WEALTH MANAGEMENT RESEARCH
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Wealth Weekly
Big Spend Up Ahead

WEALTH MANAGEMENT RESEARCH
wmr@forsythbarr.co.nz
+64 4 499 7464

The highlights of last week included the pandemic Budget in New Zealand, the easing of pandemic restrictions, and the continued strength of equity markets globally as investors weighed up the prospect of normalising activity against the difficult economic outlook and renewed tensions between the US and China.

Crisis Budget as expected

The equity market hardly budged following Thursday's Budget, suggesting it wasn't far off expectations overall. Highlights of the Budget's mammoth NZ$50 billion Response & Recovery Fund included extending the wage subsidy until September, topping up healthcare budgets, free trades training and support for apprenticeships, funding to build 8,000 state houses, an extra NZ$3 billion for infrastructure investment (in addition to NZ$12 billion already announced earlier this year), and spending to promote domestic tourism (and thereby presumably prop up the media industry). A big chunk of cash will go to yet-to-be determined spending priorities.

Successive governments in New Zealand have spent the last three decades restructuring the economy, reducing net debt, and developing financial resilience to offset rainy days like the global financial crisis and the Christchurch earthquake. **Now it's pouring, and there is again justification to intelligently invest our way out of the pandemic. Starting from a relatively strong financial position, New Zealand's public finances will now deteriorate substantially.** The government is forecast to run annual budget deficits for many years, and net government debt will rise to levels not seen for nearly three decades.

The current challenge is to ensure that taxpayers get good value out of all the money that needs to be borrowed and invested. Implementing the budgeted spending efficiently and effectively, and debating how to spend the unallocated NZ$20 billion are the big tasks ahead. **The next challenge will be reining in the extra government spending once the private sector is functioning normally again**.

Themes of the week

The government will need to issue a mountain of debt to fund its spending over the next few years. Much of it will be sold to the banks and then bought by the Reserve Bank in an attempt to keep interest rates across the economy low. **So far the RBNZ's quantitative easing (QE) has helped put downward pressure on yields, but it hasn't yet flowed through to improved liquidity in corporate bonds.** While corporates overseas have been busy issuing bonds, local companies have remained more reticent.

The listed property (LPV) sector is usually relatively defensive in normal economic conditions, but amid the pandemic it has come under pressure over concerns about revaluation losses and rent relief. The sector has underperformed utilities by -6% and the market by -8% since the start of the pandemic sell-off in mid-February. Recent revaluation outcomes have been mixed, with valuers turning away from valuation approaches based on market evidence, instead focussing on cashflows and sentiment. Industrial properties have fared the best and have provided steady gains, while some retail assets have been dealt severe write-downs. The pandemic's impact remains fluid, and with a wide range of possible outcomes **we continue to prefer LPVs with defensive asset bases and lower near-term uncertainty** including **Investore** (IPL), **Property for Industry** (PFI), and **Vital Healthcare Property** (VHP).

Looking ahead

Credit card spending data on Wednesday will be interesting. Meeting minutes from the Reserve Bank of Australia and the Federal Reserve will be released on Tuesday and Thursday, respectively. James Hardie will report its results on Tuesday, Argosy on Wednesday, Aristocrat Leisure on Thursday, and Nvidia and Medtronic on Friday.

Budget 2020

Modern monetary theory in practise

Finance Minister Grant Robertson released Budget 2020 on Thursday. Crafting a budget that pleases everyone is impossible at the best of times, let alone at the height of a crisis. The vulnerable will feel they need more, and the more fortunate will be suspicious of the quality of spending and will worry about how to pay for it all.

Robertson surprised no one when he said he's not a fan of austerity. The Budget signalled a substantial injection of spending and investment across the economy. This will continue a rapid expansion of the public sector in areas such as housing, trades training, school lunches, environment and conservation, in addition to further investment in the less controversial public services of health, education, transport and security.

Fiscal deficits are now forecast for most of the next decade and net crown debt is expected to exceed 50% of GDP again. Working off that much debt will be difficult in the sort of low growth environment we are likely to face amid central bank-induced financial repression (ultra-low interest rates).

