

Wealth Weekly

Investing in a Low Interest Rate Environment

We are in an unprecedented investing environment, with global and NZ interest rates near historical lows. We believe low rates are likely to persist for the foreseeable future. This creates a challenging backdrop for investors. In our report ‘A Low Interest Rate World — How Should Investors Respond?’, also published today, we discuss (1) the important protection role fixed interest investments still play in portfolios despite the lower income on offer, and (2) options for investors to adapt to this environment through increased allocations to higher-risk/higher-return assets, saving more or sending less, and/or consuming capital.

No silver bullet (unfortunately)

With the low income on offer from bonds and term deposits today it is understandable investors are asking “why bother with bonds”? Our response is two-fold:

1. Despite the lower income on offer, bonds or term deposits still play important protection roles in portfolios. First, they ensure medium-term financial needs are able to be met. And second, they reduce the volatility of an overall portfolio’s returns. The shorter an investor’s time horizon, or the less tolerance they have for risk and volatility, the more important bonds are in the portfolio.
2. (Unfortunately) we possess no silver bullet to deliver higher returns. Our expectation is that future returns will be more muted than what we’ve seen over the past decade. If investors are able to increase allocations to higher-risk/higher-return assets they should do so. This decision should be weighed up against saving more or spending less (which often feels unpalatable, but is probably the lowest risk option to meet portfolio objectives) and/or, for investors with an established portfolio, consuming some of their capital.

Themes of the week

Geopolitics took centre stage last week. Stocks found support on the back of a “phase one” trade agreement between the US and China, and Boris Johnson’s Conservative landslide victory in the UK. The US Federal Reserve reaffirmed it expects interest rates to remain low. It views current settings as “appropriate to support sustained expansion of economic activity”, and the majority — 13 of 17 members — of the Federal Open Market Committee expect rates to remain unchanged in 2020.

In NZ, Government announced an additional NZ\$12b to be invested in (mainly transport) infrastructure, albeit spending doesn’t ramp up until 2022. Z Energy’s share price took a considerable hit following a downgrade to FY20 earnings guidance — whilst disappointing, we believe the market’s overreaction has created an entry opportunity and have upgraded to OUTPERFORM.

Looking ahead

News flow quietens with the lead into Christmas. There is a flurry of NZ macro data including GDP. Nike and FedEx report 2Q results. And there are a number of annual shareholder meetings in NZ and Australia, including Napier Port, ANZ, National Australia Bank, and Woolworths.

This is our final Wealth Weekly of 2019. We wish everyone a happy holiday.

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In this week’s report...

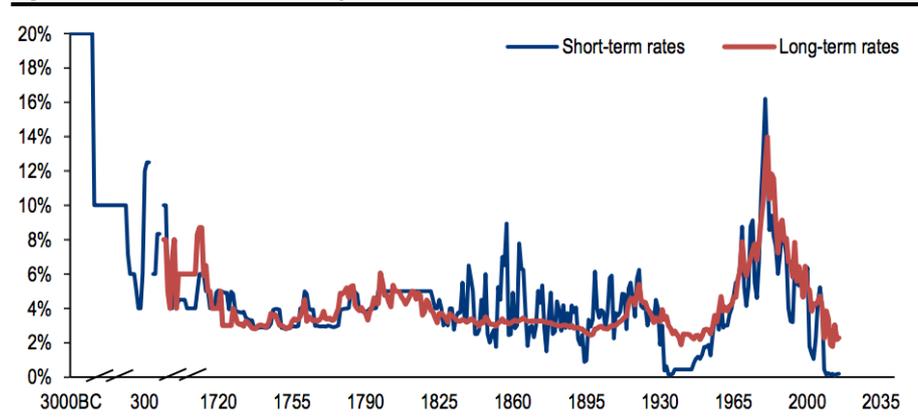
- Despite the low income on offer, bonds still have an important role in portfolios
- Our five NZ stock picks for 2020 are a2 Milk, Arvida, Chorus, Contact Energy, and Sanford
- We upgrade Z Energy to OUTPERFORM, and reaffirm our positive view on Viva Energy despite profit warnings from both companies last week
- We recommend investors trim holdings of Sydney Airport
- Interest rates to ‘sideways shuffle’ through 2020

