

Wealth Weekly

Good as Gold?

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If you thought equities were on a tear, take a look at the gold price. The yellow metal is up +34% this year, nudging over US\$2,000 per ounce last week to reach a new record high, while the S&P 500 benchmark index of US large-cap stocks is up just +3.7% in 2020.

Gold price reaches new record

Central banks around the world are currently keeping interest rates at record low levels in order to make it less attractive for anyone to keep money in the bank. Their hope is that people will borrow and spend instead. But **one of the side effects of these low interest rates is that they reduce the opportunity cost to savers of holding assets that are even less productive than cash**: they have made the 0% yield on gold — and gold's use as a store of value in times of inflation — look relatively attractive.

The consensus view is that low interest rates, the weakness of the US dollar, expansion of money supply, the threat of inflation and the disproportionate growth of debt will support the gold price. If there is a contrarian case (and it seems like a distant prospect currently), it would be that signs of inflation could drive a hawkish turn from the US central bank towards higher US interest rates, which in turn would support the US dollar and hurt gold (more on that below).

While gold has defensive properties, it isn't a one-way bet. It is as volatile as equities, it doesn't generate any income and it has already had a strong run.

For those who want to add gold to portfolios, **exchange-traded funds (ETFs) are available which hold gold bullion in vaults in New York and London.** Their fees are modest and they have historically tracked the gold price very closely. Another way to get exposure to the gold theme is through gold mining stocks or gold-mining ETFs. Gold miners benefit from operating and financial leverage to higher revenues from selling gold at higher prices. But the other side of that leverage coin is that if the gold price falls, the mining stocks will probably fall even more.

Themes of the week

There are signs the US Federal Reserve is planning to take a more relaxed approach to getting ahead of inflation, preferring instead to focus on maintaining full employment. That perception would help explain the recent continued rise in gold prices. But the simultaneous decline in US Government bond yields suggests fixed income investors are less concerned about inflation for now, perhaps because they don't see the pandemic disappearing anytime soon. If/when the pandemic finally recedes, though, the combination of rising inflation expectations and of the Fed's nonchalance towards it might lead to further weakness in the US dollar as investors seek a safer home for their cash.

Bond returns have been healthy since the depths of the equity market selloff in March, as falling interest rates have boosted the capital value of bonds in the secondary markets. But with interest rates now at record low levels, and no signs of central banks tiring of printing more money to keep rates low, can bonds continue to deliver a return for investors? **If credit spreads narrow (which the pre-GFC data suggests is possible), then that would help deliver some further capital return on bonds.**

International companies that reported last week largely continued the trend of better than expected results, with Walt Disney reporting a big earnings beat, while Siemens delivered ahead of expectations across the board. The exception was gene sequencing technology maker Illumina, which missed estimates as many of the academic laboratories it supplies aren't yet fully operational.

Looking ahead

Events to look forward to this week include the Reserve Bank of New Zealand's Monetary Policy Statement on Wednesday, and results from Tencent and Transurban on Wednesday and from NZX, Precinct Properties, Telstra and Treasury Wines on Thursday.

All that Glistens

A brief guide to gold

COVID-19 has revitalised interest in gold as a way to combat elevated equity market risk and inflation risk as interest rates globally converge towards zero. In our report [Global Gold Sector – Reviewing Investment Options](#), published last week, we outlined some ways investors can hold gold exposure in portfolios.

