

# Canopus Investments Limited

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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](http://www.canopus.co.nz)  
[www.debex.co.nz](http://www.debex.co.nz)

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## Investment Directions

29 November 2015

*"Analysis to action; opportunities to outcomes"*

### In this Issue

- 1. Overview** – "Lift-off" of US interest rates firmly back on the agenda for December this year; limited response expected from equity and interest markets as move well signalled in advance. RBNZ holds OCR at 2.75% and retains negative OCR bias but rush of corporate bonds indicates NZ is near bottom of interest rate cycle. Australian jobs data much stronger than expected in October. Margin debt in China collapses along with equity indices but both now moving up again.
- 2. Equities** – Liquidation of BBY in Australia again exposes danger of broker "segregated accounts". BHP hit by Samarco tailings dam collapse. Long term impact unable to be quantified at this stage.
- 3. Interest rates, bonds and debentures** – No movement in tabulated deposit rates during November. New Zealand appears to be at or near to, the low point in its interest rate cycle.
- 4. Strategy** – Building the fixed interest part of an investment portfolio particularly challenging right now as interest rate market looks to have bottomed. More opportunities available in equities, especially in the beaten down Australian market. Listed property sector worth examination on both sides of the Tasman. Kingfish Limited warrants exercised.

### *Space Exploration News*

*The Dawn spacecraft is now spiralling down to its closest orbit of Ceres from where even greater detail of the surface will be revealed, allowing analysis to determine makeup of the bright spots in Occator crater. For latest information see <http://dawn.jpl.nasa.gov/news/news-detail.html?id=4751>*

*More amazing close-up images of Pluto received from New Horizons <http://www.nasa.gov/image-feature/the-rich-color-variations-of-pluto> a far off minor planet, seen only as just another fuzzy point of light at the start of 2015.*

### 1. Overview

A month in the markets is a long time. Mid-October saw benchmark US 10 year bond yields fall under 2% on renewed expectations the US Fed would delay any increase in its target Federal Funds rate until early 2016. Sentiment had changed abruptly by the end of the month following Federal Reserve statements and positive new jobs data now pointing to a strong possibility that US Federal Funds "lift-off" will indeed commence in

December this year. The return of 10 year T-bond yields to above 2.20% reflects the new market view. The US Purchasing Managers' Index (PMI) rose to 54.1 from 53.1 in October, indicating increased manufacturing expansion. Construction spending increased 14.1% for the September year to US\$1.09T with expenditure on housing, highways, offices and infrastructure all growing.

When it eventually does occur, the higher US Fed Funds target rate would have to be about the most heralded economic event in history. Absence of surprise should see little further short term reaction in US interest rate markets. We may well see "buy rumour, sell fact" played out to some extent but even that scenario looks worn in this case. 10 year bond rates are already off their highs from early November.

Hence US and global equity markets should take higher US interest rates in their stride. In particular, US equities could well interpret the move as final confirmation of better times ahead and react positively once the announcement is finally made.

Any real risk to equities lies in the possibility that the Fed may accidentally (or even intentionally) signal a deviation from the expected very gradual increase in the target Federal Funds rate over an extended time to a program of more rapid increases. Janet Yellen will have to choose her words very carefully.

While the US economy is deemed strong enough to withstand its first step towards "normalisation", the rest of the world still wallows in QE and stimulation. Even the stand outs of New Zealand and Australia, amongst developed economies, are once again talking about adding stimulus through lower official interest rates as both economies face slower growth from low commodity prices. Westpac economists forecast an NZ OCR down at 2% (from 2.75% at present) by June 2016. ASB economists support the view, predicting a lower OCR, lower NZD, lower growth (2.1%) and sub-2% inflation in 2016. Interestingly, many corporate Chief Financial Officers don't seem to agree as evidenced by the rush of corporate bonds to market at low coupon rates and long terms, obviously seeking to lock in low cost debt at what they see as the bottom of the interest rate cycle.

