**_Canopus Investments Limited_**

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**Investment Directions** **23 May 2015**

*"Analysis to action. Opportunities to outcomes"*

**In this Issue**

1. **Overview** – US Fed likely to defer higher interest rates yet again. New Zealand budget neutral for equities and interest rates. Reserve banks in Australia and New Zealand both now on negative OCR bias. Major leading economic indicators still strong in China, the US and Europe. Margin debt on NYSE still growing. Credit markets vulnerable to sharp reversals as banks forced to abandon market maker role.

2. **Equities** – Little portfolio activity in this sector while Australasian markets weaken. Small shareholders in South 32, spun out of BHP Billiton, face gun. Genesis Energy lowers earnings guidance.

3. **Interest rates, bonds and debentures** – Steepening New Zealand yield curve has implications for investors. Global debt markets vulnerable to bouts of illiquidity. Deposit rates still falling. Best fixed term deposit rates from major deposit takers.

4. **Strategy** – Search for yield becomes scramble. Investors seek income by taking on very high risk in unknown sectors. Corporate bond market in New Zealand dries up as holders hang on to what they've got and new issues become rarities. Growth portfolio makes gains despite falling share indices.

*Spectacular higher resolution images show bright spots on dwarf planet Ceres as Dawn spacecraft spirals into lower orbit http://www.jpl.nasa.gov/spaceimages/details.php?id=pia19547 ."Dawn scientists can now conclude that the intense brightness of these spots is due to the reflection of sunlight by highly reflective material on the surface, possibly ice" – Christopher Russell, principal investigator for the Dawn mission, University of California, Los Angeles.*
*Latest images, May 16 2015, http://dawn.jpl.nasa.gov/news/news-detail.html?id=4594*

## 1. Overview

Latest US data, revealing a slowing economy, means the US Fed is highly unlikely to raise interest rates in June. Markets are now picking the first rise to be late 2015 at the earliest. US equity markets regained a measure of upwards momentum on 15 May after poor consumer confidence and lower than expected factory output led investors to believe the Fed would not raise interest rates in the near future – another perverse case of "bad news is good news for equities". Chicago US Fed President Charles Evans repeated his opinion that the Federal Funds Target Rate should not be raised until early 2016.

The “tight” New Zealand Budget, presented on 28 May, provided little to affect interest rate or equity markets. Auckland housing demand received some small potential relief with the proposal to free up Crown land for building along with an allocation of $52.2m, but demand still far outstrips supply and any impact on price appreciation should be minimal. Similarly, the latest Reserve Bank LVR restrictions should have little effect. Widely reported incorrectly as “a 30% deposit required by investors”, the new limit only applies to mortgages provided by NZ banks. Ways around the new rules are obvious and access to cheap overseas money is not affected for many buyers. Even the RBNZ doesn’t expect its new rules to reduce the rate of price increase by more than 2% - 4%.

The New Zealand economy is growing at about 3% p.a. supported by low interest rates, high immigration, strong building construction and low fuel prices. Negative factors include high Auckland house prices, lower dairy receipts, lingering drought effects and a high exchange rate. Inflation was -0.3% for 1Q15, due mainly to low fuel prices and cheaper international travel – meaning the next OCR move, if any, should be down rather than up but the case is finely balanced.

Growing issuance of “Kauri Bonds” (NZD denominated debt issued offshore by non-New Zealand issuers) should keep demand pressure on the Kiwi dollar from an international point of view.

The Australian OCR was dropped to 2.00% on 5 May while the NZ OCR remained at 3.50% on 30 April (despite lower consumer activity), creating an even wider cross-Tasman discrepancy and halting a slide of the NZD/AUD cross rate into the low .90’s. With the outlook being for the Australian OCR to be reduced further than its NZ equivalent and the NZ economy seen as outperforming Australia, expect the NZD/AUD to remain firm over the next few months at least. However, improving Australian consumer confidence and rising employment could yet give the RBA reason to halt OCR cuts. The ASB has forecast a new target of two reductions in the NZ OCR, both of 25 bps, to come in September and October. They might well have jumped the gun.

Concern over possible loss of Australia’s sovereign AAA credit rating helped push Australian equities down sharply in May. Goldman Sachs said S&P could give Australia a negative outlook within months thanks to poor fiscal performance. Australia is one of only 12 nations with the coveted AAA rating.