Budget priorities unchanged

The government's intention with this Budget was clear:

- Stem the economic collapse and save as many jobs as possible
- Stabilise the economic platform
- Create jobs as the economy transforms

The 2020 spending priorities remained consistent with those outlined in the 2018 and 2019 budgets:

- Mental health and welfare
- Child wellbeing
- Supporting Maori and Pasifika aspirations
- Building productivity through innovation
- Targeting sustainable investment in protecting the environment
- Regional development

Response and Recovery Fund

A $50 billion COVID-19 Response and Recovery Fund has been established to support the economy over the next four to five years. Of this, $13.9b has already been spent in the initial response to Covid-19 and $15.9b is expected to be spent in the immediate period ahead, leaving $20.2b for future initiatives (a handy war chest to have heading into an election).

The key from here will be the quality of implementation, the prioritisation of further spending initiatives, and how it will all be funded.

What was not in the budget?

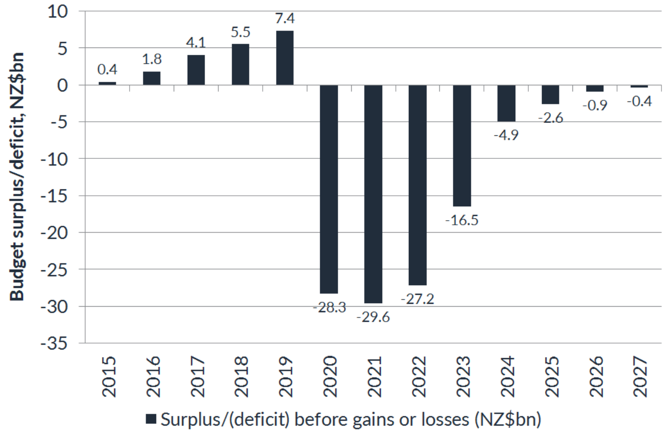
There were no new initiatives announced to incentivise business investment. There were neither tax cuts nor tax increases. The increased infrastructure spending wasn't tagged to specific projects; instead they will be chosen based on the recommendations of the Infrastructure Reference Group, with priorities given to projects targeting water quality, transport, housing, environment and health.

From surplus to deficit — debt piling up, RBNZ manning the printing presses

On current projections (Figure 1, below), the government budget is not forecast to return to surplus until 2028. Government bond issuance to fund this support package is forecast to increase to $190 billion over the next five years (from $42 billion previously). Net debt is forecast to rise to 53% of GDP by 2023 (from 19% in 2019) (Figure 2).

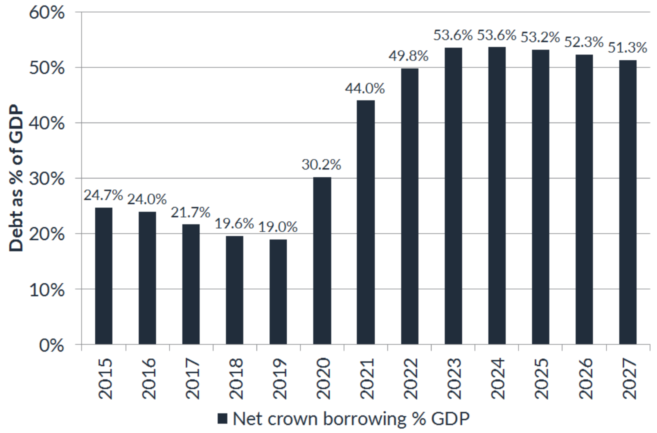
In order to fund those deficits the RBNZ has increased its quantitative easing (QE) capacity to a mammoth $60b pa. That is meant to keep interest rates artificially low.

