WEALTH MANAGEMENT RESEARCH

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Wealth Weekly
Labour Policy Powers Up Electricity Stocks

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Global equities were mostly up in local currency terms but practically flat in NZ dollars last week. European equity markets were in the lead, while US markets tossed and turned amid election-related noise, and most of Asia was shut for the second half of the week. The NZX 50 managed a modest gain, while the ASX 200 rounded out the bottom of the leader board.

Labour's smelter policy provides a little bit more certainty

The Labour Party's policy release on the NZ Aluminium Smelter (NZAS) last Monday provided a little bit more confidence that a deal to keep the smelter open for a few more years is likely. Labour's policy is to negotiate with Rio Tinto to keep the smelter open for 3–5 years, enabling an easier transition for the Southland economy (and the electricity companies). A deal isn't certain, but if NZAS stays open, we believe the main beneficiaries (in terms of their ability to lift their dividends) would be Genesis Energy, Contact Energy and Trustpower, in that order.

All of the electricity stocks are up since the Friday before Labour's announcement, with Contact Energy (+12.3%), Mercury NZ (+9.3%) and Meridian Energy (+8.5%) delivering the highest total returns over the last 10 days. Whilst share prices are closing in on pre-closure announcement prices, we see further upside if Rio Tinto announces an extension deal given the fall in interest rates and the strong performance of yield stocks.

Themes of the week

The a2 Milk Company's downgrade to FY21 guidance last week was an uncharacteristic departure from the company's strong track record of earnings growth. It seems that **lockdowns in Victoria have hindered daigou (intermediary resellers) from rebuilding their inventories of a2's infant formula for export to China**. The company's share price is down -16.6% since the announcement. While the extent of this disruption was worse than expected and has prompted us to trim our profit forecasts and target price, we see it as a one-off impact affecting only one of the company's sales channels. **Indicators of the health of a2's brand and the growth from bricks and mortar channels in China reportedly remain strong**, which is more important for a2's long-term outlook than the short-term COVID-related disruptions that led to this downgrade. **We retain an OUTPERFORM rating on the stock**.

Last week's chaotic debate between Donald Trump and Joe Biden, and Trump's subsequent illness, complicated the latter's path to re-election on 3 November. US equity markets appeared unsure how to react, with futures/stocks first declining before recovering following both events. This shows how **politics more often amounts to noise than substance as far as the real economy goes**. Other factors matter more. Central banks remain relentless in their efforts to stimulate lending and asset prices, and indeed housing appears to be one of the boom sectors both here and overseas. **Data suggests most economies are recovering** as well as or better than expected. Recent resurgences of COVID-19 might yet change that, but equally, progress on vaccines could further boost the outlook.

NZ Government Bonds (NZGBs) delivered another (final?) year of decent returns in the 12 months to the end of September. Despite yields having reached preposterously low levels, demand for NZGBs remains strong, with some parts of the yield curve in negative territory — implying that bond investors expect interest rates to fall further. **Corporate bond issuance continues to trickle along as companies look to replace some of their temporary bank debt facilities with longer-term funding**.

Looking ahead

Politics — particularly Trump's condition and progress in US stimulus talks — will be in focus this week. Australia's Budget on Tuesday night is expected to include tax cuts and higher infrastructure spending. The earnings front remains quiet, with Tesco the only major company reporting (on Wednesday). Internationally, AGMs will bring trading and guidance updates, including Transurban on Thursday. The Reserve Bank of Australia will release its interest rate decision on Tuesday and its Financial Stability Review on Friday.

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Electricity Sector

More Positive Smoke Signals From Labour Policy on Tiwai Point

In effect the Labour Party is promising to continue current negotiations with Rio Tinto (RIO) to keep the NZ Aluminium Smelter (NZAS) open for longer. Support for NZAS will come in the form of lower transmission charges, with Labour likely to accept a lower dividend from Transpower to ensure there is no increase in power prices for consumers.