In Europe a sharp rise in the Bund (German Government Bond) yield during late April and May served as a reminder that even in an ultra-low interest rate climate, credit can suddenly be squeezed. The move has been attributed to banks and institutions, traditionally market makers for government bonds, being unwilling or unable to purchase bonds for their own books as a consequence of new capital ratio requirements. Confidence they can on-sell at a profit later is lacking. A small bout of profit taking in the newly illiquid market can see a sudden “rush to the exits”, pushing yields sharply higher and prices lower until potential buyers once again see value.

The NZ dollar has fallen nearly 9% against the Great British Pound in six weeks, from 51.5 p to 47. Strong UK retail sales and economic growth plus rising employment mean the next interest rate move by the Bank of England is likely to be upwards, expectation strengthening the pound against all major currencies.

The Greek saga continues. Today a “Grexit” from the Euro would have much less impact on European and global financial markets than it would have had two years ago. Even a “temporary exit” for Greece from the Euro currency has now been suggested.

China is to cut interest rates again, the third time in five months. The 1 yr lending rate reduces 25 bps to 5.1% with the 1 yr deposit rate also declining 25 bps, to 2.25%. The Chinese Government hopes to boost business lending after exports fell 6.4% in April compared to April 2014 and consumer inflation was low at an annual rate of 1.5%.

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

| | Latest | Apr 15 | Mar 15 | Feb 15 | Jan 15 | Dec 14 | Nov 14 |
|---|---|---|---|---|---|---|---|
| 3 month LIBOR (end of month) | .28100 | .27875 | .27075 | .26160 | .25460 | .25520 | .23435 |
| TED Spread (points) | .27 | .27 | .24 | .25 | .23 | .22 | .21 |
| VIX equity volatility | 12.11 | 14.55 | 15.29 | 13.34 | 20.97 | 19.20 | 13.33 |
| US LEI | | +0.7% | +0.4% | -0.2% | +0.2% | +0.4% | +0.3% |
| Japan LEI | | | -0.4% | +0.0% | -0.1% | +0.1% | +0.6% |
| Eurozone LEI | | | +0.7% | +0.6% | +0.2% | +0.4% | +0.2% |
| Australia LEI | | | -0.1% | +0.5% | +0.4% | +0.3% | +0.0% |
| United Kingdom LEI | | | +0.2% | +0.6% | +0.2% | +0.0% | -0.4% |
| China LEI | | +1.1% | +0.5% | +1.4% | +0.6% | +0.9% | +0.8% |
| US Money Market Funds $T | 2.610 | 2.582 | 2.634 | 2.692 | 2.702 | 2.733 | 2.688 |
| US Gov. 10 year T-Bond (%) | 2.185 | 2.046 | 1.93 | 2.00 | 1.68 | 2.17 | 2.194 |
| Foreign holdings of US T-Bonds $B | | | 6175.9 | 6162.8 | 6217.9 | 6153.7 | 6112.4 |
| Margin debt, NYSE (US$ millions) | | | 476,381 | 464.933 | 444,836 | 456,283 | 457,106 |
| US M2 Money Stock (US$B) | | 11,895 | 11,846 | 11,820 | 11,701 | 11,625 | 11,562 |
| Velocity of Money US M2 | | | 1.502 | | | 1.530 | |
| Forward P/E S&P 500 (12 month) | 17.89 | 18.05 | 17.62 | 17.55 | 17.01 | 17.25 | 17.15 |
| Trailing P/E S&P 500 (12 month) | 21.47 | 20.98 | 20.52 | 20.53 | 19.71 | 19.67 | 19.27 |
| Total Put/Call options ratio CBOE | 0.93 | 1.05 | 1.13 | 1.01 | 1.10 | 1.22 | 0.99 |
| S&P 500 Share Index | 2130.82 | 2085.51 | 2067.89 | 2104.50 | 1994.99 | 2058.90 | 2067.56 |

Again, nothing in our fundamental data table indicates a sharp sharemarket reversal is imminent or even likely in the short to medium term. A new reading for US M2 Velocity of Money is the lowest ever recorded since the record began in 1959 meaning much of the money created by the US Fed during its massive QE programmes over the past couple of years has yet to find its way into the real economy. In contrast, much has found its way into margin trading accounts, boosting prices on the New York Stock Exchange. With the ever rising US money supply there is yet more where that came from. Low VIX and a low Put/Call options ratio indicate traders and investors have little concern over equities in the near term.

