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Investment Directions 30 November 2016

"Analysis to action; opportunities to outcomes"

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Space Exploration News

Trump may revive America's deep space manned exploration program, including return to the Moon, cancelled by Obama. Larger role likely for private companies including provision of renewable heavy launch rockets.

http://fortune.com/2016/11/20/trump-space-policy

http://www.theverge.com/2016/8/23/12603978/nasa-space-policy-2016-presidential-election

1. Overview

Investment Directions, September 2016, pointed out that pollsters and actual rally numbers were saying two quite different things about the forthcoming US presidential election outcome – and that both couldn't be right. Rally turn-outs for Clinton and her Vice Presidential running mate were pitiful, desperately pumped up eventually by free pop concerts while Trump continued to attract tens of thousands to his "no piano" rallies. In the end, and against all odds, rally attendance trumped pollsters "consensus" with Trump and the Republicans making a clean sweep of Presidency plus both Houses of Congress – despite gaining fewer votes in the presidential race than Clinton. But first past the post, state by state, is the system they have.

For investors, another remarkable event quickly followed the first. Against all expert predictions of sharemarket carnage, Wall Street quickly recovered its initial Trump-win shock to end the next day higher than it started. Amongst the "experts", Citigroup advised its clients the S&P 500 would fall 3% - 5% on a Trump victory while massive hedge fund Bridgewater Associates predicted a 10% fall. But sharemarkets ignored the predictions and then pushed on to set new records over subsequent days after digesting thoughts that a Trump commitment to increased infrastructure spending, lower taxes and job creation should boost GDP, corporate profitability and inflation – albeit at the expense of even greater US fiscal deficit spending. Hence, should Trump be able to mobilise the Republican hold on Congress to implement his major economic policies largely intact, the outlook must be for faster US economic growth accompanied by rising inflation and a program of more rapid interest rate rises in response, by the US Federal Reserve. Also, a significant tax amendment could open the pathway home for over US$2T of corporate funds, currently held offshore, without incurring the existing prohibitive 42% repatriation tax penalty. Trump has stated an intention to slash US$4.4T in corporate taxes by reducing the corporate rate from 35% to 15% in an effort to create 25 million new jobs over 10 years.

Trump's decisive win provides a measure of certainty - and markets like certainty. However, Republicans hold only 51 seats in the Senate, an insufficient number by themselves to repeal the bank-bail-out Dodd-Frank Act which Trump wants to dismantle.

US consumer spending, 70% of the US economy, continues to grow with core PCE (personal consumption expenditure) up 1.7% year on year to 30 September. Core PCE is the US Fed's preferred measure of inflation and, although still below the 2% target, should be strong enough to allow a Federal Funds target rate increase in December.

Perhaps significantly, gold and silver, presumed havens of safety in troubled times, have dropped back to well below "pre-Trump" levels –although some observers ascribe the move to a potential curb on imports by India, the world's second largest user of gold, following its recent disruptive cancelation of 500 and 1000 rupee notes. Others attribute the fall to dumping of gold by big dealer Stanley Druckenmiller on November 8th.

In New Zealand, the devastating chain of earthquakes affecting the upper South and lower North Islands will place even more demand on reconstruction resources and government reserves – just as the Christchurch rebuild winds down. Basic infrastructure, particularly roads and railways, face months of restitution. However, government books are in a sound to state to cope with the extra demand. Reinstatement or rebuilding of much damage to commercial and residential property should be covered by insurance. Full impact on rated insurance companies is unknown at this stage but is expected to be less severe than that following the Christchurch earthquakes of 2010-2011 as the area affected is much less populated and most general insurers have replaced full replacement policies with "sum insured", while deductibles have been increased. Ultimate impact of the earthquakes on insurers will depend largely on the effectiveness of each company's re-insurance cover. IAG, Vero and, to a lesser extent, Tower, are said to be the major general insurers in the earthquake belt. Listed insurers IAG and Tower have so far provided exchange notifications predicting limited impact of the earthquakes on financial performance.

Global Dairy Trade auction prices continue to rise as falling global supply meets firm demand. Fonterra has lifted its forecast milk solids payout to farmers for the third time in 2016, from $4.25 per kg ms at the start of the year to $6.00 per kg ms now. However, lower production on New Zealand dairy farms from a cold wet spring means improvement to dairy farm incomes overall should be limited.