We view a delay of the NZ Aluminium Smelter's closure as the most likely outcome of continued negotiations. But Labour has also set out four conditions for a deal, the two key conditions being continued staff employment and an agreement on land and aluminium dross remediation. Given these conditions, **there are still a variety of plausible scenarios** (Figure 1).

Figure 1. Possible outcomes from RIO's NZAS decision

Scenario	Rationale/thesis	FB probability
NZAS closes in August 2021.	RIO still wants to close NZAS and remediation requirements too great to accept the offered extension deal.	Unlikely
RIO reverses its decision and reverts to 12-month notice period (on a lower price than currently, but higher price than options below).	Changes at executive level and greater RIO emphasis on ESG causes reversal of original decision. Remediation costs now fully factored into decision. Also retains RIO optionality.	Highly unlikely
RIO accepts Transpower/MEL/CEN offer and extends for 3 to 5 years.	RIO still wants to close NZAS (for portfolio reasons) and was going to undertake remediation anyway — lower electricity price offer too good to refuse.	Probable
RIO reverses closure decision and decides to accept long-term deal to 2030.	RIO wants to maintain optionality/ESG considerations make staying open more attractive and accepting MEL/CEN long-term electricity price offer better than reversing decision.	Unlikely

Source: Forsyth Barr analysis

Environmental condition could be a stumbling block/result in an alternative outcome

Labour's language that it expects RIO "will do the right thing" in regard to environmental remediation is interesting as it indicates the current legal requirements on RIO to remediate land are not significant (notwithstanding the NZ$299m provision in NZAS's financial statements). That raises some questions: what did RIO assume when it announced closure? And will the combined Transpower / Meridian Energy / Contact Energy reduced electricity price offer offset the increased remediation expectations? These are not trivial questions and in our view means an extended deal is not a fait accompli.

How important is option value to NZAS?

We expect Meridian and Contact will sell the discount power NZAS currently receives to replacement users (dairy/data centres/ hydrogen). If RIO wants to preserve optionality (which has arguably increased in value over the past 2½ months due to aluminium prices firming and environmental/social/governance issues becoming more important), accepting a deal involving the Government is not an option. Alternatives would be reversing its July decision to close, or accepting MEL's low-priced offer to 2030.

Surprising share market reaction, but more upside if NZAS does stay open due to increased dividend yield certainty

The ASX electricity futures market price for FY22 is above the pre-closure announcement price, implying a near 100% chance NZAS will stay open longer.

The positive share market reaction was surprising in that Labour's policy announcement just puts into writing what Government ministers have more or less been saying for the past month in various interviews. That said, given the fall in interest rates and the strong performance of yield stocks, the **share prices could rise further if the NZAS closure is deferred**.

Dividend considerations

If NZAS does stay open for longer, the main beneficiaries (as measured by an increase in our FY21 dividend forecast) are Genesis Energy, Contact and Trustpower in that order. Whilst Mercury NZ and Meridian were among the strongest share price performers alongside Contact, we do not expect Mercury NZ or Meridian to lift FY21 dividends — for Mercury that will occur in FY22 and Meridian still needs to digest the strong FY20 performance, and it will be "paying" ~1.7cps worth to NZAS.

At current prices our preferred major electricity stocks are OUTPERFORM-rated Contact Energy and Meridian Energy.

Themes of the Week

NZ Equities

A2 Milk (ATM) — Short-Term Pain? Digesting Daigou Disruption

ATM provided a downbeat trading update last Monday morning, and the stock took a hammering as a result (-17.6% last week). ATM's new FY21 guidance implies revenue growth of between +4% and +10% year-on-year compared to FY20, which was meaningfully below expectations. Profit margin guidance was raised by a smidge to the top end of the previous range of 30-31%.

ATM blamed the downgraded outlook on weakness in demand for infant formula in Australasia, predominantly because weak tourism, a lack of international students and COVID-19 lockdowns caused a decline in demand from retail and corporate daigou. (Daigou are people who buy products outside China to sell to consumers in China.) In particular, the lockdown in Victoria has limited the incremental demand from corporate daigou to replenish inventories. **ATM indicated it expects these disruptions to continue for the rest of 1H21, followed by stabilisation and some improvement in 2H21**. ATM is running a range of incentive programmes for daigou to stimulate demand.

