

# Wealth Weekly

## Looking at the Big Picture

## WEALTH MANAGEMENT RESEARCH

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The stronger outlook for growth, particularly in the US as the vaccination programme rolls out and President Biden's US\$1.9 trillion stimulus package was approved, have contributed to increases in long-term interest rates and a cyclical rebound in the US dollar. We believe a strong growth outlook together with middling inflation is likely to be positive for equities.

**What do rising rates mean for markets?**

Central bank officials remain committed to holding cash rates around 0% for the foreseeable future, despite rising inflation expectations. In the US, medium-term bond markets are now pricing in inflation well above the Federal Reserve's target of 2.0% pa. **The implication is that a strong economic expansion is underway, enabled by Fed policy, which should lead to an even steeper yield curve** (long-term rates rising higher than short-term ones). Fed officials seem relaxed about the reasonably orderly nature of recent bond yield increases as it reflects a stronger growth and inflation outlook, which is positive in their thinking. Historically, 10-year US bond yields have risen to around +3-4% higher than the cash rate; currently they are about 1.45% apart, which suggests **there's much further to go before either the Fed starts raising cash rates or the market decides the level of longer bond yields is becoming a negative influence on growth and earnings.**

**The consensus view of most central bankers is that higher inflation will be transitory.** For inflation to be sustained at a high level, utilisation of the economy's productive capacity would need to increase, probably to above 80% in the US. If a business tries to raise prices when a competitor has spare capacity, it is likely to lose market share. Having trended down for years, utilisation is currently 74%, and it has failed to reach 80% since before the global financial crisis, so the odds of it recovering to a level high enough for inflation to become entrenched look slim.

In summary, **the steepening of the bond yield curve is very positive indicator.** A strong economic expansion is underway which augurs well for earnings growth. In some competitive sectors margins might come under pressure from rising input costs (agricultural commodities, oil, metals, freight) and higher US corporate tax rates, but inflation looks unlikely to be sustained at a high level.

We recommend remaining **underweight fixed income and overweight equities** in portfolios.

**Themes of the week**

Fishing company **Sanford** provided a market update, highlighting that the recovery in demand from the food service sector for seafood continues to lag other areas of the economy, while cost inflation from supply chain congestion and labour shortages are **weighing on profit margins.** We have cut our earnings forecasts and downgraded our target price. But we expect 1H21 earnings to represent a low in the cycle, and view the current share price as an attractive entry point. We have retained an OUTPERFORM rating.

**Precinct Properties** has internalised its management, paying its former manager a net NZ\$145m upfront to generate annual savings of NZ\$14.6m. We think the deal has merit, but comes at a full price. The resulting increase in gearing means asset sales or a capital raising may be required if the fund buys new assets. Our rating remains OUTPERFORM.

Last week **the Reserve Bank of New Zealand** said banks can apply to redeem their capital securities, ending an outright ban on redemptions that it had put in place early in the pandemic. There are three such securities from BNZ, ANZ and Kiwibank that could be redeemed in the coming months, and one from ASB with a call date in December.

**Looking ahead**

On Thursday and early Friday NZ time, the US Fed and European Central Bank will release minutes from their mid-March meetings. US corporate reporting season will kick into gear from the middle of next week. The NZ Government has announced 19 April as the start date of the trans-Tasman travel bubble.

## Macro Snapshot

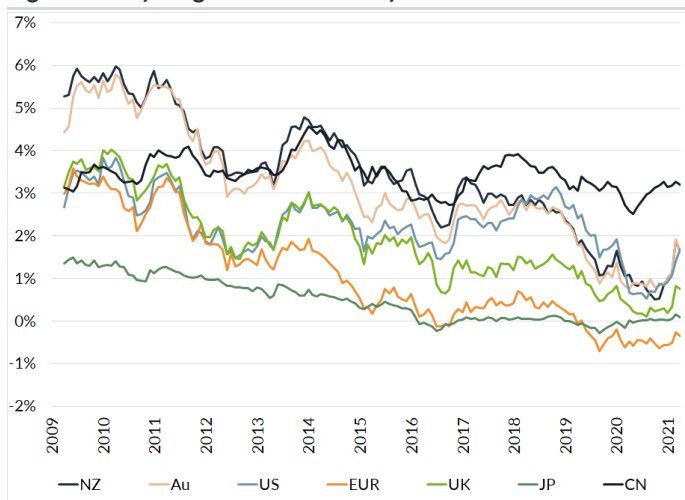
### Interest rates, yield curves, inflation and growth