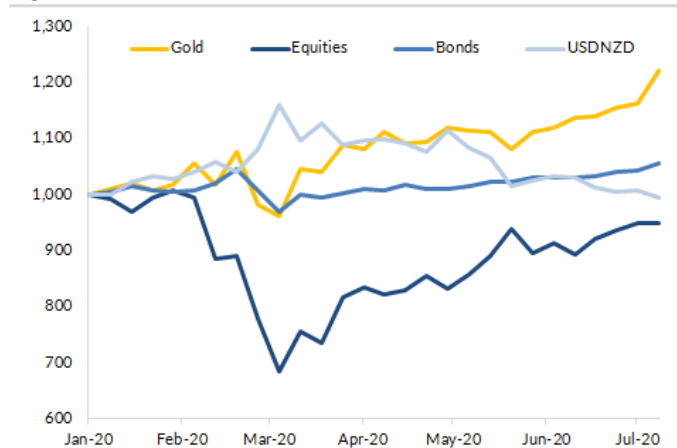
The investment case for gold

Gold sold off along with almost all other assets during the COVID-19 induced rout in financial markets in March (Figure 1). That was probably because its price had already rallied before then, allowing investors to take some profits, and because in times of stress its liquidity means it can easily be sold to generate cash to reinvest in the market.

Since then gold has made a comeback. The recent key driver for gold has probably been low/negative interest rates across developed countries, which has resulted in gold being considered a more attractive store of value than cash, the value of which can be inflated away more easily because central banks can issue infinite quantities of it. Gold has some defensive properties that make it attractive in times of uncertainty:

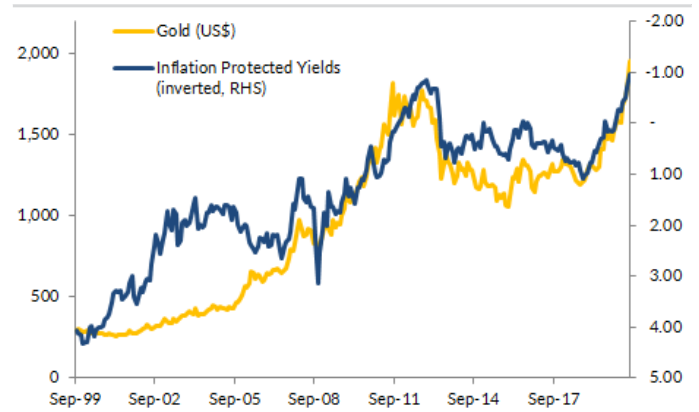
- It is widely regarded as valuable and has been used as a currency for thousands of years
- It has been seen as a good store of value in times of higher inflation
- Its value is underpinned by its practical applications in jewellery and electronics
- Its price has tended to rise when other asset prices fell ("negative correlation")
- It has no embedded credit risk (it doesn't owe anyone money so it can't go broke)
- It is easy to buy and sell ("liquid")
- It offers potential upside through price appreciation (sometimes referred to disparagingly as the "greater fool" theory of investing).

Figure 1. Asset class performances in the year-to-date



Source: Forsyth Barr analysis

Figure 2. Gold price vs 10yr US Treasury Inflation Protected Securities (TIPS) yield (20yrs)



Source: Forsyth Barr analysis

Why now?

With central banks eager to keep interest rates low to encourage consumer spending versus saving, the theme of low interest rates and the threat of rising inflation are likely to persist as a driver of the gold price.

The negative correlation between gold prices and interest rates has remained consistent in the last 10 years (Figure 2). If that continues, the lower-for-longer interest rate environment could be supportive for gold prices through the second half of 2020. Consensus is for gold prices to hold up from here (Figure 3).

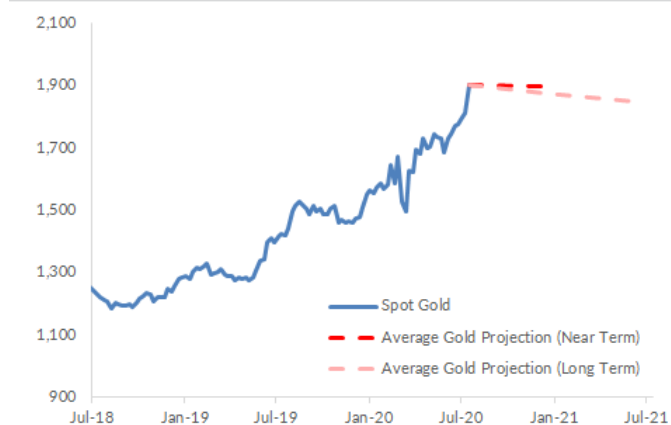
Why not now?

