

Consider This

The Hunt for Income

The rapid fall in interest rates has accentuated issues for investors needing income and led to a paradigm where equities are increasingly being used to deliver income. In this report we explore where yield opportunities may still exist but also why attention to the underlying company earnings drivers remain important.

Lower interest rates priced but more declines

Our Advisor survey, conducted prior to the RBNZ's larger than expected cut to the Official Cash Rate (OCR), shows no one is thinking interest rates are going up anytime soon. We would agree with this sentiment, however, it does mean that even lower interest rates are being baked into share prices.

While we are cautious in overpaying for yield, we believe the move by the Australian Banking regulator (APRA), to reduce the regulatory capital allowable supporting foreign subsidiaries and the RBNZ's proposed higher bank capital requirements in NZ, will result in additional cuts to the OCR and even lower interest rates.

Add in the fact that term deposit rates are only just starting to reflect the current cuts, we believe the even lower reinvestment rates will result in further inflows in higher yield equities.

Best value yield

Lower interest rates implicitly imply a higher market risk premium and lower growth. In this environment we believe investors are best served looking for yield within defensive sectors. This reduces earnings risks albeit even these companies are not immune from these issues.

Preferred companies

To identify companies providing preferred yield exposure we used the following filters:

- Lower volatility companies (beta < 1)
- Low and achievable implied earnings growth
- Cash dividend yields greater than 4%, once we adjust for dividends not exceeding 100% of cash earnings.

Figure 1. Preferred Yield

Code	Rating	Beta	Implied Growth beyond FY1	Adjusted Cash Yield ¹	Earnings risk	Fcst Payout Ratio
ZEL	OUTPERFORM	0.84	-0.1%	8.4%	Medium	72%
KPG	NEUTRAL	0.65	1.9%	4.0%	Low	108%
SPG	NEUTRAL	0.80	3.0%	4.3%	Low	92%
ARG	NEUTRAL	0.80	3.0%	4.2%	Low	103%
GNE	NEUTRAL	0.88	3.1%	5.4%	Low	53%
SPK	OUTPERFORM	0.90	3.2%	5.9%	Medium	101%
TPW	OUTPERFORM	0.88	4.0%	4.6%	Low	89%
CEN	NEUTRAL	0.88	4.1%	4.7%	Low	70%
SKC	NEUTRAL	0.99	4.1%	5.1%	Medium	82%

Source: Forsyth Barr analysis, 1. Adj Cash Yield (max 100% cash payout ratio)

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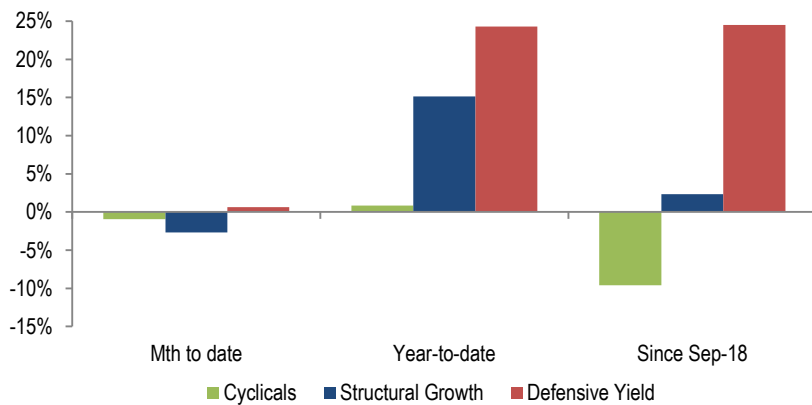
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Defensives to the forefront

The hunt for yield has already been occurring and once again interest rate declines have driven positive returns amongst Defensive thematics. This has been the case since September 2018 when growth concerns first emerged. Cyclicals, which are more closely aligned with economic growth, have disappointed, as these reflect increasing earnings concerns.

Figure 2. Thematic performance



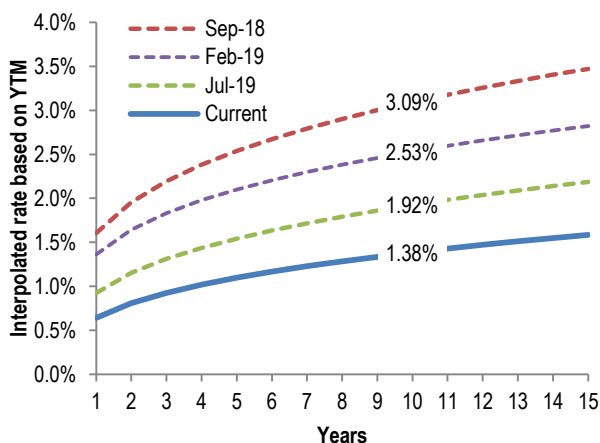
Source: Forsyth Barr analysis, Bloomberg

Expect lower rates

Interest rates have already fallen considerably. Reviewing wholesale interest rates, NZ Government bonds have been trending lower for some time with declines accelerating since September 2018. Deposit rates and the OCR declines have been more recent.

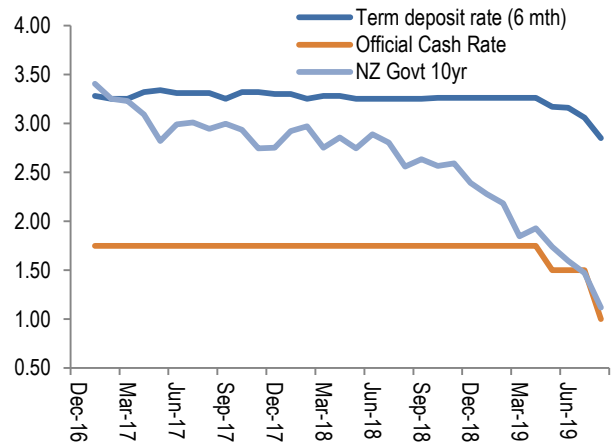
With further OCR cuts pencilled in, and these likely to be augmented by the recent change reducing bank subsidiary capital support by APRA (and the likely higher capital requirements for banks in NZ), even lower interest rates should see another wave of flows seeking higher income opportunities.