## 2. Equities

Australian and New Zealand share markets fall as leading US markets struggle to stay level during the traditionally weak May to September period and downbeat views of the Australian economy recirculate ad infinitum in the populist press. Bad news sells. Australian and New Zealand markets could well continue their sell-offs for the next two months, wiping out gains accumulated since the start of January.

This climate provides little incentive to establish new equity positions in portfolios via on market purchases for now.

**South 32 (ASX:S32)**, spun out of **BHP Billiton** to hold a stable of less attractive resource assets, listed on the ASX on 18 May with shares trading mostly between A$2.30 and A$2.36 since then. Expectations were for a price in the A$2.50 – A$3.00 range. Shares in South 32 were issued free to BHP shareholders in the ratio 1:1 resulting in many small shareholders receiving an “uneconomic” parcel. Kindly, BHP offered to take small holdings off holders’ hands via a repurchase and sale facility at nil brokerage. Small shareholders, with little use for the new resource entity as a portfolio component, had little choice but to accept the repurchase and sale offer. Holding on to sell later would see brokerage eat up an undesirable percentage of the proceeds. Selling pressure on South 32 should persist during the scheduled 8 week repurchase facility selling. Market price may then be able to rise a little, but prospects for the new niche mining company look risky.

The **Genesis Energy (NZX:GNE)** share price dived 8% to $2.00 on 29 April after the company lowered its forecast earnings (EBITDAF) to between $330m and $345m for the FY2015 ending on 30 June, compared to $363.4m forecast in the prospectus. Guidance for net profit after tax was lowered from $95.4m to “between $85m and $95m”. Dividends for the 2015 year will be held at the prospectus forecast of 16.0 cents per share through payment of a final dividend of 8.0 cents per share in October 2015. Buyers in the initial IPO have done well to date with the latest market value of $1.89 still well above the $1.55 issue price and with holdings increased by the 1:15 bonus added during April. Providing the dividend can be held at current levels Genesis remains an attractive yield play but despite its diversified and integrated energy structure, growth prospects appear minimal. Maintenance of dividend is key to Genesis having a place in portfolios. Watch for any guidance or news that may give a clue.

## 3. Interest rates, bonds and debentures

NZ yield curves are steepening. Short term New Zealand interest rates are influenced by the local OCR as set by the RBNZ but longer term rates tend to take a lead from US Treasury bonds. Just now the two leads are moving in opposite directions producing the steepening curve. Benchmark 10 year US T bond yields have risen sharply over the past month, from 1.85% to 2.21%. A low of 1.65% was reached on 30 January this year and already some fund managers, expecting the ultra-low rates to be revisited after a quick rise in February, have been caught out. In the absence of any major black swan event, current US T bond yields should be retained until firmer guidance on a rise in the US Federal Funds rate is received. News of an imminent increase, not likely now until late 2015, would put further upwards pressure on US T bond yields (lower bond prices) right across the spectrum. As in Europe, lack of market makers resulting from increased capital requirements for banks, provides an explanation for rising US T bond yields. Speculators, caught on the wrong side of the market and forced to cover losing positions, increase short term volatility.

The outlook has implications as to how we handle the bond and fixed interest portions of our client portfolios. See strategy section for more details.

The move towards lower deposit rates continues with both UDC and Heartland Bank offering lower returns to depositors.

Heartland Bank lowered its deposit rates by up to 0.45% (45 bps) during May with the largest reductions applying at the 5 year term where the rate on offer fell from 5.25% to 4.80%.

Heartland Bank has current specials of 4.50% p.a. for 12 months or 4.30% p.a. for 6 months.

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

| Issuer | $ min | Call | 3mth | 6mth | 9mth | 12mth | 18mth | 24mth | 36mth | 48mth | 60mth |
|---|---|---|---|---|---|---|---|---|---|---|---|
| F&P Finance | 1000 | 3.65 | 3.85 | 4.35 | 4.60 | 4.70 | 4.80 | 4.85 | 4.95 | 5.05 | 5.15 |
| F&P Finance | 25,000 | 3.65 | 4.00 | 4.50 | 4.75 | 4.85 | 4.95 | 5.00 | 5.10 | 5.20 | 5.30 |
| Heartland Bnk | 1000 | 3.75 | 3.80 | 4.30 | 4.25 | 4.50 | 4.45 | 4.55 | 4.60 | 4.65 | 4.70 |
| Heartland Bnk | 20,000 | 3.75 | 3.90 | 4.30 | 4.35 | 4.50 | 4.55 | 4.65 | 4.70 | 4.75 | 4.80 |
| 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 | 4.15 | 4.20 | 4.20 | 4.20 | 4.20 | 4.20 | 4.30 | 4.35 |
| UDC Finance | 100,000 | 3.95 | 4.00 | 4.25 | 4.30 | 4.30 | 4.30 | 4.30 | 4.30 | 4.40 | 4.45 |