Investing in a low interest rate world

The current unprecedented low interest rate environment is a challenging one for investors. In our report ‘*A Low Interest Rate World — How Should Investors Respond?*’, published today, we highlight and discuss:

- Interest rates are at unprecedented lows (5,000-year lows according to the research!).
- Central banks around the world are telling us interest rates will remain low for the foreseeable future. Japan is a case study — it has grappled with ultra-low interest rates for 25 years.
- Factors driving low interest rates include an ageing population, higher levels of debt around the world, income and wealth inequality, efficiencies from technology, a global savings glut, and an integrated global financial system.
- Low interest rates have reduced the income bonds and bank deposits provide to investors. But these assets still play important roles in portfolios: (1) providing cash for medium-term spending, and (2) protecting portfolios from too much volatility.
- There is no silver bullet solution that will deliver higher returns in a low interest rate world. How an investor adapts is, to a large degree, dependent on their own circumstances. Options include: (1) increasing the allocation to higher-risk/higher return assets, (2) saving more or spending less, and/or (3) consuming capital.
- Key for investors is ensuring they are optimising the returns and risks of the investments they are making.

Figure 1. Interest rates are at a 5,000 year low



Source: Bank of England, Global Financial Data, Homer and Sylla "A History of Interest Rates", BoFA Merrill Lynch

Investor checklist

We recommend reviewing your portfolio with your adviser, with an eye on the following questions, to help identify ways to optimise your investments for this environment:

- How is your portfolio positioned?
- How much risk can you tolerate? If you can bear more risk, should you gradually increase your portfolio’s weighting to higher-risk/higher-return assets?
- Is the portfolio adequately diversified across and within asset classes to ensure maximum expected return for the lowest possible risk?
- Does the balance of defensive and growth investments meet your near-term needs and longer-term objectives?
- Are there areas of spending that you could reduce without impinging on your happiness?
- How much can you safely withdraw from the portfolio each year and still meet your long-term investment objectives?

Hopefully this exercise will provide ideas to improve a portfolio, or provide comfort that everything is on track.

Themes of the Week

Equities

Our NZ equities research team has published *'The Year Ahead; Five/Five for 2020'* outlining five themes and five NZ stock picks for next year. Key themes we expect over 2020 include:

- **Late cycle recovery:** Global economic growth is expected to accelerate modestly through 2020 as central bank stimulus takes hold and the US–China trade war eases or resolves. In NZ, a robust housing market and improving consumer confidence point to a modestly positive outlook.
- **Elections:** The upcoming NZ election will inevitably put a temporary dampener on consumer demand, but to-be-announced policies are unlikely to have any meaningful impact on NZX companies, in our view. The US election promises to be more divisive, albeit few NZX companies will be directly impacted.
- **Rates:** We expect the RBNZ to hold the cash rate through 2020. Recent yield curve steepening reflects more optimism around growth. However, rates will be capped to the upside by monetary policy, the reach for yield, and the inability of the global economy to sustain materially higher rates.
- **Sustainability drive:** At government, investor, corporate and consumer levels, the drive for sustainability will increase in importance. From measuring and disclosing greenhouse gas emissions, to actively reducing waste, NZX companies will be at pains to stress their greater focus on green initiatives.
- **Mergers & acquisitions (M&A):** In 2019 the NZX lost TradeMe, Methven, Orion Healthcare and SLI Systems to M&A. Others (e.g. Abano) will likely follow in 2020. While market valuations are relatively high, cheap debt and cashed up private equity means more companies could be subject to bids through the year ahead, particularly those whose share prices have taken a hit. Our M&A screen suggests potential targets include Z Energy, Gentrack, Sky TV, and Metro Performance Glass.

Our five NZ stock picks for 2020 are a2 Milk, Arvida, Chorus, Contact Energy, and Sanford.

Z Energy (ZEL) — Share price overreaction; upgrade to OUTPERFORM

After the sharp share price reaction to last week's profit warning we believe the stock now represents a buying opportunity for investors.

ZEL lowered its FY20 EBITDAF guidance range to NZ\$350m and NZ\$385m (from NZ\$390m to NZ\$430m). Whilst we had believed guidance was under pressure, the timing and magnitude surprised us. Once again, ZEL has cited retail market competition — or the lack of a return to “normal” behaviour by a competitor — as the main reason for the downgrade, with low gross refining margins also an issue.

