

Wealth Weekly

Virus Dominates Markets

WEALTH MANAGEMENT RESEARCH

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The end of the reporting season last week was overshadowed by markets reacting to the threat that the coronavirus pandemic poses to economic growth and company earnings. Investors are justified in being on tenterhooks as they wait to see how far health agencies, governments and central banks are willing to go in response to the spread of COVID-19.

Viral markets

The NZX 50 index has fallen -8.0% since its peak on Friday 21 February, slightly better than the US S&P 500's -10.9% correction over the last week and a half. **The recent equity market drops reversed the gains made since October and November last year.** The potential range of outcomes from the spread of COVID-19 remains wide. One thing that seems certain – and which markets are anticipating – is that analysts' bottom-up earnings growth estimates will come down from the +9% level they are currently forecasting for global equities in 2020. But the value of companies (and therefore shares) is determined based on many years of future earnings, not just on one or two years. Taking a long-term view, the vast majority of market and earnings corrections have ultimately become mere blips in the long-term upward trajectory of asset returns. For investors in quality, long-term businesses, we believe watching and waiting is the best tactic at the moment.

Themes of the week

Investors' fears were reflected in a rise of the VIX volatility index. Given the range of outcomes, at this point it's rational for investors with short time horizons to be concerned. But historically, **spikes in the VIX have more often than not proved to be good buying opportunities for long-term investors.** That may turn out to be the case in this instance if the virus outbreak can be brought under control, and especially if (as expected) governments and central banks provide fiscal and monetary policy support to ameliorate the economic impacts in the most affected countries. With the tailwind of computer-driven trading, equity market sentiment could turn positive as fast as it turned down. Indeed, equity indices in Asia and the US were up strongly on Monday, with the Shanghai Composite gaining +3.2% as data showed progress in getting factories running again and the Nikkei rising +1.0% after Japan's central bank pledged to support the economy.

Bonds did their job of diversifying portfolios amid the market turmoil last week – their yields fell and prices rose as equity markets went in the other direction. Comments from US Federal Reserve Chair Jerome Powell on Friday gave investors some hope that the central bank will step in if economic conditions warrant it. The US S&P 500 rebounded +2.5% on Monday. The next central bank to watch will be the Reserve Bank of Australia, which meets today (Tuesday). New Zealand's Reserve Bank has another three weeks to see how the situation develops before deciding what to do at its next meeting.

The bulk of reporting season wrapped up last week with solid results domestically from **The a2 Milk Company** (ATM) and **Chorus** (CNU), and weak ones from **Freightways** (FRE) and **Genesis Energy** (GNE). ATM's current fiscal half-year period apparently got off to a strong start as the coronavirus outbreak prompted customers to stock up on infant formula, although there's some uncertainty about what that will mean for inventory and sales down the track. CNU's indication that it will pay out a high proportion of its rising free cashflow from FY22 got a rousing response from the market.

Looking ahead

Economic data being released this week includes various Purchasing Manager Indices on Monday: China's and the US's were weaker than expected, the UK's was in-line and Germany's was better than expected. The Reserve Bank of Australia's interest rate decision will be out on Tuesday afternoon, and the Governors of the English and Canadian central banks will give speeches on Friday. US employment data is due on Saturday.

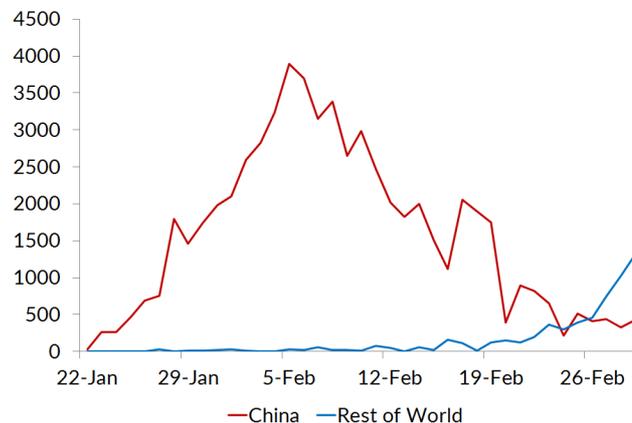
Viral Markets

The novel coronavirus that began in Wuhan in December (COVID-19) has become a pressing issue for financial markets. What was viewed as primarily an issue for China has morphed into a global crisis. The tipping point (from an investor perspective) came last week when the number of cases outside China (principally in Italy, South Korea and Japan), began to accelerate (as illustrated in the chart below).