Figure 3. Interpolated rate curve using NZ Government bond rates



Source: Forsyth Barr analysis, Thomson Reuters

Figure 4. Interest rates...term deposit rate declines more recent



Source: Forsyth Barr analysis, RBNZ

Defensive Yield the place to be

As interest rates decline more defensive sectors tend to outperform. This is borne out by both NZ and international data with Figures 5 & 6 outlining sector performances during times of low interest rates. When interest rates continue to decline, past performances suggest Defensives will continue to outperform while Cyclical tend to underperform.

Figure 5. Sector sensitivity analysis NZ equities (since 2003)

	Correlation (6mth ave)	Monthly returns/ Low rates	
		Rates Rising	Rates Declining
Defensive Yield	-0.33	-3.2%	+3.1%
Structural Growth	-0.17	-3.2%	+3.2%
Cyclicals	+0.03	+0.2%	+0.2%
NZ Market	-0.32	-2.9%	+2.6%
Health Care	-0.41	-3.9%	+2.9%
Utilities	-0.35	-4.6%	+3.6%
Real Estate	-0.33	-3.3%	+2.0%
Industrials	-0.22	-2.9%	+3.2%
Telecoms	-0.18	-2.7%	+1.3%
Technology	-0.01	-6.2%	+0.7%
Discretionary	+0.02	-6.0%	+1.1%
Financials	+0.05	-3.0%	-1.7%
Consumer Staples	+0.08	-2.3%	+3.4%
Materials	+0.08	-1.1%	-0.5%

Source: Forsyth Barr analysis, Bloomberg

Figure 6. Sector sensitivity analysis US equities (since 1990)

	Correlation (6mth ave)	Monthly returns/ Low rates	
		Rates Rising	Rates Declining
Defensive Yield	-0.08	-1.0%	+1.5%
Structural Growth	+0.27	+2.5%	-0.6%
Cyclicals	+0.27	+2.0%	-0.4%
S&P 500	+0.32	+2.5%	-0.8%
Real Estate	-0.26	-0.2%	+1.4%
Utilities	-0.19	-1.7%	+1.2%
Consumer Staples	+0.12	+1.1%	+1.0%
Telecoms	+0.16	-1.2%	+2.0%
Technology	+0.22	+3.3%	-1.4%
Materials	+0.25	+1.3%	-0.4%
Health Care	+0.27	+1.7%	+0.3%
Discretionary	+0.28	+2.7%	-0.3%
Industrials	+0.33	+2.7%	-0.2%
Energy	+0.43	+2.1%	-2.1%
Financials	+0.49	+5.3%	-2.3%

Source: Forsyth Barr analysis, Bloomberg

Reviewing company preferences

For those requiring income we have, therefore, concentrated on defensive sectors. Figure 7 outlines the companies offering yield attraction where we believe pricing is relatively attractive and dividends are more sustainable.

We prefer low volatility, required average growth not being excessive and sustainable cash dividend yields greater than 4%.

Figure 7. Company fundamentals (sorted by filters past then implied growth lowest to highest)

Code	Sector	Rating	Filters pass	Beta	Implied Growth beyond FY1	Adjusted Cash Yield ¹	Payout Ratio	Earnings risk
ZEL	Energy	OUTPERFORM	4	0.84	-0.1%	8.4%	72%	Medium
KPG	Property	NEUTRAL	4	0.65	1.9%	4.0%	108%	Low
SPG	Property	NEUTRAL	4	0.80	3.0%	4.3%	92%	Low
ARG	Property	NEUTRAL	4	0.80	3.0%	4.2%	103%	Low
GNE	Gentailer	NEUTRAL	4	0.88	3.1%	5.4%	53%	Low
SPK	Telco	OUTPERFORM	4	0.90	3.2%	5.9%	101%	Medium
TPW	Gentailer	OUTPERFORM	4	0.88	4.0%	4.6%	89%	Low
CEN	Gentailer	NEUTRAL	4	0.88	4.1%	4.7%	70%	Low
SKC	Discretionary	NEUTRAL	4	0.99	4.1%	5.1%	82%	Medium
MEL	Gentailer	UNDERPERFORM	3	0.84	4.6%	4.4%	84%	Low
IPL	Property	OUTPERFORM	3	0.73	2.7%	3.8%	101%	Low
POT	Ports	UNDERPERFORM	3	0.75	4.4%	2.5%	80%	Low
AIA	Ports	UNDERPERFORM	3	0.80	5.2%	2.4%	100%	Low
VHP	Property	OUTPERFORM	3	0.68	2.7%	3.5%	100%	Low
PCT	Property	NEUTRAL	3	0.68	2.9%	3.3%	105%	Low
PFI	Property	NEUTRAL	3	0.71	3.1%	3.2%	99%	Low
MCY	Gentailer	NEUTRAL	3	0.88	4.8%	3.2%	60%	Low
GMT	Property	UNDERPERFORM	3	0.68	3.2%	3.0%	103%	Low
VCT	Utility	UNDERPERFORM	3	0.92	4.7%	0.0%	Capex > EPS	Low
RBD	Discretionary	UNDERPERFORM	2	1.02	5.1%	0.0%	0%	Medium

Source: Forsyth Barr analysis, Preferred, 1. Adj Cash Yield (max 100% cash payout ratio)

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