserman Shultz having to announce her resignation before things even warm up! But the Democrats have more big names to stage-show than the Republicans and Clinton could well grab the lead back.

As everywhere, US political expectations are poll driven with US polls more numerous and deep than anywhere else. Potential presidential election outcomes and impact on equity markets can be summed up at this stage as:

Clinton wins after Clinton leads polls – small relief rally.

Clinton wins after Trump leads polls – big relief rally.

Trump wins after Trump leads polls – equities fall.

Shock Trump win after Clinton leads polls – Brexit-like equities collapse, only more severe.

At this stage financial markets have not priced in the possibility of a Trump Presidency. Investors will need to stay alert. A shock win to Trump would likely see a repeat of the Brexit reaction across global currencies, equities and interest rates – only more severe and lasting. Watch this space for a Clinton convention boost to put her back on top of the polls. If she fails to achieve it, at least the poll surge for Trump would mean a win for him in November would be less of a surprise – with corresponding lighter impact on markets and investors.

US 10 year T-bond yields took a quick tumble after the Brexit vote, from 1.739% to 1.46% on 27 June, reaching a low of 1.366% on 8 July. Since then the yield has recovered more than half way to 1.571%. Buyers of these bonds at the lowest yields will have suffered an immediate and substantial fall in value of their investment as longer term fixed interest securities react with greater sensitivity to changes in market rates (longer duration) than those of a shorter term to maturity. This highlights the dilemma facing investors in general and bond investors in particular – with rates so low can they go even lower? So far the answer has been “yes” for a long time and bond values have continued to rise as yields fall. With market rates now so low, negative reaction of longer term bond values to even a small rise in market interest rates can be severe – increasing risk to portfolios heavy with longer term bonds.

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

	Latest	Jun 16	May 16	Apr 16	Mar 16	Feb 16	Jan 16
3 month LIBOR (end of month) %	.7210	.6311	.67305	.63835	.62820	.63310	.61560
TED Spread (points)	.38	.39	.35	.42	.42	.30	0.29
VIX equity volatility	12.87	15.63	14.19	15.70	13.95	20.55	20.20
US LEI		+0.3%	-0.2%	+0.5%	+0.1%	-0.5%	-0.2%
Japan LEI			+0.3%	+0.2%	+0.1%	-0.3%	-1.2%
Eurozone LEI		+0.0%	+0.1%	+0.0%	+0.3%	-0.2%	+0.1%
Australia LEI			+0.1%	+0.5%	+0.1%	-0.5%	-0.5%
United Kingdom LEI			-0.2%	+0.0%	-0.1%	+0.1%	+0.2%
China LEI		+0.5%	+0.5%	-0.1%	+0.4%	+0.3%	-0.2%
US Money Market Funds \$T	2.715	2.718	2.733	2.709	2.765	2.807	2.756
US Gov. 10 year T-Bond (%)	1.570	1.488	1.834	1.819	1.786	1.740	1.931
US 5 yr inflation expectations %	1.66	1.42	1.61	1.82	1.75	1.61	1.63
US high yield-treasury spread 3-5yr %	5.39	6.21	5.97	6.24	7.05	7.75	7.77
Foreign holdings of US T-Bonds \$B			6208.3	6238.5	6287.0	6236.2	6183.1
Margin debt, NYSE (US\$ millions)		447,337	451,094	455,646	445,846	435,814	447,681
US M2 Money Stock (US\$B)		12809.3	12731.2	12651.3	12568.6	12472.8	12420.3
Velocity of Money US M2					1.459		
CNN Fear and Greed Index	85	44	77	72	64	51	17
AAII sentiment survey (% bullish)	35.4	29.0	17.8	27.4	27.2	32.0	
US retail & food service sales US\$B		456.978	454.359	453.397			
Insider Buy/Sell ratio (US) %	34	45	44	41	58	65	58
Forward P/E S&P 500 (12 month)	18.93	17.99	17.75	17.80	17.55	15.75	15.38
Trailing P/E S&P 500 (12 month)	24.87	24.22	24.04	24.11	23.53	21.82	20.69
Total Put/Call options ratio CBOE	0.90	1.23	0.93	1.15	1.08	1.20	0.91
S&P 500 Share Index	2168.48	2098.86	2096.95	2065.30	2059.74	1932.23	1940.24

NYSE margin debt fell in June but not as much as could have been expected from the bout of sharp volatility following the UK's Brexit vote. Short term indicators of CNN Fear and Greed Index, AAI sentiment survey, Put/Call options ratio and insider Buy/Sell ratio all point to equities as "overbought" just now. Expect a short term pull-back.