This could go two ways

Encouragingly, the peak in new Chinese cases appears to have passed, providing some hope that the danger will ease relatively quickly. This is significant given China's size and role in global supply chains. That said, there is much still to learn about COVID-19, and we have seen limited evidence of medical professionals willing to make strong predictions about the likely progression of the virus. The counter to the optimistic scenario is the 1918 Spanish flu which killed an estimated 50 million people. There are many reasons why this scenario remains remote, not the least being advances in medicine over the past century.

Figure 1. Number of new COVID-19 cases reported per day



Source: World Health Organisation, Forsyth Barr analysis

So how does COVID-19 impact investors?

Last week, having previously ignored the progression of the virus, sharemarkets around the world began falling. The catalyst was twofold: 1. the aforementioned progression of the virus outside of China; and 2. a steady stream of companies began to downgrade earnings, the highest profile being Apple on February 17, which highlighted the supply chain impact of having most of China down tools.

Damage to share prices has begun to mount

The United States benchmark equity index, the S&P 500, fell -12.8% before Monday's +2.5% rebound. The New Zealand sharemarket has been slightly more sheltered, falling -8.0% by Monday's close. Indeed some New Zealand stocks are actually potential beneficiaries from the virus. Fisher & Paykel Healthcare (FPH) nudged up its profit guidance due to strong demand for its medical devices from China, and The a2 Milk Company (ATM) has seen increased buying of its infant formula. We have an UNDERPERFORM rating on FPH due to its high valuation, and an OUTPERFORM rating on ATM.

The earnings impact of COVID-19 is beginning to be assessed

The consensus of stock analysts is still for +9% earnings growth globally this year. The strategists at our research partners at Citi now expect no earnings growth globally this year (previously +4%). Further reductions in estimates are possible.

How should we react?

Turbulent markets always make us feel like we should do something. Sometimes (like the 2008 financial crisis), we should. However, often sitting back and monitoring the situation is the best option. We think that is the case now. Since 2008 there have been 19 sell-offs greater than -5%. The worst, in 2018, was -19%. Every sell-off is serious – from Greece teetering on the brink of complete collapse, to the downgrade of United States Government's sovereign credit rating in 2011. But since December 2008 the United States sharemarket has risen +230%, excluding dividends. In other words, reacting to a crisis by selling shares is often a poor decision.

There is much we do not know about COVID-19 or its potential impact. Things may get worse before they improve. Conversely, there will be a growing response from governments and central banks to stabilise countries and markets. The significance of this response should not be understated. Moreover, unlike 2008, the engine of the world economy, global consumers, has been behaving prudently, lending markets resilience. Either way, our judgment and experience suggest not reacting to this volatility. Well-constructed portfolios are built to ride through tough markets. The value of a company is not determined by next quarter's earnings, but by the next 40 quarters or more. Accordingly, the best defence to uncertain events is to own sound, profitable businesses over the long-haul.

While volatile market conditions are unsettling, investors with clearly defined investment objectives are well-placed to manage investment uncertainty. **Your Forsyth Barr Investment Adviser, supported by the resources of our Research team, is available at any time to provide you with further assistance, if needed.**

Themes of the Week

Macro

Volatility spikes have been good times to buy

The VIX index – a measure of how volatile investors expect the stock market to be based on prices of S&P 500 index options – has spiked from the mid-teens to above 40, a level it last reached in 2011. **Historically, when the VIX has spiked higher, it has been a very good time to add risk (i.e. equities) to portfolios.** Most notably in 2002 (fear of a slowing US economy), 2008 (Lehman Brothers collapse), 2010 (Greece government debt crisis), 2011 (US debt ceiling and Eurozone crisis), 2016 (Brexit), 2018 (fears of US recession due to reduction of central bank stimulus).

The recent fear of a global economic slowdown is justified by the plunge in activity in China, which has been at the vanguard of the epidemic and containment response to mitigate it. But assuming the official data in China is to be believed, COVID-19's spread in China appears to be slowing. The fear in markets is now being driven by the rapid spread of the virus around the world. Yet, apart from South Korea, Iran and Italy (all in winter seasons), the infection rates have not been accelerating much within some countries, perhaps because the virus doesn't spread as easily in warm and humid weather.