The New Zealand OCR was cut to 1.75% on November 10 as expected. The cut could be seen as an RBNZ move to meet market expectations rather than as a necessity since the economy continues to grow strongly. Also, the cut is unlikely to result in cheaper money for borrowers as banks decline to pass on the OCR cut, saying more offshore funding is required and is more expensive than funding from local deposits. RBNZ Governor Graeme Wheeler said the Kiwi dollar remains unsustainably high, so the OCR cut may have been aimed mainly at assisting the Kiwi decline. Furthermore, Wheeler added, the RBNZ would be unlikely to introduce debt to income (DTI) ratios as an aid to dampening house prices, even if allowed to do so by the Government.

In contrast to NZ, the RBA left Australia's OCR at 1.5% November 1, first cutting off the rising NZD/AUD cross rate and then restricting it to the 0.94 – 0.96 range for the rest of the month. The AUD is benefitting from stronger commodity prices and demand for Australian securities from offshore buyers as the Australian economy is seen to be improving and the US dollar Trump rally matures.

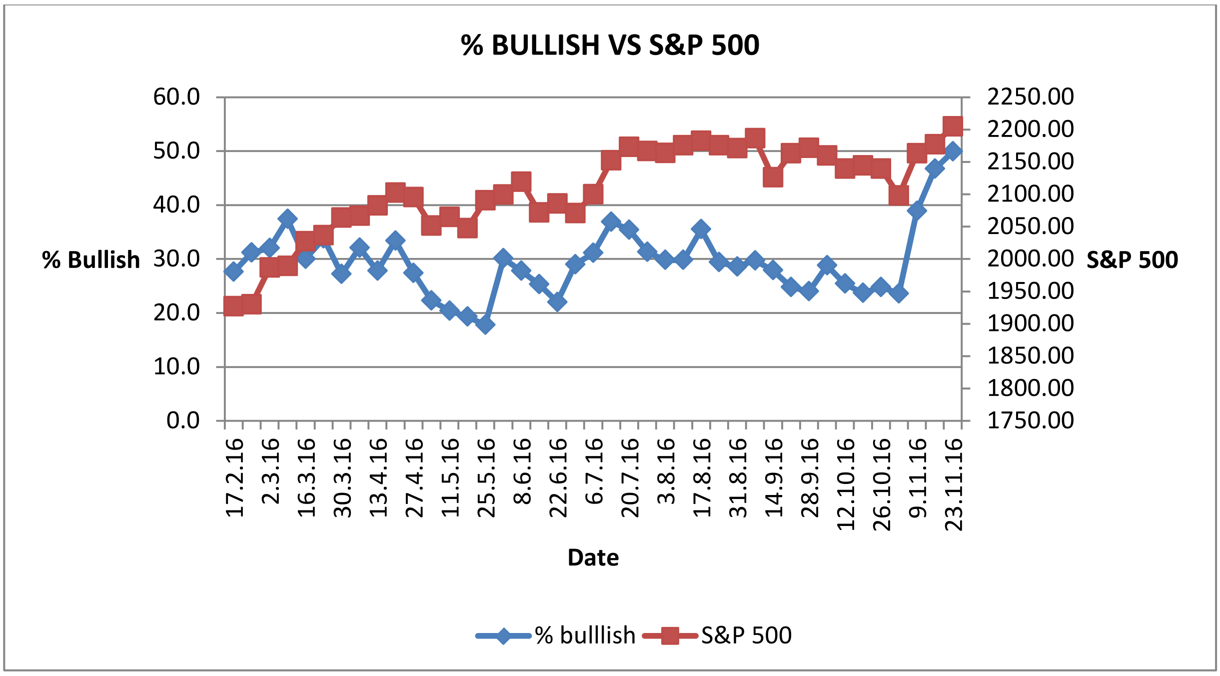
Italy holds a constitutional reform referendum on December 4 on which Prime Minister Matteo Renzi has staked his future. Many observers view the vote as a referendum on Italy's continued membership of the European Union even though the referendum has no formal status demanding such a move if the anti-establishment "no" vote prevails. The present government would not be obliged to resign although Renzi may quit the Prime Ministership if the vote goes against him. A national election is not due until 2018. Following Brexit and Trump's success, observers expect "No" to win. Unlike the UK and US though, a surprise result here would be a win to the pro-EU "yes" camp – probably positive for equities and strengthening for the Euro.