The RBNZ held its OCR on 29 October at 2.75%, saying low interest rates and high immigration are driving strong growth in the services sector and construction. It is still too early to say if improved dairy prices will be sustained. House price inflation in Auckland will take some time to be corrected by accelerated building. CPI inflation is expected to rise back into the 1%-3% target band in early 2016 as earlier effects of lower petrol prices drop out of the calculation. A recent rise in the NZD could dampen tradeable inflation and suppress medium term CPI inflation, hence the RBNZ maintains a negative bias towards interest rates.

For NZ investors, whether the views of economists or CFOs prevail doesn't really matter. The message is clear that buying new bond issues at this time is risky. Eventually NZ and Australian interest rates will follow the US lead, leaving long term, low-coupon bond holders with sub-par income and reduced capital values.

On the other hand, Australasian blue chip equities should benefit from any lead in US markets, offering high dividend yields plus a component of growth. Despite the endless doom and gloom of MSM headlines about collapsing mineral prices and continuing low dairy receipts on both sides of the Tasman, certain sectors are doing well and should strengthen further as advantages of the lower AUD and NZD get locked in. The beaten down Australian market is where possibilities lie. The Australian small cap sector is one in particular where careful investment should be well rewarded.

The RBA kept Australia's OCR at 2% on 3 November, giving the AUD a slight boost with respect to the NZ dollar. Australian unemployment fell to 5.9% in October as jobs grew by about +58,600, far exceeding forecasts of +15,000. 40,000 full time and 18,600 part time jobs were created.

Chinese authorities have set a 6.5% p.a. growth target for the years 2016-2021 while maintaining the 2015 target of 7%. 6.9% p.a. was achieved in 3Q15. The slower rate of growth is expected as China moves from an infrastructure spending and export dependent economy to one of consumer demand and services as living standards rise. Further stimulus is expected in the form of lower official interest rates. China is now attempting to limit capital outflows, after experimenting with loser controls earlier in the year, with the object of preventing further collapses in both its sharemarkets and currency. China's PMI fell to 49.8 in October, the third month of contraction in a row - albeit only slight. China is reportedly seeking to make the Yuan fully convertible by 2020, allowing it to function as an international trading currency alongside the US dollar and

Euro.

In our June and July 2015 issues we looked at the danger to equity markets posed by huge margin trading balances in China and the US. China's sharemarkets fell heavily in June, down nearly 30% after rising 152% in the preceding 11 months, powered by a massive increase in margin debt to 2.3T Yuan. By the end of September a huge shakeout of Chinese margin traders saw margin debt reduced to 0.9T Yuan –accompanying a 40% collapse in the Shanghai Composite Index. Chinese margin debt is now growing again, hopefully in a more measured way, fuelling a new rally. Margin debt information for China is difficult to obtain but bears watching when available.

Short sellers in China have reduced speculative positions but the move owes much to new government and broker rules limiting investor ability to take on new short positions. Margin requirements have been raised to 100% from 50%, i.e. borrowing by a 1 million Yuan account holder has been limited to an additional 1 million Yuan whereas, previously, the 1 million account holder could have borrowed 2 million Yuan. Nevertheless, reduced shorts means support for the indices. Hence the short term direction of Chinese sharemarkets must be seen as positive.

In contrast to guidance in the US, the Bank of England has effectively quashed thoughts of higher UK interest rates before the end of 2016 saying, on 6 November, that UK inflation is now expected to stay below 1% and the Bank now forecasts growth to be lower than earlier predictions. The news should help both the AUD and NZD maintain and even improve on their recent gains against the GBP.