The recovery in bond yields this year has had a material impact on financial markets as investors embraced the "reflation trade" – rotating out of growth stocks and into less defensive, more cyclical stocks. Despite widespread market assumptions that the Federal Reserve would intervene to keep yield curves reasonably flat, Fed officials, including Chair Jay Powell, have expressed reasonably relaxed attitudes to the rise in long bond yields. Most official commentary has taken a positive interpretation that higher interest rates reflect increasing confidence about the impact of vaccinations and fiscal stimulus on growth.

The increase in longer-dated bond yields also reflects increasing inflation expectations and concerns about global supply of bonds as government fiscal deficits expand dramatically. As inflation expectations have increased, real bond yields have also recovered from their lows (Figure 1), which is leading to a tightening in monetary conditions.

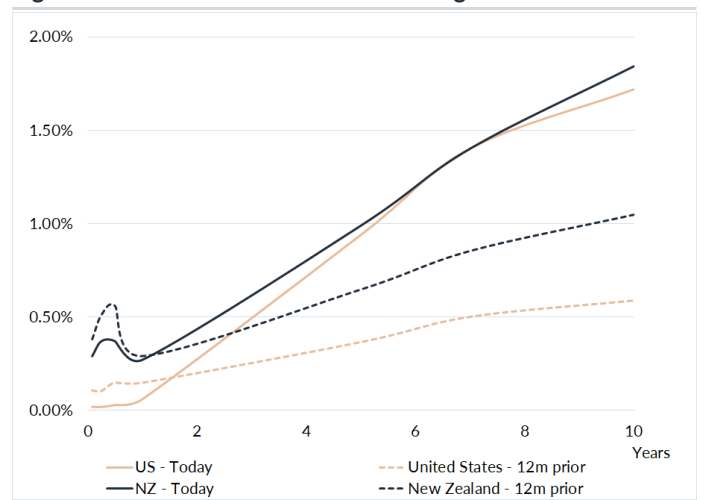
With US 10-year Treasury bond yields rising to pre-pandemic levels, and the growth outlook for the US economy improving substantially due to vaccinations and President Biden's US\$1.9 trillion American Relief Plan, the US dollar has also bounced off its cyclical lows. A stronger US dollar and higher interest rates have effectively tightened monetary conditions, which may have contributed to the recent pullback in commodity prices.

**Figure 1. 10-year government bond yields over time**



Source: Bloomberg, Forsyth Barr analysis

**Figure 2. Yield curves now vs 12 months ago**



Source: Bloomberg, Forsyth Barr analysis

### Yield curve signals

Yield curve spreads (the difference between long and short rates – Figure 2) tend to narrow when central banks are raising rates as economies are expanding strongly, and tend to flatten out/invert when the market perceives tightening has gone too far and a credit crunch/financial crisis is imminent. Conversely, yield curves tend to widen/steepen when central banks are still keeping cash rates low at the end of their easing cycle while allowing economies to recover and then expand (current environment).

Based on the official view that the Fed (and other central banks) will keep cash rates around zero for at least the rest of this year, yield curves are likely to keep steepening, with long-dated bond yields rising faster than short-term interest rates. This yield curve spread is currently around 145bp (1.45%) in the US. Based on past cyclical behaviour, this spread could get to between 200-300bp (2-3%) before the Fed starts lifting its cash rate.

### Higher nominal bond yields

Assuming yield curves continue to steepen, we could expect nominal 10-year bond yields (NZ, Australia, and US) to head to between 2-3% over the next 12-18 months, perhaps trading in a 1.5-3.0% range, similar to most of the post-GFC years. If higher global inflation does materialise in a sustained way, nominal interest rates at these levels should not be a concern for the equity market as real rates will remain close to, or below zero. With a robust growth outlook for the US and much of the rest of the world over the next 12-24 months due to a reopening of most sectors and the impact of massive fiscal stimulus, the positive impact on earnings should be well in excess of the relative increase in business cost of capital (for 2021 at least).