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

	Latest	Oct 16	Sep 16	Aug 16	Jul 16	Jun 16	May 16
3 month LIBOR (end of month) %	.93011	.88594	.84561	.83344	.75150	.6311	.67305
TED Spread (points)	.49	.54	.57	.51	.49	.39	.35
VIX equity volatility	12.34	17.06	13.29	13.12	11.87	15.63	14.19
US LEI		+0.1%	+0.2%	-0.2%	+0.5%	+0.2%	-0.2%
Japan LEI			+0.3%	-1.1%	-0.1%	-0.3%	+0.3%
Eurozone LEI		+0.3%	+0.1%	+0.2%	-0.6%	-0.1%	+0.2%
Australia LEI			+0.5%	+0.0%	+0.5%	+0.2%	+0.3%
United Kingdom LEI			+0.1%	-0.1%	-0.1%	-0.3%	-0.4%
China LEI		+0.8%	+1.2%	+0.7%	+0.2%	+0.3%	+2.1%
US Money Market Funds $T	2.705	2.677	2.680	2.724	2.715	2.718	2.733
US Gov. 10 year T-Bond (%)	2.372	1.834	1.6080	1.5680	1.458	1.488	1.834
US 5 yr inflation expectations %	2.10	1.87	1.75	1.64	1.67	1.42	1.61
US high yield-treasury spread 3-5yr %	4.66	4.91	4.97	5.10	5.69	6.21	5.97
Foreign holdings of US T-Bonds $B			6154.7	6196.4	6247.9	6281.0	6209.9
Margin debt, NYSE (US$ millions)			501,125	471,231	474,575	447,337	451,094
US M2 Money Stock (US$B)		13137.5	13060.9	12986.9	12878.0	12803.6	12728.8
Velocity of Money US M2			1.437			1.448	
CNN Fear and Greed Index	72	43	50	63	82	44	77
AAII sentiment survey (% bullish)	49.9	23.6	24.0	28.6	31.3	29.0	17.8
US retail & food service sales US$B		465.914	462.106	457.722	457.849	457.409	454.135
Insider Buy/Sell ratio (US) %	37	32	31	29	34	45	44
Brent crude oil spot price USD/barrel	45.96	46.2	48.24	47.94	40.76	48.05	49.26
Forward P/E S&P 500 (12 month)	18.45	18.02	18.43	18.59	18.93	17.99	17.75
Trailing P/E S&P 500 (12 month)	24.35	24.31	24.81	24.71	24.87	24.22	24.04
Total Put/Call options ratio CBOE	0.80	1.06	1.02	1.01	1.20	1.23	0.93
S&P 500 Share Index	2213.35	2126.15	2168.27	2170.95	2173.60	2098.86	2096.95

The Total Put/Call options ratio spiked up sharply on 8 November as professional investors rushed to insure portfolios against the expected calamity of an emerging Trump win, but abruptly declined again as sharemarkets rebounded instead.

Amongst our short term indicators, AAII bullish sentiment survey is one of the most positive just now, booming as we have not seen before on the back of Trump's win. Our records indicate the AAII bullish factor is usually less bullish than the S&P 500 itself. Follow through of this sentiment into the actual US stock markets would see a potential New Year rally confirmed. The % bullish factor is supposed to indicate sentiment 6 months ahead, but in reality is likely to reflect investor thinking over a much shorter term.



Despite the sharp US equities rebound, some useful opportunities still exist to add blue chips to portfolios at cheap prices but short term indicators have again turned unattractive for buying. Generally, now is a time to hold. A New Year rally looks likely after an early December pull-back, potentially offering a chance to quit underperformers from portfolios at reasonable prices.

2. Equities

Infratil (NZX:IFT) shares took a hit after reporting a modest 2.8% decline in underlying earnings before interest, tax, depreciation, amortisation and fair value (EBITDAF) to $246m for the six months to 30 September 2016 c.f. $253.1m for the 6 months to 30 September 2015. Difficult trading conditions for Infratil's Perth Energy division and flat results from Trustpower are seen as the main detractors from performance. Headline net profit was down 93% to $28.9m – which may have spooked some investors, but the pcp included the huge $407.1m gain from sale of Infratil's holdings in Z Energy and iSite. Overseas investors looking to move liquid assets out of New Zealand may also have taken the news as a cue to sell. Interim dividend has been raised 9.52% to 5.75 cps, from 5.25 cps in 2015.