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

|                                       | Latest  | Oct 15  | Sep 15  | Aug 15  | Jul 15  | Jun 15  | May 15  |
|---------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| 3 month LIBOR (end of month) %        | .41170  | .33410  | .32500  | .32900  | .30860  | .28175  | .28275  |
| TED Spread (points)                   | .27     | .25     | .34     | .27     | .23     | .27     | .27     |
| VIX equity volatility                 | 15.12   | 15.07   | 24.5    | 28.43   | 12.12   | 18.23   | 13.84   |
| US LEI                                |         | +0.6%   | -0.1%   | 0.0%    | 0.0%    | +0.6%   | +0.6%   |
| Japan LEI                             |         |         | -0.8%   | +0.1%   | -0.2%   | +0.8%   | +0.1%   |
| Eurozone LEI                          |         | +0.4%   | +0.0%   | +0.1%   | +0.3%   | +0.5%   | +0.3%   |
| Australia LEI                         |         |         | -0.1%   | -0.4%   | +0.3%   | -0.3%   | -0.2%   |
| United Kingdom LEI                    |         |         | -0.3%   | +0.1%   | -0.3%   | -0.2%   | -0.5%   |
| China LEI                             |         | +0.6%   | +1.6%   | +0.9%   | +0.9%   | +0.5%   | +1.1%   |
| US Money Market Funds \$T             | 2.724   | 2.717   | 2.669   | 2.694   | 2.648   | 2.618   | 2.615   |
| US Gov. 10 year T-Bond (%)            | 2.225   | 2.151   | 2.060   | 2.200   | 2.205   | 2.335   | 2.095   |
| US 5 yr inflation expectations %      | 1.91    | 1.86    | 1.75    | 2.00    | 2.12    | 2.13    | 2.03    |
| US high yield-treasury spread 3-5yr % | 6.37    | 5.90    | 6.62    | 5.70    | 5.36    | 5.00    | 4.52    |
| Foreign holdings of US T-Bonds \$B    |         |         | 6101.7  | 6098.7  | 6116.5  | 6175.2  | 6134.8  |
| Margin debt, NYSE (US\$ millions)     |         |         | 453,896 | 473,412 | 487,345 | 504,975 | 499,143 |
| US M2 Money Stock (US\$B)             |         | 12,201  | 12,187  | 12,138  | 12,059  | 11,982  | 11,938  |
| Velocity of Money US M2               |         |         | 1.491   |         |         | 1.501   |         |
| CNN Fear and Greed Index              | 58      | 69      | 18      | 3       | 9       |         |         |
| Insider Buy/Sell ratio (US) %         | 49      | 72      | 70      | 68      | 38      | 39      | 38      |
| Forward P/E S&P 500 (12 month)        | 17.55   | 18.41   | 16.45   | 17.42   | 17.82   | 17.81   | 17.89   |
| Trailing P/E S&P 500 (12 month)       | 23.18   | 22.07   | 20.59   | 21.63   | 21.18   | 21.52   | 21.47   |
| Total Put/Call options ratio CBOE     | 1.12    | 0.95    | 0.97    | 1.20    | 1.00    | 1.10    | 1.15    |
| S&P 500 Share Index                   | 2090.11 | 2079.36 | 1920.03 | 1972.18 | 2103.84 | 2063.11 | 2107.39 |

Short term indicators of Fear and Greed Index, insider buy/sell ratio and put/call options ratio all point to short term weakness in the S&P 500. With the wisdom of hindsight we can see that the ultra-low Fear and Greed Index, high insider buy/sell ratio and high put/call options ratio combined in August to indicate a good buying opportunity after the “flash crash” of 20-24 August. October figures for NYSE margin debt were not available at the time of writing but any significant reduction in margin debt could spell trouble for US equities. However, robust Money Market Fund levels and ever-growing US M2 money supply mitigate against a serious downturn in the short term.

Velocity of Money (a measure of the rate a dollar is used for transactions) reached yet another all-time low since records began in 1959, showing that much of the money created by the US Fed's QE programs has still not circulated out into the wider economy. The two big beneficiaries so far have been margin debt speculative positions on the NYSE and commercial bank deposits with the Federal Reserve. A significant rise in Velocity of Money should be a harbinger of increasing inflation and higher interest rates – but that is certainly not happening yet.