China's factories and supply chains are slowly getting back into production. If China can get on top of the epidemic and get some normality back into daily routines, the impact on global manufacturing and industrial production should be transitory. There's no doubt that Q1 growth in China will see a material contraction, with services and retail being the hardest hit. That slowdown may spread around the world along with responses to disease outbreaks. But, **assuming the containment measures continue to show success, and as the weather warms up to perhaps slow outbreaks in the other affected regions, the hit to economic activity should be acute rather than chronic.** In that case investors looking beyond the immediate impact of the current crisis would see opportunities in the weeks and months ahead.

It makes sense that rational investors should wait for signs of the panic to subside, but beware that just as computer-driven trading can take the market down sharply (as it probably has over the past week), so a recovery may be just as sharp.

Positive signs include stimulus measures in China (fiscal and monetary) and strong indications of central bank and political responses from the major economies around the world. While the situation may get worse before it gets better, it will eventually get better!

Fixed Interest

Will Central Banks come to the rescue and if so would it make any difference?

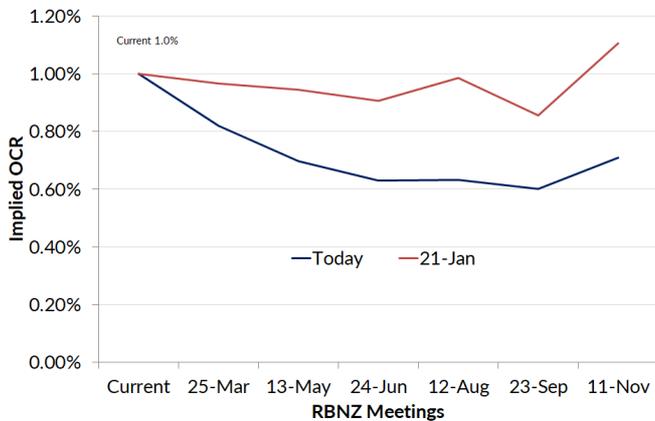
Once again the bond market provided the much needed safety net for diversified investment portfolios as stocks around the globe tumbled last week once the market began contemplating the economic impact of COVID-19. The S&P 500 fell -11% over the week, its worst weekly drop since the Global Financial Crisis (GFC) in 2008. The losses would have been greater if not for some comments from US Federal Reserve Chair, Jerome Powell, which prompted the market to pare back some of its losses. The flight to safety saw the yield on the US 10 year Treasury note fall more than -30bp over the week (bond prices rise as yields fall).

Investors had been waiting for the Fed to provide them with a life line and on late Friday (US time) Fed Chairman Jerome Powell stated:

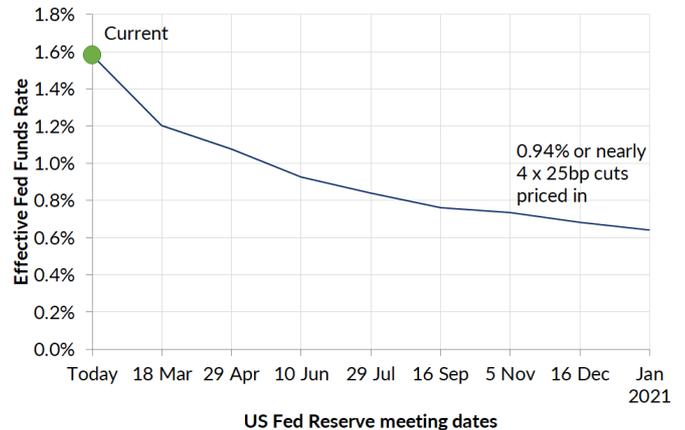
The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy.

The New Zealand Finance Minister also made comments last week about how the Government (and the central bank) may provide support to the economy should the worsening economic situation warrant such intervention.

The market is pricing in nearly four interest rate cuts from the US Federal Reserve over the coming twelve months. Whilst this may sound optimistic (or pessimistic, depending on which way you look at it), the ongoing market turmoil may force central banks to do something. Economists are expecting the RBNZ to cut the Official Cash Rate (OCR) when it next meets on 25 March. The three weeks until then could be a blessing for the RBNZ as it gets to further assess the economic impact, a luxury not afforded to the Reserve Bank of Australia (RBA), which meets on 3 March. A -25bp cut is priced in which would see the RBA's cash rate fall to 0.50%.

Figure 2. Possible OCR track


Source: Forsyth Barr analysis, Bloomberg

Figure 3. Market pricing of possible Fed cuts


Source: Forsyth Barr analysis, Bloomberg

The cream rises to the top

As stated above, New Zealand bonds (or bonds in general) illustrated their value last week as fear gripped global stock markets. The S&P/NZX50 gross Index fell -3.9% whereas Investment Grade New Zealand bonds gained +0.90%. Even the NZX property index, which is also viewed as a bond proxy, fell -1.9%. As in the case of US Treasuries, New Zealand Government bonds saw a significant gain of +1.5% for the month, highlighting that in difficult times quality bonds perform the best.