The bear case for gold would be a strengthening of the US dollar and a hawkish turn from the FOMC (pointing towards higher interest rates). However, it is hard to side with this bearish view in the current environment.

A volatile way to reduce portfolio volatility

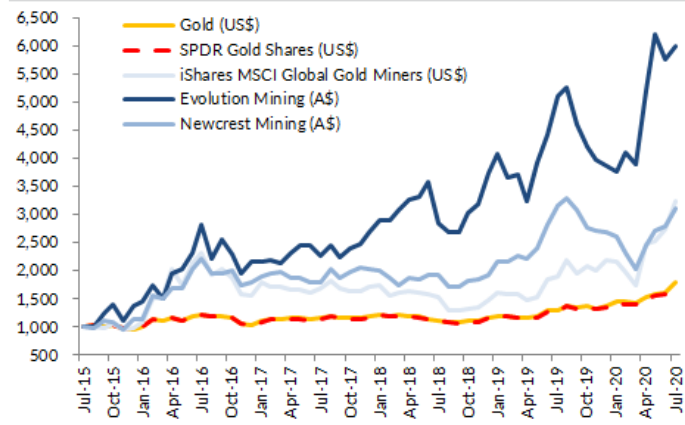
Longer-term, some caution is warranted. Viewed in isolation, gold prices are anything but steady – they are just as volatile as equities. Gold can end up being a poor contributor to portfolios. The price one buys it at makes a big difference to returns, and the gold price has increased by over 40% from US\$1,400 to US\$2,000/oz over the past year. Prior to the recent rally, gold had substantially underperformed the MSCI global equity index and most other asset classes (Figure 4) – as one should expect from an asset that generates neither current income nor the prospect of future growth in income.

Figure 3. Gold price history and forecasts



Source: Forsyth Barr analysis

Figure 4. 5 year performance among gold assets (local currency)



Source: Forsyth Barr analysis

If gold, then how?

What is the best way for investors to add gold exposure to portfolios? The answer comes down to what you want from a gold investment portfolio – diversity or capital gains?

We highlight three ways investors can add gold exposure in portfolios. The returns of a selection of these over the last 5 years are shown in Figure 4.

- **Gold bullion-holding ETFs:** Numerous ETFs solely hold physical gold bullion. They closely track the price movements of gold.
 - **iShares Gold Trust (IAU.N)** invests in physical bullion which is then vaulted in the US, UK and Canada, and has a low annual fee of 0.25%.
 - **SPDR Gold Trust (GLD.N)** is the biggest and most liquid gold ETF with the lowest bid/ask spread, but its fee of 0.40% p.a. means it is best suited for active trading and short holding periods.
- **Gold mining ETFs:** Another way to gain exposure is to invest in ETFs that hold global gold miners.
 - **VanEck Vectors Gold Miners ETF (GDX.N)** invests in gold miners across the globe, mostly in North America and Australia.
 - **iShares MSCI Global Gold Miners ETF (RING.N)** is a smaller fund that tracks a different global gold miner index, and has a cheaper expense ratio of 0.39% p.a compared to GDX's 0.52% p.a.
- **Gold miner direct equities:** A third way of gaining exposure to gold is through investing in gold miners. Four notable Australian listed gold miners are:
 - **Evolution Mining (EVN.AX;** average analyst rating is HOLD)
 - **Newcrest Mining (NCM.AX;** HOLD),
 - **Northern Star Resources (NST.AX;** HOLD)
 - **Resolute Mining (RSG.AX;** BUY). Resolute is a South African based mining company listed on the ASX, which has operated 10 different mines in the last 26 years. Its current operations are in Mali, Ghana and Senegal.

Intuitively, investing in listed equities via a broad ETF or direct equities should outperform gold bullion in a rising gold price environment because equities typically provide operational and financial leverage to the gold price. But by definition that also introduces vulnerabilities to the downside if gold prices fall or if execution setbacks occur in extracting and producing gold.