Equity markets recovered quickly from the terrorist attacks in Paris. Market reaction to any future attacks will depend on the scale of attack, which in turn, will depend on the success of the war against ISIL – now likely to be led by France and Russia. Camera footage from Russian planes of huge columns of ISIL oil tankers plus revelations that the ISIL command and training structures remained largely intact highlight just how ineffective the US “coalition” has been in “containing” the terrorist Islamic State. “Containment” is not an option if ever more massively damaging attacks on civilian populations are to be avoided – such as a “dirty” radioactive device that could effectively close down a city.

## 2. Equities

Clients of large Australian brokerage firm BBY Limited will have received a nasty surprise on appointment of liquidators to the Company that they will not automatically receive the funds they thought they had in their “Client Segregated Accounts”. Firstly the Liquidator's Notice to Creditors reports “..there is likely to be a significant overall shortfall between client claims in relation to CSAs, and the funds held in CSAs.” Secondly the liquidators believe “..BBYL did not maintain comprehensive records that show the client or clients who are entitled to the balance of any particular CSA.” Thirdly “..there appear to be transactions between CSAs within and across different product lines.”

The liquidators have now applied to the Supreme Court of New South Wales for direction on how the funds still in the CSAs should be distributed. It seems the “Client Segregated Accounts” will be far from segregated when it comes to dividing up the proceeds. Pooling of funds with significant losses to many (maybe all) clients is a real possibility. The liquidator's application to the Court can be found here <http://www.kpmg.com/AU/en/services/Advisory/Transactions-Restructuring/Restructuring/bby/Documents/bby-notice-to-creditors-6-november-2015.pdf>

In contrast, where an investor retains direct ownership of securities in a portfolio, coupled with an individual true bank account as the repository for dividends, interest and spare cash, unequalled security of ownership, transparency of transactions and peace of mind is achieved.

Already down from falling commodity prices (oil, coal, copper and iron ore) the **BHP Billiton** share price was hit again when a tailings dam owned by South American mining company Samarco failed in Minas Gerais on 5 November, causing at least 13 deaths according to reports, and devastation to villages below. Samarco is a 50/50 joint venture between BHP Billiton and Vale. BHP's share of Samarco (equity accounted) usually represents about 5% of BHP's EBIT. Reinstatement of the affected area and reopening of the mining operation is likely to take 2-3 years at best. There is a possibility the mine will never reopen.

BHP, Vale and Samarco have announced plans for a joint fund of about US\$260 million to finance initial emergency measures and to recuperate the affected Rio Doce river system. Contradicting a United Nations report that tailings discharge from the failed dam is toxic, BHP claims independent research confirms the tailings are chemically stable and non-toxic to humans, being clay and silt from washing and processing of earth containing iron ore which is naturally abundant in the region. The Brazilian Federal Government and two states have stated they intend to sue BHP and Vale for US\$5.2B over the burst tailings dam. An initial fine of 250 million Real (US\$92m) has already been imposed on the joint venture partners. To what extent such imposts would be covered by insurance is unclear but the initial amount is said to exceed insurance carried by Samarco itself. Samarco carries debt of about US\$4B which the joint venture partners are expected to meet. Total cost of the disaster to BHP is impossible to quantify at this stage but is likely to affect financial performance of the company for several years.

Some analysts predict that the BHP dividend will be cut from US\$1.24 per share to 80 cents in 2017 in an

attempt to “defend the balance sheet”. That cut may now come sooner.

The news could hardly be worse for any listed company. Share markets hate uncertainty. Whether the current depressed BHP share price fully anticipates the future impact of Samarco on BHP remains to be seen. Many formerly large holders may have already felt pressured enough to sell out – as evidenced by recent high trading volumes. Those holding just a few shares can probably afford to stay in for the longer haul and better news.

### 3. Interest rates, bonds and debentures

A December “lift-off” for the US Federal Funds target rate is firmly back on the agenda following improved US economic and jobs data and much firmer guidance by the US Federal Reserve.