Medium term, confidence in US equity markets is still strong. US retail & food service sales are still expanding and leading economic indicators have swung into positive territory.

The next number of big interest will be US M2 Velocity of Money for Q2. A reversal upwards in rate of transactions from its huge and long-lived decline would provide an important indicator that higher Fed interest rates are on the way. Continuation of decline would merely imbed "lower for longer" for longer still.

2. Equities

Marlin Global (NZX:MLN) warrants come up for exercise on 5 August at 81 cents per new share to be issued on the exercise of each warrant. At today's market price of 80 cents per share the warrants are marginally out of the money, meaning shares could be bought on market cheaper than via exercise of the warrants. For some investors, addition of brokerage to on-market purchases would result in little difference between the two.

As explained here last month, Marlin Global offers investors access to a diversified portfolio of international equities, including some major global household names such as Alibaba, Alphabet (Google), eBay, Adidas, Mastercard and Nike. Portfolio composition has changed significantly over the past couple of years from the original objective of being an investor in smaller companies to a focus on global large caps. Currently Marlin sells at a discount to Net Asset Value of about 8%. The unique Fisher Funds' dividend policy of distributing 2% of average NTA per quarter makes Marlin a special case through which private investors can derive a high dividend income from international equities. The question for investors, apart from immediate share price, is whether Marlin can continue to afford this attractive dividend policy. Whereas the other Fisher listed investment companies Kingfish and Barramundi appear to have sufficient cash to back a similar policy for some time, according to published figures, Marlin is rather short on cash and may well have to revert to paying out a measure of capital from sale of investments to maintain the 2% NTA payout per quarter. Directors appear to be dedicated to the current dividend policy and hence dipping into capital to maintain distributions looks more likely than reduction in the 8% annual NTA payout target. Slight shrinkage of the Marlin portfolio is therefore a real possibility. Current prices are unlikely to encourage a strong uptake of the August warrants, so cash situation for the company is unlikely to show any major improvement after the final exercise date.

We will be watching the share price and Net Asset Value of Marlin very closely as final exercise date approaches. A final decision to exercise or not will be made on the late numbers.

3. Interest rates, bonds and debentures

Little movement in deposit rates during July. UDC has a 9 month special at 3.50% p.a.

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	2.50	2.95	3.65	3.70	3.75	3.80	3.85	3.90	3.95	4.05
F&P Finance	BB	25,000	2.50	3.10	3.80	3.85	3.90	3.95	4.00	4.05	4.10	4.20
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	AA-	5,000	2.20	2.70	3.20	3.50	3.45	3.45	3.30	3.30	3.30	3.40
UDC Finance	AA-	100,000	2.70	2.75	3.25	3.50	3.45	3.45	3.35	3.35	3.35	3.45

Canopus advisory clients receive a full rebate of any brokerage paid on term deposits.

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 took the brief opportunity offered by the Brexit crash to add international equities to portfolios where appropriate. Depending on individual portfolio needs and circumstances, additions took the form of ETFs, listed investment companies or individual companies with significant overseas earnings exposure. The quick global rebound means we are now back again on the sidelines with all purchases in positive territory.

The RBNZ's firm guidance of another OCR cut to come in August means finding useful additions to the fixed interest component of our personalised portfolios is even more challenging. New retail bond issues of reasonable quality offer very modest yields but even 4% is high compared to the zero and negative treasury yields ruling in Europe and Japan. Until such time as rising US rates start leading global yields higher, we can expect offshore demand to help keep downwards pressure on local yields. Higher US yields are still possible this year but on-flow to global markets could be two to three years away. Although well below our target portfolio income return, we may add the occasional good quality bond to secure a base level of income even if yields turn out to be "*much* lower for *much* longer". On the balance of probability though, new issues purchased now should provide reliable income but show little, if any, capital appreciation during their term. A real possibility exists of a small decline in bond value at some stage during the term, recovering to the original \$1 at maturity.

Our published personalised portfolios rebounded strongly in July from the post-Brexit vote sell-off in June. Units in both portfolios are at record highs right now but volatility is still high. 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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Contact me if you would like to open an account alan@canopus.co.nz or telephone 09 444 8055.

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.

Canopus does not cancel portfolio units to meet fees. In Canopus portfolios, fees are taken on the nose as a portfolio expense. Hence, if you start with 100,000 units of \$1.00 and make no further contributions or withdrawals, you will still have 100,000 units years later. The number won't be whittled away and the current unit value times the original number of units will represent your true portfolio value.

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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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