Figure 1. Forecast NZ government annual surplus/(deficit)



Source: NZ Government, Forsyth Barr analysis

Figure 2. Forecast NZ net government debt as % of GDP



Source: NZ Government, Forsyth Barr analysis

Where to from here? Long-term effects debatable

The RBNZ's QE policy should spark up debate around whether ultra-low interest rates are beneficial. In the paradigm of the world's central bankers, ultra-low rates are meant to boost asset prices, discourage saving, encourage spending, boost bank profitability and lending and lower the currency, thereby driving higher growth, employment and inflation. Some would argue that ultra-low rates in fact discourage spending by savers, shift savings into higher-risk and speculative assets, and reduce productivity growth; all of which would impinge on economic growth and inflation. Time will tell.

The policy debate leading into the election may highlight the distinctions between the political parties' long term visions, which will determine the potential implications for financial markets depending who holds the Treasury benches after 19 September.

Themes of the Week

Fixed Interest

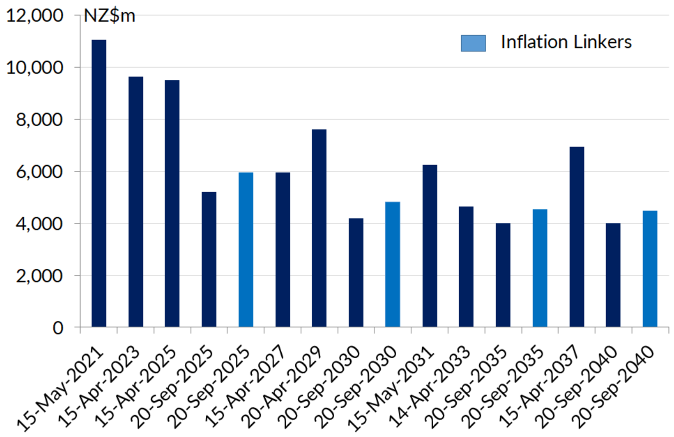
Crank up the printing press

A wall of debt will hit the market over the next year with the New Zealand Government expected to borrow an additional NZ$50bn in response to the economic impacts of COVID-19. The New Zealand Debt Management Office (DMO), which issues the debt on behalf of the government, will issue around NZ$1bn of debt per week for the next year. The next three weeks' tenders have already been announced, with NZ$1,050m to be issued each week, with a new May 2024 maturity set to kick-off in June. The individual cap sizes for each tranche has also been increased from NZ$12bn to NZ$18bn.

Selling it to ourselves

Who will buy all of this new issuance? More than likely the Reserve Bank of New Zealand (RBNZ) via its recently upsized Quantitative Easing (QE) programme. The RBNZ has been granted a ceiling of NZ$60bn, of which it has so far spent around NZ$10bn buying New Zealand Government Bonds (NZGBs) and a few Local Government Funding Authority (LGFA) Bonds.

Figure 3. NZGBs on issue



Source: Forsyth Barr analysis, NZ DMO

Figure 4. NZGBs to be issued

Year ending 30 June (face value)	2020	2021	2022	2023	2024
Gross NZGB issuance (NZ$bn)	25.0	60.0	40.0	35.0	30.0
NZGB maturities and repurchases (NZ$bn)	5.4	11.1	0.0	15.8	15.4
Net NZGB issuance (NZ$bn)	19.6	48.9	40.0	19.2	14.6
NZGBs on issue (NZ$bn)	90.2	139.1	179.1	198.4	213.0
NZGBs on issue (% of GDP)	31%	47%	55%	56%	57%
Forecast Treasury Bills on issue (NZ$bn)	10	10	10	10	10

Source: Forsyth Barr analysis, NZ DMO

QE has delivered lower yields but not liquidity across the market

At present the RBNZ buys these bonds via the secondary market, however, the central bank has not ruled out buying bonds directly from the DMO. This provides liquidity and enables the owners of those bonds, primarily the banks, to sell these bonds and to lower yields, reducing borrowing costs for the government. The theory is that with yields heading lower, sellers of the bonds will then invest in higher yielding bonds i.e. corporate bonds, creating a flow on effect of lowering yields down the line. This part hasn't worked so well in practical terms, with the liquidity in the corporate bond sector remaining very poor.

