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Investment Directions

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"Analysis to action; opportunities to outcomes"

In this Issue

1. **Overview** – RBNZ may not cut OCR in October as economic data improves. Expectations of federal funds rate rise by US Federal Reserve moving out to 2016, boosting equity markets to strong recovery after sharp downturn in August and September and overshadowing mediocre quarterly reporting season. China's central bank introduces new raft of stimulus measures. QE programs disrupt historical correlations in financial data.

2. **Equities** – Westpac announces light rights issue as part of capital raising. Kingfish warrants worth exercising despite small discount to head share price. Infratil sells out of Z Energy completely with handsome profit – looks to aged care and renewable energy sectors for reinvestment.

3. **Interest rates, bonds and debentures** – "Lower for longer" message from US Fed, but voting pattern of next FOMC meeting could indicate growing sentiment for higher rates. Latest investment rates from major deposit taking institutions.

4. **Strategy -** Strong equities surge in October could be limited if US Fed gives firm guidance on higher federal funds rate target for late 2015 or early 2016. Not a time to go all in. Rental property investors should consider investment portfolio to provide both income and growth without the work and stress.

Space News

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

Despite publishing an easing bias in September, the Reserve Bank of New Zealand may not cut the OCR again on 29 October as the economy shows further signs of improvement along with the rising NZD. Business confidence rose in September after declining for five months, investment and hiring intentions rose, profit expectations and consumer sentiment improved. The ANZ commodity index rose 5.5% in September driven by recoveries in dairy prices and aluminium but meat, logs, horticulture and seafood all fell. The OCR decision should be a close call – a further cut would help the RBNZ achieve its target of 2% inflation but could refuel the Auckland property market and reduce the Reserve Bank's own ammunition to counter any future economic crisis.

The New Zealand Government achieved a budget surplus of $414m for 2014/15, a huge turn-around from the deficit of $18 billion four years ago resulting from the Global Financial Crisis and Canterbury earthquakes. The surplus, if maintained, could lead to an upgrade in New Zealand's credit rating which would reduce government borrowing costs in future.

The Australian dollar fell on news that CBA Bank would follow Westpac in raising mortgage rates slightly as part of its capital raising program, undertaken in response to regulatory requirements by APRA. Tightening by banks is expected to restrict consumer spending, obliging the RBA to lower the OCR from its current 2% in order to maintain economic stimulus. ANZ and CBA have just announced similar moves.

Macquarie Bank says Australian house prices are set to fall up to 7.5% starting in March 2016 with a recovery starting in 2H17. The prediction is based on trends showing credit growth, auction clearances, house prices and settlement volumes are declining or slowing while population growth is easing just as housing supply is surging. Rapid price adjustments could occur in Melbourne and Sydney but persistent low interest rates should mitigate against any large number of mortgage defaults or market crash.

Wall Street turned on after-burners last week despite poor quarterly earnings reports from major corporates including Wal-Mart, Coca Cola, General Electric, IBM, Caterpillar, YUM Brands and American Express. Alcoa 3Q earnings fell 77% year on year compared to a 53% decline expected. US companies dependent on overseas sales suffer as the US dollar strengthens. Although weak earnings were expected in the current reporting round, many results have been worse than anticipated. The apparently contradictory surge on Wall Street typifies the "bad news is good news" scenario as investors now see even less chance of the Fed raising interest rates this year. A poor jobs report early in October strengthened the view, sending 10 year US T bonds below 2% briefly although the yield has recovered marginally to 2.08%. A further interest rate cut by China's central bank and indications of more economic stimulus to come this year in Europe added impetus from the "bad news" side but strong earnings from several major tech companies including Microsoft and Alphabet (parent to Amazon and Google) added strength to the recovery from a positive viewpoint.

China's central bank reduced its benchmark one year lending rate by 0.25% to 4.35% in October with the one-year benchmark deposit rate going down 0.25% to 1.50%. The reserve requirement ratio for banks was lowered by 0.5% and the ceiling on bank deposit rates was scrapped, a move intended to allow banks to price loans according to their risk and reduce waste. The new stimulus comes after imports for September fell 17% year on year although exports fell only 1.1% giving a trade surplus of 376B Yuan (US$59B). China is expected to set a new five year growth target of 7% per year, giving priority to growth over economic reform but analysts believe growth in 2016 could fall to 6.3%.