Reaction to Infratil's announcement follows a familiar pattern of swift sell-down of any company failing to meet shareholders' high short term hopes in full. Infratil is banking on growth at Wellington International Airport plus contributions from recent investments in King Country Energy, Canberra Data Centre and Australian National University student accommodation to achieve annual earnings at the lower end of the $485-$525m guidance range for FY2016. At the current expected payout of 15.5 cps for FY1016 and recent price of $2.84 the dividend yield would be 5.46%. Infratil has a cash war chest of more than $500m plus undrawn bank facilities with which it intends to make additional investments in growth sectors such as renewable energy, retirement housing, telecommunications infrastructure and waste management. The company has a $50m share buyback program under way which should help improve earnings per share for existing shareholders who retain their full complement.

At today's reduced price Infratil offers the potential for growth, diversification and high dividend yield. Portfolios currently without this share should benefit from a purchase.

Fisher Funds' listed Australian investment company **Barramundi (NZX:BRM)**, has made yet another 1:4 issue of free warrants to existing shareholders as at 21 November 2016. This will be the fourth issue of warrants since Barramundi listed in October 2006. The exercise date is 24 November 2017. Exercise price is $0.63 less the sum of any dividends declared during the 12 month period up to the exercise date. Assuming continuance of Barramundi's high distribution policy of paying out 8% of NTA per year as dividends, final exercise price should be around $0.58 per new share. Originally intended as a holding company for a portfolio of small Australian listed stocks, Barramundi's NAV and share price were hammered by the Global Financial Crisis which developed soon after the company listed in October 2006. Original investors at the $1 issue price have seen little return on their money in 10 years but those investing at the low point of about $0.40 in 2008 have seen their return treble from both capital growth and high dividend yield. A major review and redirection from small caps to mid and large cap stocks has produced a broadly diversified portfolio of about 30 well-regarded companies which should respond positively to any general upward movement in the Australian market as a whole. Very small cap shares look to have been eliminated from the portfolio altogether.

The previous issue of Barramundi warrants saw only 47% of warrants exercised at the exercise price of $0.62 per new share, giving the company $9.1m in new capital. With a continuing program of high dividends, many being reinvested through the dividend reinvestment program, and issuance of new shares through exercise of warrants, some private Barramundi shareholdings will have grown substantially in number since the IPO. Others will have made a more fortunate entry at the low market prices prevailing in 2008. In either case these shareholders will now be asked to contribute quite an appreciable amount of new capital on the exercise of the new warrants in November 2017. Shareholders will need to see a substantially improved portfolio and share price performance before then if Barramundi is to succeed in its latest appeal for more funds. Redirection of investments into the "new" portfolio does offer that chance. There is little point in shareholders committing new capital to a company whose share price just heads downwards over the long term, irrespective of high dividends.

New warrants trade on the NZX under code **BRMWD**.

The sharp sell-off of **Orion Health (NZX:OHE),** after reporting an $18m loss and cash burn of $33m for the 6 months to 30 September 2016, provides yet another salutary lesson for investors buying into "hot sector" IPOs. Despite operating revenue increasing 9% to $104m (2% in GAAP terms), investors are concerned the company may not have sufficient cash to see it through to expected profitability in FY2018. Many apparently doubt whether the latest projection is actually achievable and think the company may have to approach shareholders to contribute more cash – something many are clearly reluctant to do. However, CEO, Ian McCrae, believes the cash balance at 30 September of $24m plus Orion's bank facility of $40m is adequate to see the company reach profitability in 2018. As with Wynyard Group, mentioned here last month, development of a potentially high demand software product in a fast growing sector does not automatically translate into a profitable investment from a portfolio point of view. Orion shares first listed on the NZX in November 2014, having been issued at $5.70. After a quick peak around $6.50 the shares had drifted down to $2.50 by February 2016, recovered strongly on optimism to over $5 in June, only to wither again as confidence in the company flagged. At the latest price of $1.98 original investors, still holding, are down 65%.

Of course there are always exceptions such as **Xero (NZX:XRO)** which has rewarded original holders handsomely despite never having made a profit nor paid a dividend since listing in June 2007. Losers here have been those who bought into the fast growth story much later, the shares having fallen 55% since peaking at over $40 in March 2014.

IPOs remain an area where private investors should exercise extreme caution. New Zealand investors are not alone – see http://www.abc.net.au/news/2016-11-02/small-investors-still-locked-out-of-lucrative-asx-listing-change/7990824

We tend to avoid IPOs unless fortunate enough to receive a (small) allocation of shares in one representing real value and kept closely guarded by brokers or through participating in a promising issue to which we may become entitled via an existing shareholding such as the Westpac sell down of BT Investment Management (BTT).