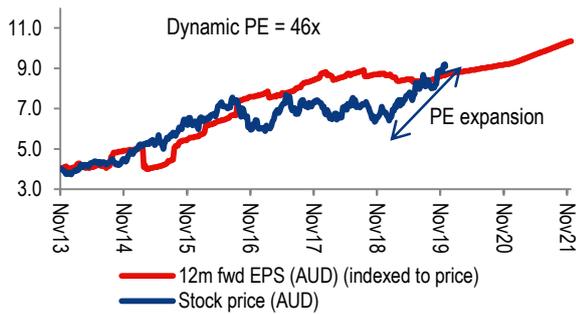
We believe ZEL is now offering good value to investors, and have upgraded our rating to OUTPERFORM. There are several reasons why we believe the upside potential is greater than the downside risk.

- The share price is factoring a further -4cpl to -5cpl decline in retail margins which we view as unlikely.
- Retail margins are back to ~2012 levels, which is likely to result in service station closures and slow the rate of expansion of the low-cost networks.
- ZEL has the ability to take cost-out. To date it has focussed on adding value (which has invariably meant adding cost).
- We believe ZEL is now a possible takeover target.
- Valuation metrics are better than they appear. We estimate FY20 adjusted PE is 9.0x, falling to 8.7x in FY21.

Sydney Airport (SYD.AX) — Time to clip SYD’s wings

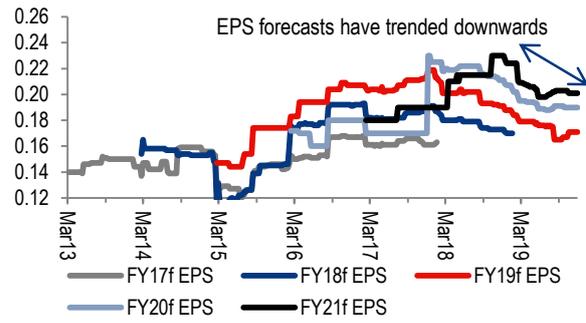
SYD has been a star performer this year, having delivered a total return of +36% in NZD. This has been despite modest profit downgrades; hence, its PE multiple has expanded along with other defensive yield stocks. Whilst we continue to like SYD’s long-term strategic position, it’s not without some challenges. SYD is becoming a taxpaying entity in FY21 (December balance date). For NZ investors, as SYD begins to pay tax, this will lead to a lowering of the company’s cash yield (current cash yield is 4.4%). Further out, there are unknowns surrounding the new development of a second airport which will compete with SYD’s domestic services. We share Ord Minnett’s view that now is an appropriate time to take some profits.

Figure 2. SYD share price and EPS



Source: Forsyth Barr analysis, Bloomberg

Figure 3. SYD - evolution over time of EPS forecasts by fiscal year



Source: Forsyth Barr analysis, Bloomberg

Viva Energy (VEA.AX) — Trading update disappoints; maintain positive view

VEA has had a turbulent run since its IPO in June 2018 due to downgrades related to volatile refining margins, and softer than expected retail margins and volumes on the back of competitive pressures and a softer macro backdrop. Last week, VEA provided the market with a trading update, which disappointingly included a downgrade to FY19 operating earnings and net profit guidance. All divisions appear to be tracking behind expectations as a lift in volumes has not been enough to offset margin pressures.

Despite the disappointing update, we continue to believe retail margins will recover as competition in the retail market becomes more rational. VEA’s volume growth suggests it has been a major contributor to depressed retail margins. We believe that once VEA achieves a volume level that management is happy with, pricing should improve and support expanded retail margins.

At its current share price, VEA trades at a material discount to its peers and the broader Australian market. Three of our Australian research affiliates have positive ratings on the stock (UBS: Buy, MST: Buy, Ord Minnett: Accumulate), with expectations for a material improvement in earnings in the medium-term via improving retail volumes, and eventually improving margins. VEA is expected to report its FY19 result on 27 February 2020. We retain VEA in our Australian Model Portfolio.

Webjet (WEB.AX) — More talk of deals

As we have discussed recently, we expect takeovers to be a feature of markets given the improved confidence in global economic conditions and low interest rate environment.