Equities

Last week a number of our Model Portfolio companies delivered results. Below we provide a brief summary of those that were the most noteworthy.

New Zealand

The a2 Milk Company (ATM) reported a strong 1H20 result, modestly ahead of our expectations, with market share gains evident across all products and markets, and another lift in its cash position. Highlights were (1) strength of sales in-market in China, with a further broadening in sales channels; (2) gross margin momentum; (3) supportive brand and demand indicators. We continue to see the risk/reward as favourable with valuation metrics attractive vs peers, history and the market, particularly given ATMs strong free cashflow and growth outlook.

Chorus's (CNU) 1H20 result and upgraded guidance were ahead of our expectations; however, we suspect it was the indication of a material, medium-term step up in dividend that triggered the positive market reaction. CNU inferred that from FY22 it will pay out a high portion of its free cash flow (FCF) as dividends. This attractive FCF profile continues to underpin our positive investment view.

Freightways (FRE) reported a disappointing 1H20 result impacted by parcel volumes declines and further margin woes in Information Management. Some relief should come during 2H20 in the form of (1) recent restructuring moves to lower the cost base, and (2) the commencement of a major digitisation project in Australia. Moreover, FY21 earnings should recover further from the pricing for effort initiative and the cycling of a number of one offs from FY20, however, the risk to the earnings growth outlook is to the downside, in our opinion. We believe the risk/reward for FRE is balanced in light of its increasingly hazy earnings outlook.

Genesis Energy's (GNE) 1H20 EBITDAF result was weak as expected, hampered by the Kupe maintenance outage and high thermal generation fuel costs. Management guided to record 2H earnings, with CEO Marc England stating the next 18 months will be GNE's best ever. Falling thermal fuel costs and a strong retail performance bode well for 2H20 and beyond.

Australia

Qube (QUB) reported 1H20 revenue growth of +13% and net profit growth of +5%, largely in line with expectations. Positives included a strong contribution from Patrick (50% JV) despite market volume declines, and progress on a major tenant at Moorebank. On the negative side, underlying earnings from QUB's Operating and Infrastructure & Property divisions were weaker than expected, and gearing was slightly higher. Management's outlook commentary suggested that underlying earnings growth in FY20E is expected to be lower than previously forecast due to uncertainty around the impact of the Australian bush fires, coronavirus and adverse weather events.

Rail operations at Moorebank commenced in November, and IMEX automation equipment was delivered on site in January. Moorebank is QUB's largest capex project, hence, management believe it is prudent to start a partnering process to reduce future funding requirements. QUB believes it is an opportune time to do so as Moorebank has been largely de-risked, IMEX automation is now operational, infrastructure has been built out, cap rates are attractive, and there is strong demand for quality infrastructure assets and industrial property. Management said it will take several months for management to evaluate whether to proceed with monetising QUB's Logistics Assets. They were pleased with the initial level of interest from potential funding partners.

Viva Energy (VEA) delivered a largely in-line FY19 result, and announced that the ~A\$680m in proceeds from the Viva REIT sale will be used for a buyback. The commitment to buy back ~18% of the company has to be a good thing, given where the share price and this sector's history of reticence on capital returns has been. We continue to think the largest accretion for Viva could come from potential M&A around the Caltex story, but we need to see how it all plays out. Either way, with retail margins roaring, albeit with refining margins not, Viva looks a good place to be.

International

Palo Alto Networks (PANW) delivered a mixed set of results relative to estimates. Billings came in slightly ahead of expectations, driven by a doubling in Next Generation Security billings, which now represent ~20% of total billings. However, product revenue came in below estimates, declining for a second consecutive quarter, as changes made to sales incentives are taking longer than expected to deliver benefits. Operating margins are likely to remain compressed since Palo Alto uses discounting to close orders and tuck-in acquisitions to bolster its product offering. FY20 revenue guidance was downgraded by -2.6%, and EPS by -7.6% at the midpoint, while Next-Generation billings was reaffirmed. Both Citi and UBS have retained Buy ratings and are positive on PANW's long-term growth prospects as the company builds an early leadership position in cloud security offerings, whilst reducing reliance on up-front revenue sources.