Our preferred way to invest in gold would be through a gold bullion ETF (e.g. iShares Gold Trust, IAU.N, which has a modest fee and good liquidity).

Investments in listed gold mining companies make sense if/when stock valuations offer attractive value-for-risk; currently they appear fully valued.

Themes of the Week

Macro Snapshot

Fed policy shifts from fighting inflation to encouraging inflation

If a *Wall Street Journal* [article](#) (behind paywall) published on 2 August is accurate, **the US Federal Reserve is about to abandon its 30 year old policy of using pre-emptive rate hikes to get ahead of inflation**. The article contends that the US central bank is prepared to allow inflation to run above 2% p.a. to "symmetrically" make up for the episodes when it was below 2%. It suggests the Fed has had one eye on the Eurozone and Japan over the last 10 and 20 years respectively, where policy makers have struggled to generate inflation even with vast amounts of stimulus.

The implications for such a change in policy would include:

- US rates staying at current low levels for a very long time, even if inflation did start to increase
- The Fed and other central banks possibly changing inflation targets to an average through the business cycle, rather than a hard number
- The Fed focussing more on policies aimed at creating full employment, rather than on price stability.

Could inflation make a comeback?

For inflation to return in the short-term, COVID-19 would need to make a quick exit, perhaps as a result of a vaccine or effective treatment becoming widely available. This would allow borders to re-open, global trade and travel to resume, and pent-up demand to drive an increase in economic activity. All the excess money sloshing around could drive not just asset prices but also consumer prices higher.

If the Fed was to keep interest rates low despite such an emergence of inflation, investors would seek more attractive inflation-adjusted returns elsewhere; the release valve for those investment outflows from the US would be a **weaker US currency**, which we have seen in recent months.

The surge in gold prices is already reflecting concerns by many investors that money printing by central banks and surging fiscal deficits by governments will drive inflation.

Interestingly, however, the bond market is currently telling us something else. **The bond market looks for inflation and at the moment is not seeing any**: the US 30-year Treasury (government bond) yield was 1.7% in June and has since fallen to 1.2% (the trend should be in the other direction if inflation was being perceived as a rising threat). Perhaps bond investors are more pessimistic than gold investors that COVID-19 will disappear and economies will rebound quickly.

Low rates for longer — and a lower US dollar

The bottom line is that:

- The risk of cash rates rising in the next 12–24 months seems low, even if inflation does start to increase towards and above central banks' official targets.
- The Fed has plenty of firepower to buy bonds from any sellers, and will likely try to keep US bond yields around 1% for the foreseeable future.
- Higher US inflation pressure would be more likely to be reflected in further weakness in the USD, which could push the NZD up towards 0.7000 against the USD and potentially beyond.

Fixed Interest

Money for nothing

One of the side effects of the latest global economic crisis (due to COVID-19) is that interest rates around the globe are either at 0% or very close to it. The world has decided that increasing debt (printing money) is the answer, despite the level of debt having already increased significantly following the Global Financial Crisis (GFC) – an event that was itself caused by debt. How this all ends is anyone's guess.

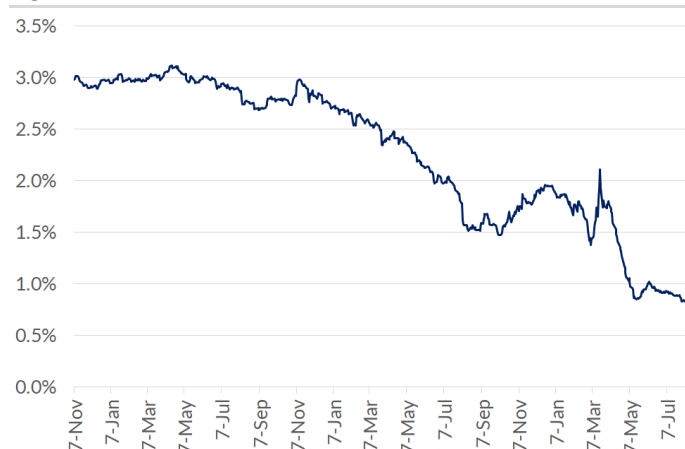
What about those who have bonds in their investment portfolios?