Shares of WEB, which sit within our Australian model portfolio, jumped +10% on Wednesday on speculation that an investment bank has been promoting a sales pitch on behalf of the company. However, WEB downplayed the media speculation, stating “should a proposal be received that was compelling and certain, the company would put it to shareholders”, and that “no such proposal exists at present”.

WEB shares are down -29% from a peak in August 2018, on the back of an unfavourable seasonal read-through from Thomas Cook at the beginning of the year, followed by that company’s liquidation in September.

With WEB shares trading on a forward PE multiple of ~15x, and analysts forecasting a double-digit EPS growth outlook over the next three years, we believe the stock offers an attractive risk-reward balance. As such we wouldn’t be surprised if an offer for the company did eventuate, especially given heightened M&A activity over the last month.

Fixed Interest

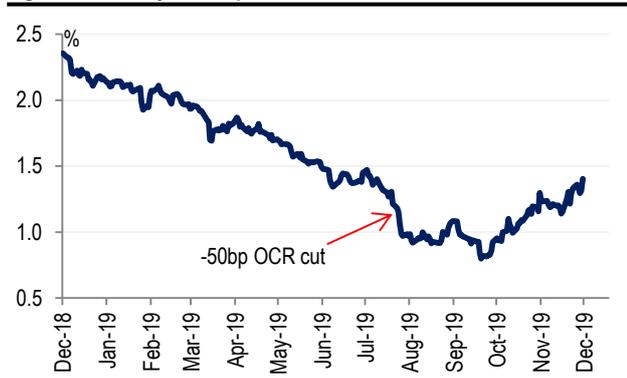
As we begin to say goodbye to 2019, we take a quick glance at a quite remarkable year in fixed income. The NZ five-year swap rate (the base rate for corporate bonds) traded over a wide 139bp range, with a high of 2.18% and a low of 0.79% and negative interest rates on the cards at one stage. The benchmark interest rate for the world, the US 10-year Treasury bond, also saw its yield fall by -86bp as the US eventually came to the party and began lowering the Fed Funds rate.

If the negative interest rate scenario appears to be off the table, where are NZ interest rates heading for 2020?

Over the past couple of months the Reserve Bank of NZ (RBNZ) has been instrumental in turning around the fortunes of the NZ economy. Six months ago it was doom and gloom, with business and consumer confidence at record low levels, forcing the RBNZ to reduce the Official Cash Rate (OCR) by -50bp. This sort of move is usually reserved for disasters such as the Christchurch earthquake. The -50bp cut initially accentuated those fears, but a post August campaign spread the message that the cut was starting to work and there were continual pleas for the government to provide some fiscal stimulus.

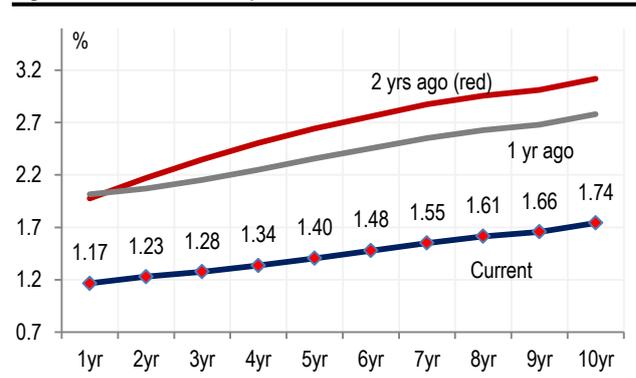
Which brings us to where we are now, with the government finally coming to the party with some spending, albeit with vague details and a long lead time for its infrastructure package. The RBNZ also played another significant part by watering down its bank capital reforms which, if implemented, could have delivered some economic pain for NZ.

Figure 4. NZ five year swap rate



Source: Forsyth Barr analysis. Thomson Reuters

Figure 5. New Zealand swap curves



Source: Forsyth Barr analysis, Thomson Reuters

A tough road ahead

All of the above leads to a likely difficult 2020 for fixed income investors. The above chart highlights the one-way trend of interest rates for most of 2019 before a reversal from the beginning of October. While we don't hold the view that interest rates are going to head materially higher, the 'easy' gains appear to have been made with a 'sideways shuffle', more than likely occurring in 2020.