Research Worth Reading

New Zealand

Air New Zealand (AIR) – 1H20: No Vis On COVID

AIR reported a subdued 1H20 result characterised by below trend revenue growth. Coronavirus uncertainty and associated demand reductions are having a material impact on current profitability despite capacity cuts. In this environment it's difficult to have a strong view on AIR. We expect a rapid recovery in demand if the coronavirus is ultimately contained, but we anticipate newsflow getting worse before it gets better. NEUTRAL. (Published by Forsyth Barr)

Meridian Energy (MEL) – Breaking Records is Becoming a Broken Record: 1H20 Result Review

We weren't surprised that Meridian Energy (MEL) once again reported record breaking 1H20 EBITDAF, +20% higher than the pcp and +4% higher than 2H19. It is MEL's third consecutive record six-monthly EBITDAF. However, overhanging MEL's commentary, and actions is NZAS uncertainty. MEL has kept its interim dividend flat for that reason despite the record result. NEUTRAL. (Published by Forsyth Barr)

Michael Hill International (MHJ) – 1H20 Result: Needs a Polish

Michael Hill International (MHJ) reported a softer than expected 1H20 result due to margin contraction. The company signalled it expects 1H20 to represent a gross margin trough, as it looks to advance a number of sales initiatives and supply chain efficiencies to expand margins. Whilst corporate cost-out is encouraging and growth in market share is a longer term positive, we remain cautious over the rate of margin improvement. We see the current risk/reward as balanced. NEUTRAL. (Published by Forsyth Barr)

New Zealand King Salmon (NZK) – 1H20 Result: Channelling Value

NZK delivered a 1H20 result with few surprises and remains on track to hit full year guidance, provided water temperatures are ok in March. NZK is facing a period of subdued volume growth following the FY19 mortality event, combined with a change to its operating model. Medium-term growth remains attractive in our view. We see significant upside should NZK gain additional water space to allow increased production volumes. OUTPERFORM. (Published by Forsyth Barr)

Port of Tauranga (POT) – 1H20: Slow Steaming

POT's softer 1H20 result was a function of a decline in bulk cargo (including fertiliser, feed supplements and oil) while container volumes continued to rise. The coronavirus outbreak makes the near term outlook uncertain, which has led management to modestly reduce its full year earnings guidance range. Notwithstanding a material decline in the share price in recent weeks and scope for industry structure changes over the longer term, POT continues to trade at an elevated valuation. UNDERPERFORM. (Published by Forsyth Barr)

Summerset Group (SUM) – FY19 Result: Sun Still Shining

SUM reported a robust FY19 result, driven by a much stronger 2H performance, as expected. But SUM flagged a slower growth rate in FY20 as it invests in the business and builds its capability to deliver to its medium term target of 600 units per year. While the stalling in earnings growth momentum is disappointing, SUM remains well positioned to capitalise on its substantial growth opportunity in NZ and Australia. OUTPERFORM. (Published by Forsyth Barr)

Tourism Holdings (THL) – 1H20: Togo To Go?

THL's 1H20 result was challenged by US vehicle sales woes and start-up losses in its tech JV, Togo. Both provide earnings upside opportunity over the medium term, but together with the potential demand impact from coronavirus, they add to near term uncertainty. Valuation levels look appealing but we are wary of a deteriorating demand backdrop given the evolving coronavirus situation. NEUTRAL. (Published by Forsyth Barr)

Scales (SCL) – FY19: Horticulture Margins Less Dazzling

Scales (SCL) delivered a mixed end to FY19, with a strong performance in its Food Ingredients businesses offsetting misses by Horticulture and Logistics. We have trimmed our expectations on the back of wage inflation pressure and weaker than expected apple prices. We are attracted to SCL's long-term strategy, but earnings growth remains muted over the near-term as orchards are redeveloped. In addition, SCL's large capital headroom for a potentially transformational acquisition creates investment uncertainty, in our opinion. NEUTRAL. (Published by Forsyth Barr)

Australia

Ramsay Health Care (RHC.AX) – In line result Australia marginally softer, Europe better

RHC delivered a largely in-line result. In Australia, RHC experienced an EBITDAR margin decline, largely driven by a lack of price increase from health insurers. Citi expects this decline to be lower in 2H20 and reverse in FY21. Citi also has confidence that the synergies in Europe will materialise, contributing to ~8% FY21E group EBITDA growth. NEUTRAL. (Published by Citi)