With record low (and falling) interest rates, **bonds have continued to perform well**. US investment grade bonds returned a whopping +21.6% since the 20 March low in the financial markets. New Zealand investment grade bonds have not done too badly either, returning +5.52%.

The question is, can this performance continue?

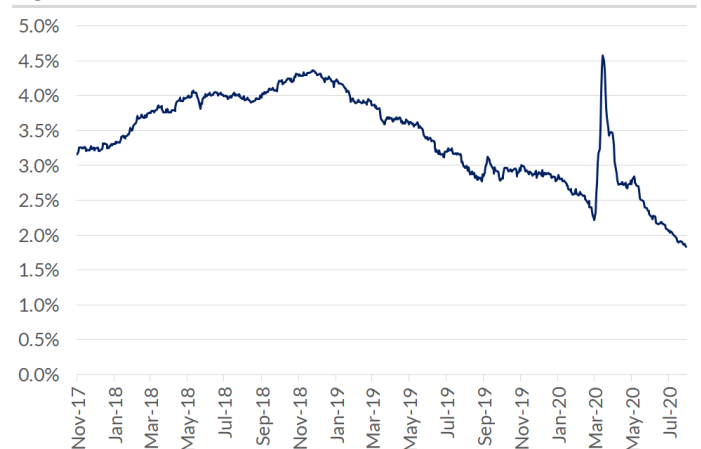
Both the US and New Zealand investment grade bond indices now have record low yields of 1.83% and 0.83% respectively. However, **if we look back to compare credit spreads from prior to the GFC to today, there appears to be more room for these spreads to decrease**. This indicates that it is possible to see further positive performance in bonds.

Figure 5. New Zealand Investment Grade bond yield



Source: Forsyth Barr analysis, Bloomberg, NZX/S&P Investment Grade Bond Index

Figure 6. US Investment Grade bond yield



Source: Forsyth Barr analysis, Bloomberg

Finally some issuance in New Zealand

There were two bond deals of significance last week. First, the New Zealand domestic bond market welcomed its first corporate bond deal post COVID-19. Wellington International Airport (WIA) raised NZ\$100m via a six-year senior offer at a coupon of 2.50%.

In the US Alphabet (Google) raised US\$10bn with the US\$1bn 5-year tranche issued at a coupon of 0.45%. This was the lowest coupon on a 5-year US corporate bond in at least the last 40 years, possibly ever.

Equities

Reporting season continues

This has been one of the more interesting reporting seasons of recent times. Overall, US company earnings have come out better, or rather, less bad than analysts' lowered expectations. But there have been plenty of surprises on both the upside (Walt Disney and Siemens last week) as well as on the downside (Illumina).

We hold Siemens and Illumina in our International Model Portfolio, although after Illumina's very strong performance this year we have lower conviction in it going forward.

Walt Disney (DIS.N)

Walt Disney reported a decent set of 3Q results. Revenue was slightly below consensus, but EPS of US\$0.08 was well ahead of expectations for a loss of -US\$0.64. The profit beat was helped by Media networks as ESPN did not expense a lot of sport content costs, which have instead been deferred until live sports games resume.

Disney+ and other Direct to Consumer (DTC) offerings continue to gain traction. Disney+ now has over 60m subscribers, and Walt Disney has over 100m subscribers in total across its subscription video on demand (SVOD) offerings. This is impressive, given it took Netflix (NFLX) eight years to get to that level. Investors seemed largely focussed on these positive subscriber numbers, and comparatively unfazed by expected increases in losses from these businesses as Walt Disney invests in new initiatives. Disney+ losses increased in the 3Q, and DTC losses are expected to rise to -US\$1.1bn in the 4Q, up from -US\$740m last year.