## US inflationary expectations

Central bank officials currently are speaking in unison about the expected 'transitory' nature of higher inflation over the next 12 months due to the base effect of a slump in prices during the pandemic that will roll out of official year-on-year data from Q2 onwards.

Using the long-run Federal Reserve breakeven inflation data, the market's current inflation expectations are running well ahead of the Fed Funds Rate. Inflationary expectations have only gone back to the long-run average, and the Fed and other central banks seem adamant they won't repeat the previous mistake of raising their cash rates too early, until actual inflation heads well above the mandated targets. If the Fed is so far behind the inflation curve, that would suggest an economic boom is underway, which supports remaining overweight equities in portfolios.

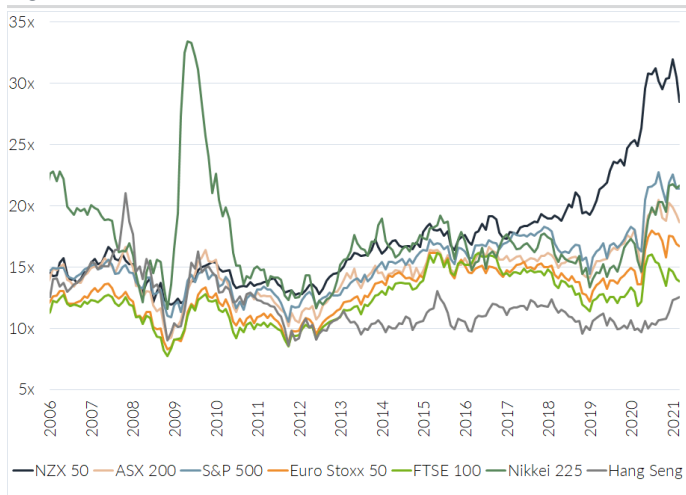
## Could sustainably higher inflation materialise?

Corporate pricing power is dependent on a high level of capacity utilisation. If a business tries to raise prices at the same time as competitors have spare capacity, it will likely lose market share. In the US, the magic level of capacity utilisation seems to be around 80%. Since the GFC, the US economy has rarely touched this level. Maybe it will over the next 12 months or so, but history suggests it will be fleeting and unsustainable – particularly as more and more technology is introduced to cut costs and improve productivity.

## Equity valuations

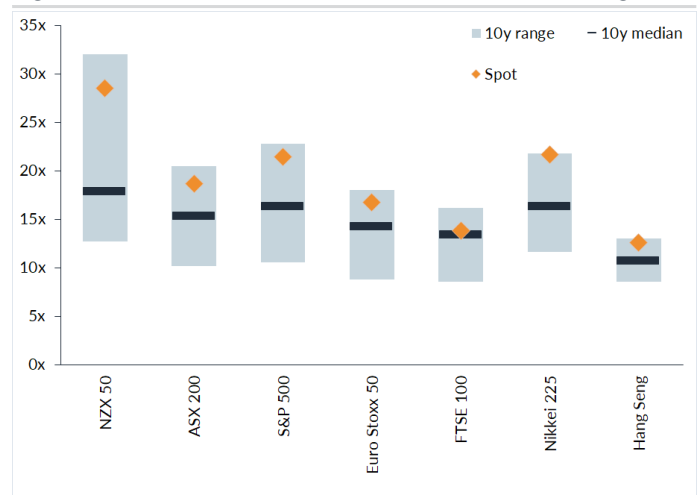
The recent rise in bond yields doesn't seem to have dented investor appetite for equities, with the S&P 500 having recently closed at a new all-time high. The main reason seems to be analysts revising up their earnings-per-share (EPS) growth forecasts. Consensus expectations are for +26% EPS growth this year and +15% in 2022. The positive outlook for earnings as well as the tsunami of liquidity that continues to flow through most economies continue to prop up valuations, which remain not far off their cyclical highs (Figure 3).