3. Interest rates, bonds and debentures

UDC has marginally increased its short term deposit rates.

S&P has raised its credit rating on Liberty Financial to BBB from BBB-, saying "the rating reflects our opinion of the unconditional, irrevocable and timely guarantee provided by Australian parent company Liberty Financial Pty Ltd", which has also been upgraded to BBB. The outlook on the ratings for both Liberty Financial and its parent is negative.

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	A-	5,000	2.05	2.70	3.30	3.60	3.60	3.65	3.30	3.30	3.30	3.40
UDC Finance	A-	100,000	2.55	2.75	3.35	3.60	3.60	3.65	3.35	3.35	3.35	3.45

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

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4. Strategy

Talk of faster US growth and rising interest rates is now so widespread that we can expect markets to over-react, as usual, in response. The "consensus" view is that certain equity sectors such as high yielding "bond proxy" infrastructure and property stocks will suffer while cyclical growth stocks should benefit and banks should gain from increased margins as interest rates rise. But daily media writers are good at repeating what has already happened - and hence what we should have done three months earlier. They provide little useful advice for today. The fact is, bond proxy stocks have already been soundly beaten down to attractive levels while numerous stocks in more favoured sectors such as construction are already heavily overbought. The real risk to bond proxy stocks is not that interest rates will rise, but the possibility that rates may rise faster than expected. Highly leveraged utilities, infrastructure and property companies with little or no growth prospects are the most at risk. High yielding firms providing income well above bank deposits, with manageable debt and favourable growth prospects should continue to add worthwhile diversity to individual portfolios, especially when purchased at knocked down prices. For the private investor "rotation" of holdings from one sector to another, chasing the latest hot topic, is unlikely to prove productive. Aggregation of a diversified portfolio over time, seeking both income and growth, is a better way to build wealth and protect savings. Individual holdings should only be sold or purchased when the case is compelling, irrespective of sector.

Many large funds have reportedly been caught holding large allocations to cash in their portfolios which must now be put to productive work if managers are to justify their high rewards. This would at least partly explain unexpected equity market strength post-Trump. Also, a growing trend by giant US insurance companies to divert significant portions of their reserves from bonds to equity Exchange Traded Funds (ETFs) would help underwrite market strength. ETFs offer insurance companies the option of liquidity or long term investment as required to meet claims while providing diversity and potentially greater returns than traditional bond holdings.

For most of 2016, The NZX has outperformed the ASX S&P/200, but now the NZX 50 is down 7% over the last three months while the S&P/ASX 200 is marginally up by 1%. For the year to date, the NZX50 is up about 9.5%, leading the Australian index on a 4% gain. Sentiment is turning to a continued outperformance by Australia into 2017. Diversification of holdings on either side of the Tasman helps reduce portfolio volatility while improving overall portfolio gains. After such a strong and unexpected Trump rally in the US we should expect some pull-back in the weeks ahead, likely to be reflected locally. The high likelihood of a US Federal Reserve interest rate rise in mid-December seems to have been forgotten in the rush. The rate rise, if it does eventuate, should therefore have some immediate negative impact on equities but such a long-expected event is solidly in the "known known" category and negative impact should be quite limited.

We took the opportunity to add some blue chip shares, offering both growth and dividends, to portfolios at knocked down prices just prior to the US presidential election when sentiment was overwhelmingly negative. Although a little early as it turned out, the Trump rally has generally turned those purchases positive. Any further pull-back, particularly in Australia, may provide more opportunities. A sharper than expected near term pull-back in international equities, possibly from a one-two combined US Fed and Italian referendum punch, may present a useful opportunity to add international equities through purchase of some highly regarded global listed investment companies. We would need to see a major retreat in short term indicators though before taking the plunge.

Access to any useful type of bond for investment purposes is almost non-existent at present, as interest rates look to be on the rise in the US and bottoming out in Australasia. We will be content to sit on our current bond holdings which we intend to hold to maturity over the next few years. We do not hold any perpetual bonds or long term fixed interest securities which could be badly hit by rising interest rates. For now, we will hold unused cash on short term deposit or on call.

Preliminary results for November show both our published portfolios as having made small gains for the month. The NZX 50 is down 0.6% so far with the S&P/ASX 200 up 2.7%, both lagging behind the S&P 500 which is up 3.6% for November after Trump won the US Presidency.

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.

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Regards,

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