These daigou disruption themes aren't new, but the magnitude of the impact was a surprise. The slower growth expected in FY21 is a blemish on ATM's otherwise consistent track record of profit growth.

The key question now is whether this a temporary issue, or something more permanent. We view this as a temporary setback. While the short-term pain is worse than anticipated, **this appears to be a single-channel, single-product problem, with other areas still growing strongly and meaningful growth avenues remaining**. ATM signalled that brand health metrics are at record levels and other channels (including the important China offline channel) continue to deliver strong growth.

We cut our operating profit estimates for ATM over the medium-term as a result, and reduced our target price to NZ$23 (also partly due to a lower share price for ATM's stake in Synlait Milk, which last Monday reported a disappointing FY20 result and also gave weak guidance for FY21). **Our rating on ATM remains OUTPERFORM**.

Macro Strategy

US presidential election noise

US equity futures took a hit in after-hours trading following the unruly debate between presidential candidates Donald Trump and Joe Biden, but in the regular trading session the next day the US market rallied quite strongly. Equities (and especially the big tech stocks that have driven this year's market gains) then took a dive on Friday morning after Trump announced his COVID-19 diagnosis, which seemed to raise the odds of a Biden victory, but cyclical stocks recovered later in the day on hopes that the uncertainty caused by Trump's condition might increase the willingness of US politicians to reach a compromise on a new fiscal stimulus package.

One way to think about potential outcomes from the US presidential election would be:

- If the current gridlock between the Democrat-led House and Republican-led Senate is maintained, the market will probably view this as business as usual and respond favourably.
- If the outcome is close and contested, then there could be a reasonable market correction while uncertainty persists.

It's important for investors to look through the short-term noise of political headlines and focus on what we do know and what drives the real economy in the longer-term — the outlook for a vaccine or effective treatment for COVID-19, monetary policies, economic stimulus, and trends in employment, housing and consumption.

Global macroeconomic data continues to improve

Globally, recent economic data points to a broadening recovery. In China the manufacturing expansion continues, led by new export orders (which is a positive sign for the rest of the world), and China's services expansion is currently the strongest it has been since 2013 (during the last major stimulus phase).

The Eurozone's economic sentiment index has strengthened more than expected while in the US, the Case-Shiller home price index has exceeded expectations, adding to the wealth effect for US home owners. Consumer confidence and retail sales have also been well ahead of expectations. As activity and consumption increase, depleted inventory levels need to be replenished, which is feeding back into the manufacturing cycle.

Housing boom

Central banks are committed to keeping interest rates low for years. One of the early beneficiaries of this policy has been the housing sector. Housing related activities — construction, home improvement spending, homewares spending and house prices — are booming in New Zealand, the US and elsewhere. While house construction itself contributes a relatively small amount to overall GDP in most countries, it tends to be associated with strong multiplier effect that has positive influences throughout the economy:

- construction increases activity directly in the trades and indirectly in the manufacturing sector to supply and transport materials;
- higher household formation tends to be accompanied by higher spending on ancillary goods like furniture, electronics, cars etc;
- robust housing demand strengthens the outlook for bank lending.

Housing can be subject to booms and busts, with the GFC primarily caused by the US house price crash. But the current boom looks to have legs for now as bank balance sheets are in a stronger position, prudential regulators like Australia's and New Zealand's have taken their feet off the regulatory brakes, and central banks are resorting to ever more creative methods of stimulating banks to lend, including providing direct funding at very low rates.

Increasingly rosy outlook

So, ignoring the noise from politics, the outlook for the real economy looks reasonably robust. Add in the potential for a vaccine or effective treatment in 2021, and the potential for blue sky is increasing.