Quality is still the preferred option

While interest rates have been quite volatile of recent times, credit spreads have not. Credit spreads are the risk premium that a corporate pays above the benchmark interest rate; the riskier the corporate the higher the credit spread. Usually in times of economic stress — which central banks were communicating via lower cash rates — credit spreads widen as the probability of default increases. This has not been the case and as corporate yields head lower, yield chasers have moved further down the quality curve, pushing these yields to levels that do not reflect the risk/return characteristics that should be assessed when buying fixed income assets.

Diversification, liquidity and quality remain three key factors when assessing fixed income and may become more prominent in 2020 and beyond with uncertainty around asset price increases.

Research Worth Reading

New Zealand

Z Energy (ZEL) — Unwanted Black Friday Discount

ZEL provided its own Black Friday discount, with the share price reaction to its earnings downgrade providing investors with an unwanted buying opportunity. That said, we don't expect ZEL is on many investors' Christmas card lists after it downgraded its FY20 EBITDAF guidance range by ~NZ\$45m (10%), to NZ\$350m to NZ\$385m. Once again, a tough retail market has been cited as the main issue. We upgrade our rating to OUTPERFORM as we believe there is more upside risk than downside.

Equity Strategy — The Year Ahead; Five/Five for 2020

A new year and a new decade follow the longest bull market in modern history. Markets are in uncharted territory — with record high valuations (at least domestically) and record low interest rates. Key drivers (growth, rates, and regulation) will remain supportive to elevated valuations through 2020, in our opinion. Our key picks for the year ahead are A2 Milk (ATM), Arvida (ARV), Contact Energy (CEN), Chorus (CNU) and Sanford (SAN).

Pushpay Holdings (PPH) — Expands into US Church management

PPH has bought Church Community Builder (CCB) for US\$87.5m. This announcement was not a total surprise as PPH has been looking at acquisition opportunities for a while. Industry feedback suggests CCB is one of the best church management software providers in the US. The two companies have similar target markets and cultures so this looks like a bolt-on acquisition with a good fit. Maintain BUY. (Published by UBS)

Australia

Aristocrat Leisure Ltd (ALL.AX) — Key Call: UBS Evidence Lab inside: Digital app revenue trends — December 2019

UBS Evidence Lab tracks revenue share data for top social gaming and social casino apps in the iOS and Google Play stores. Early data in 1H20 points toward an acceleration in the social casino market, which bodes well for ALL. BUY. (Published by UBS)

James Hardie Industries (JHX.AX) — Looking into 2020

JHX's share price has doubled over the last 12 months, reflecting the resumption of growth in the US housing market, the company gaining market share, and rising confidence in the CEO's strategy for growth and cost outs. While expectations have improved and the share price has doubled, UBS has more confidence today in the strategy and outlook than 12 months ago. BUY. (Published by UBS)

Sydney Airport (SYD.AX) — Investor day feedback, downgrade to Lighten

SYD hosted an investor day last week and in this note Ord Minnett provides an overview of the key points from the presentations. Ord Minnett expects soggy growth in passenger numbers will place pressure on operating earnings and on its 4% dividend growth. Sydney Airport has some very attractive development opportunities, but Ord Minnett believes these are medium-term, rather than short-term, opportunities. LIGHTEN. (Published by Ord Minnett)

Viva Energy Group (VEA.AX) — CY19 EBITDA guidance c15% below UBSe: Why have we retained Buy?

VEA's CY19 profit guidance was materially below expectations, with earnings expected to be weaker across all divisions. On a more positive note, volume growth was strong, implying margin pressure is the issue. VEA is by nature a volatile business, reflected in the high PE discount to the market. However, UBS views the 2-3yr earnings outlook for VEA as strong. BUY. (Published by UBS)

Leading Lights — Our Best Stock Ideas

Ord Minnett highlights its top stock picks across:

- **Core Blue Chip:** ANZ Banking Group, CSL, GPT Group, Origin Energy, Rio Tinto, Sonic Healthcare, Transurban.
- **Value:** APA Group, AusNet, Coca-Cola Amatil, Charter Hall Long WALE REIT, Event Hospitality, National Australia Bank, Perpetual.
- **Growth:** Ansell, Aristocrat Leisure, Charter Hall, Cleanaway Waste Management, ResMed, WorleyParsons.
- **Small caps:** Alliance Aviation, Austral, Centuria Industrial REIT, Clover, HUB24, Integral Diagnostics, Lynas, People Infrastructure, Service Stream.