Issuance (everywhere but here)

The corporate debt issuance train just keeps on chugging away but has so far failed to stop at New Zealand. Record debt issuance in the US has seen many options presented to investors and Australian companies are also getting in on the action. Woolworths (BBB) raised A$1bn last week via a five and a 10 year transaction. The A$400m five year deal was priced at a credit spread of 145bp. By way of comparison Vector, which is also rated BBB, has a security quoted on the NZDX with five years remaining trading at a 161bp spread.

Listed Property

Moving parts in a steady industry

One industry that is currently being challenged in an unprecedented way is property. Rent collection has become a prickly issue in New Zealand with many businesses unable to access their premises over the government-enforced lockdown, while other businesses have seen revenues fall by up to -100%. This has left some property owners in a unique position, where they must try to balance the needs of the tenant and the bounds of their lease.

Rent relief impacting LPV revenues

This week, we published a report — *Real Estate Reflections: Flattening the Earnings Curve* — in which **we revised down our earnings estimates for the NZ Listed Property Vehicles (LPVs) over the next few years**.

Company announcements and industry anecdotes suggest that LPVs are being good corporate citizens, providing a mix of deferrals and abatements to tenants in need of rent relief. With the government not announcing a package to support tenants or landlords, **we expect rental support to be landlord-funded**.

LPVs with retail properties will be the most impacted, while those with industrial or medical portfolios should be the best placed. We estimate that gross rents will be impacted by -1% to -14% depending on LPV exposure (Figure 5).

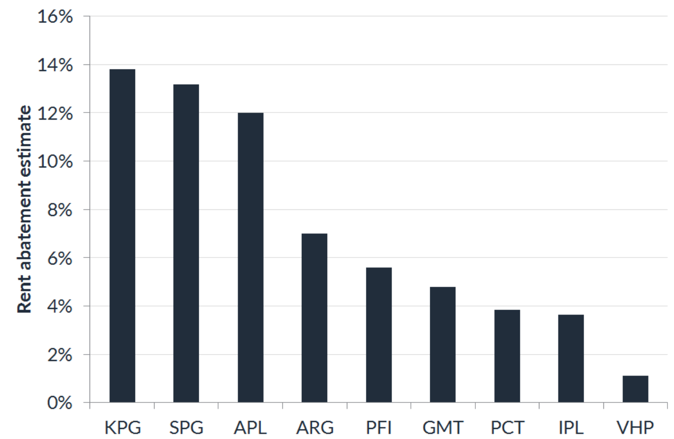
While rent relief will impact LPV revenues and willingness to pay distributions, some of this impact will be offset by the reinstatement of building structure depreciation, and lower interest costs.

Depreciation/tax changes and lower interest rates provide earnings tailwinds

As part of the initial stimulus package announced by the government in mid-February, the ability for landlords to depreciate commercial building structures was reinstated from April 2020. **This change results in a significant tax benefit for commercial property owners**; for LPVs, we estimate a +2% to +9% benefit to adjusted funds from operations (AFFO — a measure of financial performance in the property sector [Figure 6]).

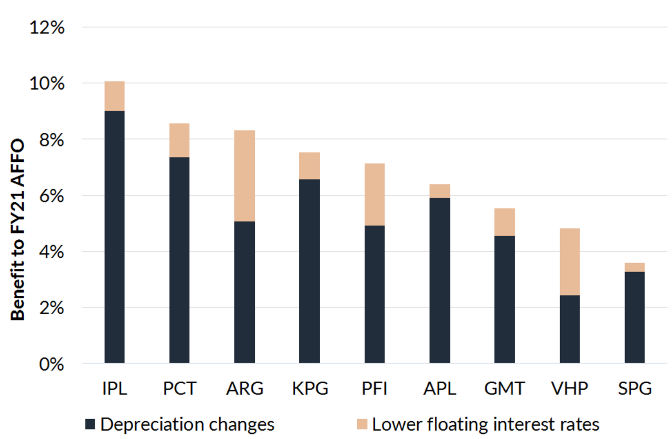
Another tailwind for earnings stems from lower interest costs. With the Reserve Bank of New Zealand lowering the Official Cash Rate to 0.25%, floating interest rates have fallen to record low levels. We estimate this will provide an additional AFFO benefit of between +0% and +3% for the LPVs.