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

	Latest	Sep 15	Aug 15	Jul 15	Jun 15	May 15	Apr 15
3 month LIBOR (end of month) %	.31640	.32500	.32900	.30860	.28175	.28275	.27875
TED Spread (points)	.31	.34	.27	.23	.27	.27	.27
VIX equity volatility	14.46	24.5	28.43	12.12	18.23	13.84	14.55
US LEI		-0.2%	0.0%	0.0%	+0.6%	+0.6%	+0.6%
Japan LEI			+0.2%	-0.2%	+0.8%	+0.1%	+0.0%
Eurozone LEI			+0.3%	+0.3%	+0.5%	+0.3%	+0.5%
Australia LEI			-0.4%	+0.3%	-0.3%	-0.2%	-0.3%
United Kingdom LEI			+0.2%	-0.2%	-0.2%	-0.5%	+0.3%
China LEI		+1.6%	+1.0%	+0.9%	+0.5%	+1.1%	+1.5%
US Money Market Funds $T	2.699	2.669	2.694	2.648	2.618	2.615	2.582
US Gov. 10 year T-Bond (%)	2.083	2.060	2.200	2.205	2.335	2.095	2.046
Foreign holdings of US T-Bonds $B			6098.7	6116.5	6175.2	6134.8	6137.3
Margin debt, NYSE (US$ millions)		453,896	473,412	487,345	504,975	499,143	507,153
US M2 Money Stock (US$B)		12,195	12,138	12,059	11,982	11,938	11,895
Velocity of Money US M2					1.501		

CNN Fear and Greed Index	58	18	3	9			
Insider Buy/Sell ratio (US) %	72	70	68	38	39	38	32
Forward P/E S&P 500 (12 month)	18.41	16.45	17.42	17.82	17.81	17.89	18.05
Trailing P/E S&P 500 (12 month)	22.07	20.59	21.63	21.18	21.52	21.47	20.98
Total Put/Call options ratio CBOE	0.77	0.97	1.20	1.00	1.10	1.15	1.05
S&P 500 Share Index	2075.15	1920.03	1972.18	2103.84	2063.11	2107.39	2085.51

More evidence is accumulating that the Fed's series of QE programs conducted over the past three years have indeed acted as a "disruptor" (to use the modern parlance) of historic relationships between financial data sets. For example, in earlier times US money market funds generally reflected the inverse of equities – funds flowed out of equities and into money market funds and visa-versa as risk appetite declined or grew. Today it seems, with the ever increasing US M2 money supply, sufficient liquidity exists in the US financial system for both to gain simultaneously.

Similarly, the historic correlation between performance of US equity indices and NYSE margin debt appears to be in the process of breaking down. Negative momentum in margin debt previously presaged a sharp fall in equities but access to copious funds by speculators and others looks to have reversed the traditional linkage in October. Should equities strength continue into the New Year we can expect to see negative margin debt momentum reversed, the data thereby losing significance as a useful forward indicator.

A rising Fear and Greed index plus high Insider Buy/Sell ratio coupled with a low Put/Call Options ratio and low VIX volatility all point to current US equities positive momentum being maintained in the short term. Further out (early–mid 2016), rising Forward P/E ratios, declining US Leading Economic Indicators and the possibility of higher US interest rates indicate the upside is limited.

2. Equities

Westpac Bank (ASX:WBC) has announced a 1:23 rights issue at A$25.50. The issue is a relatively light impost on shareholders and comes as part of Westpac's capital raising exercise which includes sale of assets (portion of BTIM sale just completed) and a small (0.2%) lift in mortgage interest rates on owner-occupied homes. ANZ, CBA and NAB are also raising mortgage rates in response to regulatory body APRA demands that more capital be held by banks against mortgages. WBC is trading at A$31.80 on the ASX at the time of writing. The majority of analysts surveyed expect Westpac to at least maintain its current dividend payment, giving a yield on the new shares of 7.14% p.a. As the diluting effect of the light issue will be small, an immediate capital gain on the new shares of over 20% is also likely.