**Figure 3. Forward PE multiples over time**



Source: Forsyth Barr analysis

**Figure 4. Current PE multiples vs 10-year median and range**



Source: Forsyth Barr analysis

When comparing forward price/earnings multiples, New Zealand stands out as the most expensive equity market (Figure 4). Mostly this is due to compositional differences, with the local index being overweight defensive yield stocks, which tend to be more expensive everywhere. This bias to "expensive defensives" also makes the local market more vulnerable to a larger correction as interest rates rise.

Australia by comparison is much cheaper, due to the underperformance of financials (which dominate the ASX 200 index) in recent years.

The UK, which has a lower starting point for valuations, may offer tactical opportunities due to its cyclical recovery potential as the successful vaccination programme continues.

While the US market is relatively expensive in a historical context, higher US rates, a larger fiscal support package, steeper yield curves (good for financials) and a stronger US dollar, should ensure the majority of global equity allocation remains in the US.

## Themes of the Week

### NZ Equities

#### Sanford (SAN.NZ) – Still Looking to the Horizon...

SAN's market update last week highlighted ongoing challenges in the seafood sector.

**The recovery in foodservice demand is slow** and is lagging other areas of the economy. Parts of Europe have entered another lockdown and while demand in North America is improving, it remains at suppressed levels. Positively, volumes are beginning to move again and the growth in inventory has slowed. SAN is trying to shift product towards the retail channel, and market anecdotes suggest a number of small wins, particularly in King Salmon and Orange Roughy.

But for now SAN remains a largely commodity-driven business, and **on average, product prices are down -8% on prior year levels**, led by weakness in mussels. We expect price recovery to occur as demand returns and excess inventory clears.

**Cost inflation is compounding the earnings pressure**, with supply chain congestion and labour shortages weighing on margins. Supply chain and inventory holding costs are up c.+25% on the prior year.

The path and timing of a recovery in earnings remains uncertain. **We have made material cuts to our near-term earnings forecasts, and pushed out a recovery to a pre-COVID-19 level of earnings to FY23.** We expect 1H21 to represent the low in SAN's earnings cycle.

**Soft earnings and high inventory working capital requirements have pushed gearing to elevated levels**, although it remains within covenants. The company is re-prioritising capital expenditure as a result. Previously signalled asset sales have generated NZ\$24m of cash to alleviate some pressure.

We downgraded our target price to NZ\$6.00. **We view the current share price as an attractive entry point for exposure to a series of unique fisheries and marine farm assets, for investors who are willing to be patient.** OUTPERFORM.

### Listed Property

#### Precinct Properties NZ (PCT.NZ) – Better Off Alone

PCT last week announced that it is becoming an internally-managed vehicle from 1 April 2021, with the management team transferring from AMP Haumi Management (AHML) to become employees of PCT. PCT has paid AHML a lump sum of NZ\$215m (or a net NZ\$145m assuming favourable tax treatment and after cancellation of NZ\$10m of development fees). In return, PCT will no longer have to pay AHML NZ\$14.6m pa in fees, which PCT expects will eventually increase its available funds from operations (AFFO, an operating profit metric) by +6% pa. PCT's management expense ratio will decline to a sector low of 0.31% (from 0.74%).

The large upfront payment to AHML will increase PCT's gearing to the upper end of the company's target range, which limits balance sheet flexibility. With speculation that PCT is looking to purchase the Downtown carpark contiguous to 88 Quay Street in Auckland, and the final stage of Wynyard yet to commence, further asset sales and/or a capital raising are now more likely.

**We think the internalisation deal has merit as it better aligns management and shareholder interests. But it comes at a full price compared to other recent transactions.** We maintain our OUTPERFORM rating, with internalisation supporting better medium-term dividend growth prospects.

## Fixed Interest

### RBNZ paves the way back to normality

Last week the **Reserve Bank of New Zealand (RBNZ)** lifted its ban on New Zealand banks redeeming their existing capital securities. The temporary restrictions have been in place since April 2020 in response to uncertainty about what impact the COVID-19 pandemic and subsequent lockdowns would have on the economy and banking sector. The RBNZ has allowed banks to start paying dividends again, albeit a 50% restriction applies until July 2022.