Fixed Interest

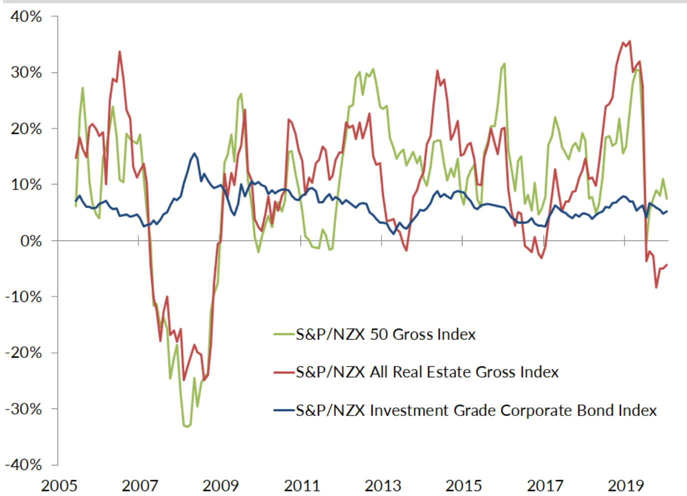
There is nothing like the real thing

The underlying theme in financial markets is that ultra-low interest rates will continue to support the move from bonds to equities. Whilst this is a fair argument, **bonds have continued to perform well, particularly when compared to the so-called bond proxies like property stocks**. Over the last year, practically risk-free New Zealand Government bonds (NZGBs) have returned +4.45% whereas the S&P/NZX Real Estate Index has returned -4.30% (Figure 2), illustrating that there is no replacement for the real thing. Bond coupons have continued to be paid while property companies have cut or cancelled dividends, and the protection of capital on bonds remains; whereas this is clearly not the case for property stocks where valuations have taken a haircut as a result of COVID-19.

The continued outperformance of NZGBs — despite having coupons that are negative in some cases (Figure 3) — indicate where wholesale investors believe interest rates are heading: down. **Demand for NZGBs is meeting the unprecedented supply**, with last week's NZGB tender witnessing bids easily outweighing the amount of NZGBs on offer. For example, the NZ$250m of April 2029 bonds offered at a yield of just 0.38% received NZ$1,156m of bids.

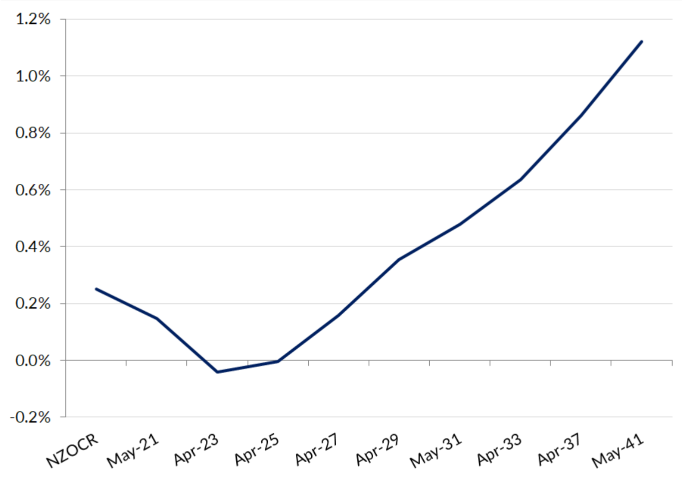
Corporate issuance continues to trickle along with Oceania Healthcare (OCA) the latest to join aged care sector issuers Summerset and Metlifecare in issuing 7 year bonds. We would expect corporates in this and similar sectors to be regular issuers in the market, with banks looking to offload some of the temporary debt facilities that may have been established during lockdown.