Rio Tinto (RIO.AX) – CY19 result review

Rio Tinto (RIO) reported a CY19 underlying net profit +18% above the same period last year, broadly in line with Ord Minnett's forecast. Higher costs and lower iron ore volumes have led Ords to lower its CY20 earnings forecasts by -7%. Rio Tinto is trading on a compelling price to net present value (P/NPV) ratio of 0.83x and 6% forecast dividend yield. ACCUMULATE. (Published by Ord Minnett)

SEEK (SEK.ASX) – First-half FY20 result review

SEEK delivered a solid first-half FY20 result despite fears of macro-economic pressures going into the release. Even as the online classifieds businesses in Australia, Hong Kong and China came in weaker than expected due to slowing economic growth, they were offset by better growth in Zhaopin's offline business, online education services and its early-stage ventures. ACCUMULATE. (Published by Ord Minnett)

Qube (QUB.AX) – 1H20 Result Operating Outlook Deteriorates for FY20e

Citi expects slower top-line growth combined with underlying growth in costs of doing business will weigh on EBITDA margins in 2H20e. Citi values Moorebank at an average of A\$1.4bn to A\$1.6bn, but this is much more art than precision. Citi thinks the current share price has either i) a too optimistic view of the Moorebank value or ii) places significant value on the remaining land and operating businesses which Citi doesn't see, with the exception of Patricks. SELL. (Published by Citi.) [Forsyth Barr Wealth Management Research retains a positive view on QUB.]

Treasury Wine Estates (TWE.AX) – Coronavirus Risk Acknowledged

TWE lowered expectations again, noting that, given the coronavirus impact on sales in China, it no longer believes it can achieve +5%-10% EBITs growth in FY20e. The company has not yet seen any impact outside of China from coronavirus. The drop in sales could easily be 50% or more in recent weeks. That could be at least \$11 million impact. As a guide, Citi estimate Treasury makes \$22 million EBITs each month. NEUTRAL. (Published by Citi)

International

Salesforce.com Inc (CRM.US) – Surprise Co-CEO Departure Takes Focus From Strong Finish to FY20

Q4 results and FY21 guidance were better than expected. However, the surprise departure of Co-CEO Keith Block was the focus. Many investors view Block as a leading architect behind Salesforce's successful push deeper into Enterprise accounts, and UBS expects his departure to fuel fears that growth might stall post his exit. CEO and Co-Founder Marc Benioff remains in place and the sales force continues to run full steam ahead. BUY. (Published by UBS)

Walt Disney (DIS) – Disney CEO Change: Timing Is a Surprise

Disney announced that Bob Iger will step down as the firm's CEO. He will be succeeded by Bob Chapek. Mr Iger's contract was set to expire in 2021. With Disney potentially facing a handful of headwinds including the impact of COVID-19 and an economic expansion that is long in the tooth, investors may see the timing as a way for Mr Iger to step down on a high note (whether the timing was impacted by exogenous factors or not). BUY. (Published by Citi)

Global Strategy – Coronavirus: Cutting EPS, Market Targets

The weakening outlook for the global economy means Citi's strategists now expect flat global EPS in 2020, down from their previous +4% forecast. Citi's new MSCI All Country World Index target for the end of the year now implies a +5% gain in equities from here. Citi's Bear Market Checklist shows 5.5/18 red flags, the highest in this market cycle but still too low to call the start of the next major bear market. Citi's Panic-Euphoria sentiment indicator hit Euphoria in January. The signal would be more favourable if the indicator were closer to the Panic end of the scale before going all-in. It is not there yet. (Published by Citi)

Calendar

Figure 4. Description

| Date | New Zealand | Australia | International |
|-------|-----------------------------|---------------------------------|--|
| 2-Mar | | | CN: Caixin Manufacturing PMI (Feb) DE: Manufacturing PMI (Feb) UK: Manufacturing PMI (Feb) |
| 3-Mar | | AU: RBA interest rate decision | US: ISM Manufacturing PMI (Feb) EU: Consumer Price Index (Feb) |
| 4-Mar | NZ: Building consents (Jan) | AU: Gross Domestic Product (Q4) | UK: Services PMI UK: Bank of England Monetary Policy Committee Treasury Committee Hearings (tentative) |
| 5-Mar | | | US: ADP Nonfarm Employment Change (Feb) US: ISM Non-Manufacturing PMI (Feb) CA: Bank of Canada interest rate decision |
| 6-Mar | | AU: Retail Sales (Jan) | UK: Bank of England Governor speaks CA: Bank of Canada Governor speaks |
| 7-Mar | | | US: Nonfarm Payrolls (Feb) US: Unemployment Rate (Feb) |

Source: Bloomberg

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