Pandemic shutdowns impacted operations in the Parks and Studio segments as expected, with Parks revenue down -85%, and an EBIT loss of ~US\$2.0bn. Our research affiliates forecast continued losses for Parks in the 4Q, with operations recovering to breakeven in FY21.

Management commented they will consider resuming the dividend in late 2020, but reiterated that **investment in growth of the DTC business is the top priority, which means losses could be further extended with new initiatives.**

Siemens (SIEGn.DE)

Siemens delivered 3Q20 results well ahead of expectations. Revenue of 13.5bn was better than feared, but down -5% on the prior year, while free cash flow increased to 2.5bn from 434m helped by a strong performance from Siemens Mobility which saw order growth of +2%, with some large order wins in the quarter. Higher taxes dragged on net income of 535m, representing a drop of -53% from a year ago.

The Digital Industries segment helped drive the better than expected performance, as it experienced double-digit growth in its software business and in China, which helped offset softness in the core automation business in Europe. Siemens CEO, Joe Kaeser, highlighted that China has recovered very quickly since the onset of COVID-19, and between April and June, Chinese orders increased +6% from a year ago. However, all other regions where Siemens does business, apart from Germany, recorded a drop in orders.

Siemens did not provide detailed guidance for the remainder of the year, but continues to expect a moderate decline in comparable revenue in fiscal year 2020, with the book-to-bill ratio remaining above 1 (implying more orders received than filled) indicating decent demand. The spin-off and public listing of Siemens Energy is expected to be completed before the end of this fiscal year.

Illumina (ILMN.O)

Illumina delivered soft 2Q results, below consensus estimates at both the top and bottom lines. Revenue of US\$633m missed consensus of US\$680m, while 2Q EPS of US\$0.62 was also below expectations of US\$0.67. Management did not reinstate guidance; their commentary pointing to modest improvements in demand going forward implies revenue and EPS will be well below consensus expectations.

Next Generation Sequencing (NGS) sales were down -22% yoy, with NGS consumables sales down -22%, and service down -11%, all below consensus. NGS instruments beat consensus although still down -32% yoy. The results highlighted that Illumina's revenues remain largely reliant on sequencing volumes at academic labs (~60% of sequencing consumables sales). **Management has taken a more cautious stance around the return of academic labs,** as ~55% of labs are currently running at reduced capacity, with less than ~33% fully operational, implying that 10–15% of academic labs remain closed. Illumina has started selling to many different COVID-19 related projects, however, it will likely take several quarters for these areas to deliver a material impact.

Illumina shares sold-off -11% following the result, however, remain up +70% from mid-March levels. We continue to like Illumina as a portfolio company and see an attractive long-term opportunity with clinical NGS acceleration as a key driver, but shares could face further pressure until confidence is restored. At current prices we suggest reviewing weightings in portfolios with a view to locking in some of Illumina's strong performance before its result.

Research Worth Reading

New Zealand

Equity Strategy – Recovery Heat Map; Four Months On

Our COVID-19 domestic recovery heat map this week shows that there has been a small backward step in a number of indicators. Both domestic passenger flights and hotel occupancy have dropped this week, possibly a delayed result of the school holidays ending. Corporate bond spreads have widened slightly, possibly due to new issuance being announced, whilst vehicle traffic, electricity volumes and credit card spending remain stable. Unemployment data released last week for the June quarter positively surprised versus economists' expectations, but Jobseeker Support and CIRP (COVID-19 Income Relief Payment) recipients continue to increase, albeit slowly. The New Zealand economy appears remarkably resilient at this stage of the recovery. (Published by Forsyth Barr)