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

In this ultra-low interest rate environment the search for yield is becoming a scramble. Savings are being dispersed into new high risk ventures offering highly speculative returns, examples include:

- Peer to peer lending. Reports from the US, where this form of fund raising is more established, say banks are now accepting loans being sought on peer to peer lending platforms. These high risk loans are then being securitised and sold off to third parties as "collateralised debt obligations" – removing risk from the banks' balance sheets altogether. Sound familiar? Yes, that's exactly how the Global Financial Crisis got started – collapse of "sub-prime" mortgage CDOs based on the vast US housing market. Fortunately this market is much smaller – but still big enough for the banks to get involved with.

- Crowdfunding. Another fundraising avenue new to New Zealand intended to raise relatively small amounts of equity for new ventures with minimal disclosure required. Again, ventures can be high risk with speculative returns being indicated (but not promised). There appears to be little history of success rate or return from ventures funded via crowdfunding platforms overseas where the practice is more established. Individual investments in New Zealand have reportedly reached quite significant amounts – in the many thousands of dollars. Another catch – the shares offered via crowdfunding may be "B" shares in the company, i.e. shares that carry an entitlement to any financial return but have no voting rights.

- Deeply subordinated "Tier 1" bank notes. These are intended to protect the bank (*not* the investor) against insolvency in the event of a new general banking crisis or should the individual bank strike difficulties of its own. Offered to the public in New Zealand and Australia but banned from sale to retail investors in the UK where they are known as "contingent convertible" instruments or "Cocos", these capital notes may carry the household name of a big bank and offer 7% p.a. interest or more. In reality the investor is exposed to non-payment of interest or even complete loss of capital through cancellation of the note in the event of a new financial crisis threatening the bank with insolvency.

- Venture capital start-ups. Not widely available to the New Zealand public at present, but sure to come - another opportunity to invest in high risk, early-stage businesses. Reports from overseas suggest hedge funds and even more traditional managed funds are taking on the risk of venture capital in the hope of finding higher returns.

The good news for those of us avoiding such schemes is that even if they all fell over together the combined losses would be insufficient to cause any real damage to the wider economy. Individual investor losses though could be serious.

The scramble for yield is further highlighted by heavy scaling of the recent issue of Warehouse Group senior bonds. Offering 5.30% p.a. (the low end of the indicated range) for a 5 year term, allocations were scaled such that some investors received less than half the amount sought. To overseas investors, in a region of near-zero, or even negative yields, 5.30% for a senior bond looks good. The steepening New Zealand yield curve is pivoting around a 4 year term so should shorter term yields continue to decline – as seems highly probable – 5.30% should be looking highly attractive in a year or so for a senior bond of short term to maturity.

On the NZDX, bonds of reasonable quality offering even a modest return are now almost unobtainable. Anyone astute enough to have purchased earlier is holding on. Now is not the time to be investing in international bond funds. Rising longer term yields and falling values look to be the greater probability.

Activity in the equities class of our portfolios has been minimal as share indices level out in the US and fall in Australia and New Zealand. The Genesis bonus has been taken on board by those eligible and the NAB cash issue at A$28.50 deserved acceptance. International equities show gains as the New Zealand dollar comes off its highs against the US dollar, Australian dollar and UK pound. We continue to monitor a broad range of potential equity buys but prefer to see the current downturn work itself out first. We pursue diversification where value arises but will not diversify just for the sake of diversification – as prescribed by some theoretical asset allocation model.

Our published growth portfolio unit value managed another small increase in April while the more conservative income portfolio unit came off very slightly. At this stage indications are that May should be more positive.

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

Please note that I cannot make application for new issues of bonds or shares, trade securities on your behalf or provide personal investment advice unless you have a sharebroking account opened through Canopus.

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.

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 the investor'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.

I will be at the SiFA conference in Auckland from Sunday 24 May to Tuesday 26 May.

Regards,

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