Early in October, **Infratil (NZX:IFT)** announced the sale of its remaining 20% stake in Z Energy, at $6.00 per share, gaining an overall profit of $392m from sale of its holding. As a consequence of the sale, EBITDAF guidance for the year to 31 March 2016 has been cut to $500m - $530m from $520m - $550m with operating cash flow expected to fall from $270m - $300m to $250m - $280m. Net debt reduces to $310m putting Infratil in a strong financial position to pursue new investment opportunities, possibly in the aged care and renewable energy sectors where it already has a presence but new sectors where Infratil management expertise could provide benefits may also be explored. Hence another generous special dividend is unlikely this year but even without that IFT is forecast to distribute a rising stream of dividends, taking the cash yield at today's price of $3.15 to nearly 5%. The consensus of analysts surveyed is for solid EPS growth in the 2016/17 year of 20% or more.

Kingfish Limited (NZX:KFL) has warrants due for exercise by c.o.b. on 6 November at a price of $1.18 per new share. With the current price of $1.25 most likely depressed by the request for capital, the new shares could show a modest capital gain of 6%, plus provide a cash dividend yield of approximately 9% p.a. Kingfish is an actively managed listed investment company investing in NZX-listed mid and large-cap shares. With a policy of paying out 2% of NTA per quarter, the shares need to be viewed as an income producer rather than a capital appreciation investment.

3. Interest rates, bonds and debentures

The outlook for global interest rates remains weak with expectations of US “lift-off” moving out to 2016 as the Fed takes more notice of international developments and effects, rather than just US jobs and inflation, when deciding the target rate for federal funds. More quantitative easing in Europe, until September 2016, and lower interest rates in China add to the downward pressure.

Should the US Fed decide against raising the target Federal Funds rate in October (as is expected), attention will centre on the number of dissenters. If sole “hawk” from September, Jeffery M. Lacker, President of the Reserve Bank of Richmond, is joined by a significant number of others then a December “lift-off” is still possible.

Movement in New Zealand deposit rates has been muted during October although UDC shaved another 25 points off its call rate.

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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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

When selecting both equity and bond investments we need to keep in mind the disruption effect caused by US Fed QE programs over the past three years as described in our Overview section this month. Equities upside may be limited in the mid-term and some of our indicators may no longer be reliable. So even though equity markets look to be making a strong recovery from the sharp reversal over August and September, this is not a time to go all-in. There is no “blood in the streets” at present. Hence we will continue to pick shots carefully, concentrating on the special offers that come our way through direct ownership of securities and by considering opportunities created by other special offers in the market. Often a request for capital through a rights issue will cause temporary weakness in a share price, allowing entry at a reasonable, if not cheap, price.

The deteriorating outlook for higher interest rates in the US has encouraged us to reconsider the new issue market for bonds even though local coupons and yields have fallen to barely useful levels and maturities are longer than we would like. Each issue can be considered on its merits. The secondary corporate bond market in New Zealand is still starved of offers with many listings showing no offers at all. Anyone with a reasonable quality bond is hanging on to it. The few that are offered for sale come with low yields and high prices.

A 74 year old landlord was recently reported to be earning $14,500 per week in rent on a residential property portfolio comprising 37 properties with a total value of about $18m and with a rating value of $13.6m. Debt on the portfolio is $4.8m. After interest, rates, repairs, legal fees, insurance and property management it is likely he receives less than half the headline rental –probably a lot less. But $7250 per week represents a return of just 2.1% on his deployed funds or 2.86% on his equity. Of course he has no doubt made substantial capital gains over the 29 years of his property program but the numbers show he is now reliant on those gains for any useful return on his investment. The work and stress of owning 37 residential properties is something most of us wouldn't care to think about.

Rental property owners with just one or two properties may well receive similar yields on their investment and could well find themselves in the "asset rich, income poor" category. Diversifying into an investment portfolio offering both good income and growth is an option well worth considering.

Equity markets staged another retreat in September after that of August, pushing the ASX down 12% for the two months and off 7.2% for the year. The NZX50 fared better, down just 5.7% over August and September and up 2.35% for the year.

Consequently both our diversified income and growth portfolio units retreated a little further to the end of September but strong recoveries during October have left our income portfolio on a gain of 6.2% for the calendar year to date and the growth portfolio up 10.72% at the time of writing.

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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