Whilst the RBNZ has given the green light for banks to 'ask' if they may redeem a number of capital securities, the RBNZ has stated that a cautious approach will be taken before any such permission is granted. With new rules around capital securities coming into play on 1 July 2021, banks may choose to wait and replace — or will the Australian parents have other ideas?

There are four securities that are immediately impacted by the lifting of the restrictions. BNZ has NZ\$550m of subordinated Tier 2 securities (BNZ090) that it would have surely redeemed in December 2020, had the restrictions not been in place. ANZ (ANBHB, NZ\$500m) and Kiwibank's (KCFHA, \$150m) Additional Tier One Subordinated Notes would have also been redeemed in May of 2020 if the banks had been allowed. ASB's (ABB050) NZ\$400m of subordinated Tier 2 securities have a call date in December 2021, which may fit nicely with new rules and a transition period in place once that rolls around.

In April both ANZ and Kiwibank would have to announce to the market their redemption plans should they wish to redeem in May.

The banks have had plenty of time to adjust to the new regime. We believe the banks would be well prepared to comply with the new capital security rules.

## Research Worth Reading

### New Zealand

#### Kathmandu (KMD) — 1H21 Result — Solid Footing, Time to Climb

KMD's 1H21 result was supported by a strong Rip Curl performance, which offset seasonal weakness in its Kathmandu brand. KMD reported 1H21 underlying EBITDA of NZ\$48m, in the middle of its guidance range. Positively, the 2H21 outlook appears supportive of a return to earnings growth, with Rip Curl's wholesale forward order book ahead of pre-COVID-19 levels, accelerated cost savings realised from operating synergies, and a clean inventory position for Kathmandu's seasonally important winter period. We view earnings momentum as tilted to the upside and maintain our positive investment view. **OUTPERFORM**. (Published by Forsyth Barr)

### Australia

#### Charter Hall Group (CHC.AX) — Development Pipeline

CHC held a virtual development presentation, showcasing its capabilities, projects and pipeline. CHC has ramped up the scale of its office and industrial developments, with development likely to provide a higher proportion of assets under management (AUM) growth as transactional markets are tight. In Ord Minnett's view, CHC has a better track record and a larger pipeline than the market gives it credit for. It has delivered A\$5b of developments since FY15, equating to about 15% of its AUM growth over that time. Its current development pipeline is A\$7.0b, which would add a further 15% in AUM. More than half the pipeline (A\$3.6b) is committed and under construction. **ACCUMULATE**. (Published by Ord Minnett)

#### Nufarm (NUF.AX) — ADAMA 4Q20 result and outlook read-through

Off-patent crop protection player ADAMA's 4Q20 result and outlook suggests global demand for crop protection products remains strong, supported by a positive outlook for crop prices. While increased supply saw lower raw material prices in China in 4Q20, ADAMA has flagged a more recent pickup in procurement costs this year, which could impact gross margins industry-wide. NUF is currently emerging from a tough set of agricultural and industry-related headwinds that have buffeted the company over the past three years. NUF is trading on ~6x EV/EBITDA based on FY21 estimates, which Citi views as good value given a 3-year EBITDA CAGR of +23% to FY23e and a strong balance sheet. Citi expects the scaling-up of Nuseed's omega-3 canola opportunity would also provide further long-term growth optionality. **BUY**. (Published by Citi)

#### Santos (STO.AX) — Barossa final investment decision

STO announced final investment decision (FID) on the Barossa gas project, which will backfill the Darwin LNG project. This should sustain production from the facility for a further 20 years. STO's planned equity sell-downs at the Bayu-Undan, Darwin LNG and Barossa projects will further strengthen the balance sheet and provide the company with flexibility to fund future growth projects. **ACCUMULATE**. (Published by Ord Minnett)

### International

#### Apple (AAPL.O) — Go Ahead, Bite the Big Apple; Auto Optionality Offsets "Normal" iPhone Cycle. Upgrade to Buy

No Supercycle? No problem. Valuation + optionality + seasonality = Buy. UBS upgraded AAPL to Buy and raised its price target to US\$142 from US\$115 to reflect a more stable long-term iPhone demand backdrop, with better average selling prices and to capture the "real" option value of AAPL's likely entry into the auto market that UBS believes is not reflected in AAPL's shares. While UBS's analysis of iPhone procurement and mix drives UBS's FY22 estimates higher and its "core" value to US\$128 (from US\$115), analysis of the auto market and AAPL's multi-year investment in the industry suggests that AAPL's auto optionality is worth at least an incremental US\$14/share. From a timing perspective, UBS's upgrade should also capture the relative and absolute outperformance that typically accrues to AAPL's shares 180 days prior to autumn iPhone launches. **BUY**. (Published by UBS)