Although the RBNZ maintains a negative bias towards future OCR moves, chief financial officers of New Zealand companies are rushing long term bond issues to market at low coupon rates, hoping to lock in low funding rates at what they see as the low point of the interest rate cycle.

There has been no movement at all in our table of deposit rates during November – a very long time since that happened. Interest rates look to be at or very near their bottom for this cycle although any upward movement is likely to be a long way off.

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    | 3.60* | 2.90 | 3.50 | 3.50 | 3.70  | 3.65  | 3.70  | 3.75  | 3.80  | 3.90  |
| Heartland Bnk | 20,000  | 3.60* | 3.00 | 3.50 | 3.60 | 3.70  | 3.75  | 3.80  | 3.85  | 3.90  | 4.00  |
| Liberty Fin.  | 5,000   |       | 3.95 | 4.55 | 4.85 | 5.20  | 5.55  | 5.80  | 6.40  | 6.40  | 6.30  |
| Liberty Fin.  | 20,000  |       | 4.10 | 4.70 | 5.00 | 5.35  | 5.70  | 5.95  | 6.55  | 6.55  | 6.45  |
| Liberty Fin.  | 100,000 |       | 4.15 | 4.75 | 5.05 | 5.40  | 5.75  | 6.00  | 6.60  | 6.60  | 6.50  |
| UDC Finance   | 5000    | 2.70  | 3.20 | 3.50 | 3.55 | 3.65  | 3.55  | 3.60  | 3.65  | 3.75  | 3.85  |
| UDC Finance   | 100,000 | 3.20  | 3.20 | 3.55 | 3.60 | 3.70  | 3.60  | 3.65  | 3.70  | 3.80  | 3.90  |

\*Heartland Direct Call Account

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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](mailto:alan@canopus.co.nz) or telephone 09 444 8055. No brokerage is payable by investors on applications made through Canopus.

### 4. Strategy

As explained in our Overview and Interest Rate sections this month, New Zealand appears to be at, or very near to, the bottom of its interest rate cycle despite the RBNZ maintaining its negative OCR bias. Hence we are unlikely to participate in any of the long term, low coupon bond issues currently being rushed to market by corporations hoping to lock in low borrowing costs for an extended period. Although our current shorter term, higher coupon bond holdings have high market values at present, we will hold to maturity in most cases. Reinvestment of capital gains at an acceptable long term return is virtually impossible in the fixed term market

just now. Accumulated cash we will hold on short term deposit or even call, accepting the current low rates until better opportunities arise. Building the bond portion of an investment portfolio is particularly challenging at present under the existing interest rate environment.

Equities offer more possibilities. We will be looking to the beaten down Australian market for opportunities across small, mid and large cap sectors. As usual we prefer to hold large-cap shares individually and rely on specialist listed fund or investment companies for accessing a diversified holding of small and mid-caps. We prefer listed investment entities to unlisted managed funds owing to ease of access, greater liquidity, disclosure, transparency of operation and regulation. Sometimes listed investment entities can provide access to a portfolio of shares at a useful discount to market value.

We exercised all Kingfish warrants held in portfolios at the strike price of \$1.18. The new shares now trade at \$1.26, an immediate gain of 6.78%. Cash dividends should be about 8.95% for the first year giving a total gain of 15.73%, more if the share price moves up, less if it falls.

After a strong October, the S&P 500 is still down slightly in November following the Paris terrorist attacks. Similar results are seen for the S&P/ASX200 and the NZX50 although the Australian market is severely lagging both NZ and the US.

Both our published diversified income and growth portfolios recovered ground in October with further gains expected by the end of November.

Click this link to see charts [http://www.canopus.co.nz/investment\\_advice.html#returns](http://www.canopus.co.nz/investment_advice.html#returns)

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Regards,

Alan King  
Authorised Financial Adviser  
Canopus Investments Limited  
Email: [alan@canopus.co.nz](mailto: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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