F&P Healthcare (FPH) – Unmasking Competitor Commentary

Competitor commentary and industry data points reinforce the material tailwinds being experienced by FPH's Hospital segment. We expect a stellar 1H21 result and there remains an attractive long-term growth runway. COVID-19 has substantially increased clinician exposure to FPH's high flow nasal cannula oxygen therapy, which is likely an accelerant for adoption rates. However, at current price levels we see better value for risk elsewhere, although momentum remains firmly on the stock's side. UNDERPERFORM. (Published by Forsyth Barr)

NZX – 1H20 preview – Quick off the Blocks

Our analysis of NZX's monthly operating metrics suggests the company has performed well over the last six months, with standout performances in the Secondary Market and Data & Insights divisions. Consequently, we update our forecasts before the interim result on the 13th August. Given the strong start to the year, we see upside risk to full year forecasts and potential for a tightening or raising of full year guidance if better than expected trends continue. OUTPERFORM. (Published by Forsyth Barr)

Power Points – Should I Stay Or Should I Go? – August 2020

The Clash wasn't thinking about the Tiwai Point aluminium smelter when it wrote its classic 1982 song, but it does seem appropriate given what has unfolded in the past month. Rio Tinto (RIO) announced on 9 July that it was closing NZAS by 31 August 2021. A month on and the door last week appeared slightly ajar, and news that Transpower is accelerating its lower South Island transmission project is a significant positive for Contact Energy (CEN) and Meridian Energy (MEL), our preferred electricity sector stocks, both with an OUTPERFORM rating. (Published by Forsyth Barr)

The Cost of Capital Conundrum – When TINA Came to Our Shores

This year the NZ market has experienced its sharpest drop on record and then its fastest recovery in over 30 years. We have taken a hard look at all the input values in the Weighted Average Cost of Capital (WACC) calculations that we use to discount companies forecast future cashflows to a current valuation. Our changes imply an average reduction of WACC by ~1%, which all else equal increases the DCF based component of our price targets by c.25% and our average price target by around half of that, but there are large variations across stocks. The reduction to our WACC assumption reflects a reduction to our estimated implied Market Risk Premia (to c.6%) and a risk free interest rate of 1.3%. We will roll out updated cost of capital estimates throughout earnings season but also want to emphasise that "all else" is not equal. (Published by Forsyth Barr)

Australia

Aristocrat Leisure (ALL.AX) – Competitors Cutting Capex and R&D

ALL competitor IGT's 2Q20 result featured similar themes to SciGames's 2Q20 result, where both are cutting back heavily on capex and R&D in order to preserve liquidity as they swing to losses. At the same time, casino revenues have proven resilient. While ALL will face near-term pressure on profitability, this reaction from competitors and the resilience of casinos is supportive of the medium-term outlook for ALL's game performance and gaming operations revenues. Citi continues to expect a normalised environment to return by FY22e. BUY. (Published by Citi)

James Hardie Industries (JHX.AX) – Louisiana Pacific 2Q20 result read-through

Louisiana Pacific (LPX), a key competitor of JHX in the US wall siding market, reported its second-quarter CY20 result. Ord Minnett sees -5.5% volume decline for SmartSide as the best figure to use when comparing to JHX's guidance for exterior volume growth of 0-2% in the same period, which implies JHX continues to outperform LPX on volumes. BUY. (Published by Ord Minnett)

Origin Energy (ORG.AX) – Fourth-quarter FY20 production report

ORG delivered its June-quarter production report. Ord Minnett believes headwinds in the energy markets business represent the biggest near term risk, with FY21 guidance to be provided at the financial result on 20 August. ACCUMULATE. (Published by Ord Minnett)

ResMed (RMD.AX) – FY20 result – COVID headwinds and tailwinds, EPS 6% ahead

Citi's forecasts change on the better-than-expected Q4 result (FY20 EPS was 26% better than consensus), and assumptions around the impact of COVID-19. Citi reiterates that near-term forecasts are difficult while this pandemic continues, with ventilator revenue to decline, and Obstructive Sleep Apnoea revenue recovering, but at a slower rate. NEUTRAL. (Published by Citi)