International

Alibaba Group (BABA.K) — Revisiting Our Thesis and Initiating on H-Shares

Citi is convinced of BABA's ability and capacity to achieve its near- and long-term visions, leveraging off its technological advancements and innovations. BABA has extended its commerce addressable market to New Retail, and is working with industry partners to transform and digitise their operations via the Alibaba Business Operating System. Citi has initiated on BABA H-Shares (9988.HK) with a BUY rating, and upgraded the US-listed ADR target price to US\$284 (from US\$230). (Published by Citi)

Home Depot (HD) — Investor Day Takeaways

We note key takeaways from Home Depot's investor day. With more than half of the US housing stock 40 years or older, coupled with record high home equity levels, home improvement spend is expected to outpace overall GDP growth over the longer-term. HD is working to simplify its pro B2B site. Digital now accounts for about 10% of sales with more than half of online orders being picked up in store. BUY. (Published by Citi)

Sectors

US Cloud Computing, Cybersecurity & Software — Three Days at AWS Re:Invent — Checking in on Hyperscalers and Software

Following the AWS Re:invent event Citi come away with key takeaways and conclusions for software and hyperscale cloud providers.

- Positive conclusions for **Palo Alto Networks**, Okta, Ping Identity and Sailpoint Technologies in security, with little/no credible competition from hyper-scalers (Amazon, Google, Microsoft) themselves.
- Citi continues to see SaaS players who aggressively adopt "cloud native" as advantaged (**Salesforce** comes to mind).
- For hyper-scalers, **Microsoft**/Azure remains the story of this space. Demand appears to be diverging between "innovators"/"builders" choosing **Amazon**/AWS and "IT"/"corporate" choosing Azure, while **Alphabet**/Google plays a more niche role.

European Capital Goods — 2020 vision: Farsighted focus on corporate change + structural growth

Citi has highlighted five key sector themes for 2020 and updated their view on 25 key end markets. Citi's top picks into 2020 are BUY-rated **Siemens**, **ABB**, **Vestas**, **Volvo**, **Sandvik**, **Alfa Laval**, **Smiths Group**, **Melrose**, and **IMI**.

Macro

Global Economics — Is the 2020 Global Growth Outlook Half-Full or Half-Empty?

Despite the synchronised global slowdown in 2019, Citi's coincident and leading indicators show that the global economy is still holding on. Citi's 2020 growth outlook reflects a stabilisation in global growth driven by stable investment and a slight moderation in consumption. We expect global monetary policy to remain supportive and only a relatively modest looser fiscal stance in 2020. We consider the balance of risks to be tilted to the downside as the several risks that have been weighing on the global outlook have not dissipated, and there is a non-small probability that these intensify in 2020 (and even more in 2021).

Calendar

Figure 6. Calendar

	New Zealand	Australia	International
16-Dec	Performance of Services Index	Charter Hall Group Extraordinary General Meeting	CH: Industrial Production CH: Retail Sales EU: Markit Manufacturing PMI UK: Markit Manufacturing PMI
17-Dec	ANZ Business Confidence	ANZ Banking Group ASM Orica Ltd ASM Woolworths Group Ltd ASM RBA Meeting Minutes AU Owner-Occupier Loan Value	US: Building Permits US: Housing Starts US: Industrial Production EU: Trade Balance UK: ILO Unemployment
18-Dec	Balance of Payments	National Australia Bank Ltd ASM AU House Price Index	China Railway Extraordinary General Meeting FedEx Corp 2Q20 result JP: Trade Balance EU: CPI (final) UK: CPI UK: House Price Index
19-Dec	GDP Trade Balance	AU Unemployment	Bank of China Ltd Extraordinary General Meeting JP: BoJ Interest Rate Announcement UK: BoE Interest Rate Announcement US: Philadelphia Fed Business Outlook US: Existing Home Sales US: Initial Jobless Claims
20-Dec	Napier Port Holdings ASM ANZ Consumer Confidence	Incitec Pivot Ltd ASM	NIKE Inc 2Q20 result US: Core PCE US: PCE Deflator US: Uni of Mich. Sentiment Survey (final) JP: CPI UK: GDP
23-Dec			US: New Home Sales
24-Dec			US: Durable Goods Orders

Black – company news, Red – economic news
Source: Forsyth Barr analysis

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