Figure 2. Rolling 12 month index returns (gross) bonds v equity



Source: Forsyth Barr analysis, Refinitiv

Figure 3. NZ Government Bond Yield Curve



Source: Forsyth Barr analysis

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Research Worth Reading

New Zealand

Air New Zealand (AIR) — Strategy Refinement: From Supercharge to Enrich

At its Annual Shareholder Meeting, AIR said it has drawn down NZ$110m of the government's funding facility and suggests it will be "looking to go to the market in the early part of 2021" for an equity recapitalisation. New CEO Greg Foran's strategy refresh is more refined than radical. There is a less apparent growth emphasis and no mention of the previous Pacific Rim approach. AIR's cash burn and equity dilution continues, yet its share price remains in the NZ$1.30–NZ$1.40 range. We retain an UNDERPERFORM rating. (Published by Forsyth Barr)

Real Estate Reflections — Who Can Buy Growth?

The listed property vehicles (LPVs) outperformed the broader market for the third month in a row (+2.6% in September vs. the S&P/NZX 50G -1.6%) as COVID-19 uncertainty slowly abates and low interest rates support valuations. Portfolio activity has picked up with balance sheet capacity being accretively deployed and non-core assets divested at premiums to book value. We continue to favour Investore (IPL) and Vital Healthcare Property (VHP) for their defensive attributes and Stride (SPG) for the leverage in its asset management platform. But given recent share price performance, the upside to our target prices has moderated across the sector. (Published by Forsyth Barr)

Sanford (SAN) — An Alternative Valuation

SAN provides investors exposure to a series of unique, quasi-property assets, in its significant fishing quota holdings and extensive marine farm licences. SAN's share price has seen a material de-rating through 2020 as the company attempts to navigate COVID-19 headwinds. Whilst news flow is expected to remain negative in the short-term, we view SAN's share price as approaching an asset backed support level and therefore see an attractive entry point. At the current market price, investors appear to be receiving the aquaculture assets for free. OUTPERFORM. (Published by Forsyth Barr)

Australia

Amcor (AMC.AX) — Investor day feedback

AMC held an investor day. Part of the session was designed to introduce new investors to the company, with CEO Ron Delia providing a basic overview. In Ord Minnett's view, the message was clear that AMC sees a plethora of growth drivers across both divisions, including 1) growing markets, 2) customers and end-user desire for more sustainable packaging, and 3) favourable shifts in mix by segment and customer. ACCUMULATE. (Published by Ord Minnett)

CSL (CSL.AX) — The brief on Behring: June PPTA data, Sept plasma centre openings and mobility update by key state

Of the 91 plasma collection centres opened over the last 12 months, 40 (~44%) were owned by CSL. With 13 centres opened since June-20, CSL appears well on track to reach its FY21 target of 20-30. Inability to catch public transport to plasma centres has been identified as a contributing factor to the decline in donor attendance. UBS is currently forecasting a -20% decline in plasma collection in the April-September period, with recovery thereafter. BUY. (Published by UBS)

James Hardie Industries (JHX.AX) — Louisiana Pacific investor day read-through

JHX's competitor Louisiana Pacific (LPX) held an investor day. The key update relates to siding sales guidance for the September quarter. End-market exposure differs between LPX and JHX, although Ord Minnett believes the significant step up in expectations for Strand reflects continued improvement in end-market demand. This is positive for JHX, in Ord Minnett's view, and bodes well for its exteriors business in the quarter. ACCUMULATE. (Published by Ord Minnett)

Santos (STO.AX) — NSW government approval for Narrabri Gas Project

The NSW state government's Independent Planning Commission has announced a "phased approval" for the STO's Narrabri Gas Project. The approval paves the way for federal environmental approval, but also subjects the project to a number of groundwater assessment and emissions offsetting requirements. ACCUMULATE. (Published by Ord Minnett)

International

Alibaba Group (BABA.N) — Investor Day 3/3: earnings growth sustainable despite competition and long term investments

UBS feels slightly more bullish on BABA's opportunities in cloud and logistics after the analyst day, but there should be no major changes to consensus estimates. BABA believes digitalisation is the biggest opportunity of our time, which is even clearer after COVID-19, and sees three key growth drivers: domestic consumption, cloud, and globalisation. UBS believes the first two drivers hit inflection points this year, with online retail penetration reaching a new high and enterprises ramping up cloud investments. But due to geopolitics, globalisation ambitions are more limited to Southeast Asia, in UBS's view, at least in the near to medium term. BUY. (Published by UBS)