Viva Energy Group (VEA.AX) – Trading update

VEA provided a trading update on July sales volumes for Victoria, indicating flat volumes for petrol and diesel combined, while petrol volumes fell -25%. Victoria accounts for 25% of Viva's national volumes. ACCUMULATE. (Published by Ord Minnett)

International**Comcast (CMCSA.O) – Asset Portfolio Poised to Recover, Cable Still on Solid Ground**

CMCSA reported better C2Q results on headline metrics led by the Cable business, while commentary from CMCSA and its competitors suggest the broader asset portfolio should recover in C3Q. Citi recognises the recovery is apt to take some time with some cross-currents based on employment levels, government stimulus, as well as live events and engagement. However, when Citi looks at a mostly-recovered operating environment in 2022 and the favourable valuations at which cable assets trade, Citi continues to like the upside potential. BUY. (Published by Citi)

L'Oréal (OREP.PA) – Faster than anticipated LFL recovery further strengthening L'Oréal's competitive advantages

L'Oreal's like-for-like (LFL) sales growth improved through the course of Q2 from -34% in April to -5% in June. UBS believes that L'Oreal's faster than expected top-line recovery will enable the company to further ramp up its advertising & promotional spending in 2H20, which should pave the way for additional market share gains and bring new impetus to the make-up and fragrance categories. BUY. (Published by UBS)

Microsoft (MSFT.O) – Starting the Clock on Talks to Buy TikTok

MSFT confirmed on its corporate blog ongoing, active discussions to acquire a portion of TikTok including the company's US business, pending talks with the US government. MSFT's efforts in ad-supported consumer internet services have been a mixed bag historically, and as a result UBS expects some investor scepticism regarding the proposed transaction. That said, MSFT has had success in recent years in taking an arms-length approach to acquisitions, which could help TikTok succeed where other MSFT efforts in consumer internet have struggled. Even a relatively large amount paid for TikTok would be fairly small within the greater whole of MSFT, limiting risk from an acquisition. BUY. (Published by UBS)

Calendar

Figure 7. Calendar

Date	New Zealand	Australia	International
10-Aug	ANZ Business Confidence (Jul) NBNZ Own Activity (Jul) Contact Energy FY20 Vital Healthcare FY20		
11-Aug	Electric Card Retail Sales (Jul)	NAB Business Confidence (Jul) NAB Business Survey (Jul)	US: JOLTs Job Openings (Jun) UK: Average Earnings Index +Bonus (Jun) UK: Claimant Count Change (Jul) EU: German ZEW Eco Sentiment (Aug) Prudential Plc 1H20
12-Aug	External Migration & Visitors (Jun) Permanent/Long-Term Migration (Jun) Visitors Arrivals (MoM) RBNZ Interest Rate Decision RBNZ Monetary Policy Statement RBNZ Press Conference AFT Pharmaceuticals AGM	Westpac Consumer Sentiment (Aug) Wage Price Index (Q2) Commonwealth Bank FY20 Transurban FY20 Downer FY20	US: EIA Short-Term Energy Outlook US: PPI (Jul) UK: GDP (Q2) UK: Manufacturing Production (Jun) UK: Monthly GDP 3M/3M Change Tencent 2Q20
13-Aug	Food Price Index (Jul) NZX 1H20 Precinct Properties FY20	Employment Change (Jul) Full Employment (Jul) Participation Rate (Jul) Unemployment Rate (Jul) MI Inflation Expectations Woodside Petroleum 1H20 Goodman Group FY20 Telstra Corp FY20 Treasury Wines FY20 QBE Insurance 1H20	US: Core CPI (Jul) US: Crude Oil Inventories
14-Aug	Business NZ PMI (Jul)	RBA Governor Lowe Speaks National Australia Bank 3Q20	US: Initial Jobless Claims CH: Industrial Production (Jul) Applied Materials 3Q20
15-Aug			US: Core Retail Sales (Jul) US: Retail Sales (Jul)

Source: Forsyth Barr analysis

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