**Intuitive Surgical (ISRG.O) – Moving Robotic Surgery from Science Fiction to Reality**

Citi is initiating coverage of ISRG with a Buy rating and an \$862 target price. ISRG created the robotic surgery market, initially for prostatectomy procedures, but expanding into: other urology, gynaecology, general surgery, head and neck, and cardiothoracic procedures. Since the first system was introduced in 1999, ISRG has developed five additional iterations that assist in minimally invasive surgery. The technology has clear momentum: 1) Clinical data has been published in >24,000 peer reviewed publications; and 2) It now operates in 67 countries, with 5,989 systems currently in place, and more than 8.5m procedures performed worldwide. Although ISRG has revolutionised surgery, it has only begun to tap the six million annual procedures its da Vinci system is indicated for, with ~1.2m da Vinci surgeries performed in 2020. BUY. (Published by Citi)

**Thermo Fisher Scientific (TMO.N) – What Will TMO Earn in 2022 & 2023? Lowering Forecasts (Less Testing); See Attractive Entry Point**

After strong performance for most of 2020, TMO's stock has lagged, UBS believes in part due to the coming deceleration in COVID-19 test numbers, which creates a notable drag for revenue and margins. UBS is lowering its forecasts largely to account for a steeper COVID-19 PCR test decline. UBS views the current TMO share price as attractive given: 1) TMO should exit this period a stronger (faster growing) company, which UBS believes warrants a higher multiple. 2) With consensus forecasts getting into the right spot (UBS is near the high end), the stock can look ahead towards a recovery. 3) TMO is primed for mergers and acquisitions (up to ~US\$40b), which can be a material driver. BUY. (Published by UBS)

**Unilever (ULVR.L) – Still an H2 recovery call, but patience needed**

Citi still views ULVR as the best consumer staples stock to capture an emerging markets recovery, not just due to its well flagged exposure but thanks to its corporate scale in rural emerging markets, which should allow it to generate a “multiplier effect” in the first phase of the recovery. However, Citi thinks that with already robust Q1 expectations and uncertainties around H1 margins, the story may only pick up later in the year via earnings acceleration and more news flow around portfolio changes, which should allow for some re-rating. BUY. (Published by Citi)

## Calendar

Figure 5. Calendar

| Date   | New Zealand  | Australia   | International  |
|--------|--|---|--|
| 5-Apr  | Easter Monday  | Easter Monday   | UK/EU: Easter Monday<br>HK/CN: Qingming Festival   |
| 6-Apr  |  | ANZ Job Advertisements<br>RBA Interest Rate Decision (Apr)<br>RBA Rate Statement                    | HK: Day Following Easter Monday<br>US: ISM Non-Manufacturing PMI (Mar)   |
| 7-Apr  | GlobalDairyTrade Price Index<br>NZIER Business Confidence (1Q)<br>NZIER QSBO Capacity Utilisation (1Q) | AIG Construction Index (Mar)<br>Services PMI<br>ANZ Commodity Price index<br>RBA Chart Pack Release | US: EIA Short-Term Energy Outlook<br>US: JOLTs Job Openings (Feb)<br>UK: Composite PMI (Mar)<br>UK: Services PMI (Mar)   |
| 8-Apr  | ANZ Business Confidence<br>NZX AGM   |   | US: Crude Oil Inventories<br>US: FOMC Meeting Minutes<br>UK: Construction PMI (Mar)<br>EU: ECB Monetary Policy Statement |
| 9-Apr  |  |   | US: Initial Jobless Claims<br>US: Fed Chair Powell speaks  |
| 10-Apr | CFTC NZD Speculative Net Positions   | CFTC AUD Speculative Net Positions  | US: Producer Price Index (Mar)   |

Source: Bloomberg



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