FedEx (FDX.N) — Margin Runway Is Long & Improving FCF Provides Support; Highlights From Our Call With FDX

On Tuesday UBS hosted a conference call with FDX's Investor Relations team which covered a broad range of topics including cyclical factors like international airfreight capacity and company specific drivers such as last mile efficiency and collaboration between Express and Ground. UBS believes the mix of company specific drivers and benefits from a very strong package delivery market point to EPS growth potential that supports further upside for FDX, even after the strong run it has had this year. BUY. (Published by UBS)

LVMH Moet Hennessy Louis Vuitton SA (LVMH.PA) — Q3 with scope for a positive surprise

Over the past three months shares of LVMH have underperformed the sector and especially its closest peer Kering by c.-17% due to the much needed consensus rebase following 1H results. However, UBS believes Q3 results have room to surprise positively due to:

- sequential improvement in sector trends (driven by a stronger than expected US consumer in addition to ongoing China robustness),
- LVMH Fashion & Leather Goods brands still outperforming peers (according to UBS Evidence Lab data)
- Not overly positively skewed buy-side positioning into the print.

BUY (Published by UBS)

Siemens (SIEDn.DE) — A new Siemens inplace: Spinning Energy AS leaves a €122 PT and more milestones ahead…

Post the spin-off of Siemens Energy, SIEGn will be focused on four business segments which in UBS's view have interesting long-term growth trends:

- Digital Industries focused on factory automation, process automation, software and service
- Smart Infrastructure, focused on building automation and electricity distribution amongst other activities
- Mobility, focused on rolling stock, signalling, services and solutions
- Healthineers, focused on healthcare equipment. UBS believes the transformation story of SIED is not finished yet.

BUY (Published by UBS)

Walt Disney Co (DIS.N) — Job Cuts Announced at Disney's Parks Segment

DIS disclosed plans to lay off 28,000 employees within its Parks, Experiences and Products division. Citi suspects that DIS bears may interpret this move as a sign that the recovery in the firm's Parks segment may be progressing more slowly than anticipated. However, given that management has been keenly focused on managing the profitability of Parks in the current environment, Citi does't believe that this move should come as too much of a surprise. BUY. (Published by Citi)

Calendar

Figure 4. Calendar

Date	New Zealand	Australia	International
5-Oct	ANZ Commodity Price Index	Services PMI Melbourne Institute Inflation Gauge NAB Business Confidence (Sep)	UK: Composite PMI (Sep) UK: Services PMI (Sep) CN: Mid-Autumn Festival (Markets Closed) US: ISM Non-Manufacturing PMI (sep)
6-Oct	NZIER Business Confidence NZIER QSBO Capacity Utilisation	AIG Construction Index (Sep) Exports & Imports (Aug) Trade Balance (Aug) ANZ Job Advertisements RBA Interest Rate Decision (Oct) Saracen Minerals AGM	UK: Construstion PMI (Sep) CN: Mid-Autumn Festival (Markets Closed)
7-Oct	GlobalDairyTrade Price Index	AIG Services Index (Sep) RBA Chart Pack Release Home Loans	US: EIA Short-Term Energy Outlook US: JOLTs Job Openings (Aug) CN: Mid-Autumn Festival (Markets Closed) Tesco 1H21 result
8-Oct	ANZ Business Confidence	NAB Business Survey Transurban Group AGM Transurban 1Q21 Sales & Revenue Brambles AGM	US: Crude Oil Inventories US: FOMC Meeting Minutes US: FOMC Statement CN: Mid-Autumn Festival (Markets Closed)
9-Oct	Business NZ Purchasing Managers Index Food Price Index	RBA Financial Stability Review	US: Initial Jobless Claims UK: GDP UK: Manufacturing Production (Aug) UK: Monthly GDP 3M/3M Change EU: ECB Monetary Policy Statement JP: GDP Costco September Sales & Revenue

Source: Forsyth Barr analysis

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