Figure 5. Estimated rent abatement in CY20 (% of gross rent)



Source: Forsyth Barr analysis

Figure 6. Benefit of lower tax and interest expense (% of AFFO)



Source: Forsyth Barr analysis

Following our earnings changes we continue to like LPVs with defensive asset bases and lower near-term uncertainty, retaining our preference for **Investore** (IPL), **Property for Industry** (PFI), and **Vital Healthcare Property** (VHP). Our least preferred LPVs remain **Kiwi Property** (KPG) and **Asset Plus** (APL).

What's next for the LPVs?

As with past cycles and recessions **we are likely to see a significant downward adjustment in market rents as economic conditions weigh on occupier demand**. Downsizing of existing requirements, revisited growth ambitions, and changed work habits (increased working from home, potentially offset by a need for greater physical distancing) will impact demand across all sub-sectors. In recessionary periods market rents typically take 2–3 years to bottom.

The LPV sector is generally in better shape than it was heading into previous down-cycles, with higher quality assets and lower gearing. Additionally, strong leases, good tenant quality, and LPV portfolios being under-rented should provide some cushioning if market rents take a fall or if vacancy lifts.

Over the coming weeks, seven LPVs will be reporting results, which will provide further insight into the sector's financial health and outlook.

Research Worth Reading

New Zealand

NZX (NZX.NZ) — The Wise Man Built His House Upon The Rock…

We initiate coverage of NZX with an OUTPERFORM rating and a target price of NZ$1.57. We believe NZX presents an excellent buying opportunity for the long term investor, exhibiting both defensive qualities and an attractive growth profile. OUTPERFORM. (Published by Forsyth Barr)

Z Energy (ZEL) — Pumping in the Equity — FY20 Result

ZEL's FY20 result announcement was the supporting act to the equity raise announcement and cost out initiatives. ZEL last week raised $290m from an Institutional Placement and plans to raise $60m from a Share Purchase Plan. The equity raise is required to improve balance sheet metrics due to COVID-19 negatively impacting on operational performance. In addition to the equity raise, ZEL has indicated it is targeting to deliver $74m of opex saving in FY21 and will not be paying a dividend until 30 September 2021, at the earliest. The FY20 result was slightly ahead of expectations and ZEL's latest guidance, but not materially so. RESTRICTED (Published by Forsyth Barr — **Forsyth Barr Limited is a Co-Lead Manager of the Institutional Placement and Share Purchase Plan and will receive fees in connection with this role.**)

Australia

Amcor (AMC.AX) — Third-quarter FY20 result review

AMC delivered a third-quarter FY20 underlying net profit of $246m, up +36.5% on the same period last year. Underlying earnings before interest and tax (EBIT) of $360m came in +9.8% above a year ago. AMC remains Ord Minnet's key preference in the packaging sector. Ord Minnett sees ample opportunity for the company to grow ahead of peers. ACCUMULATE. (Published by Ord Minnet)

APA Group (APA.AX) — Defensive & growing yield, upgrade to Buy

Aside from the lower FY20 earnings related to Orbost delays, Citi's earnings estimates are largely unchanged. At Orbost, Citi has estimated the liquidated damages APA may be liable for, should the plant not reach its nameplate capacity. BUY. (Published by Citi)

Aristocrat Leisure Limited (ALL.AX) — SciGames result reflects US land-based industry pressure

ALL's pokie machine competitor SciGames' saw a deterioration in outright sales, gaming ops, and systems revenues in its March quarter, with COVID-19 pressures becoming more disruptive through the quarter. While ALL faces similar industry pressures, Citi believes ALL's strong balance sheet position and game outperformance places the company well to outperform its US land-based competitors. BUY. (Published by Citi)

Australian Banks — 1H20 Results: When 'Unquestionably Strong' is Not What it Seems

1H20 saw the major banks take the opportunity to prepare their balance sheets for the COVID-led economic crisis. Pending write-downs and costs were brought forward; collective provisions were boosted; and dividends deferred or materially reduced. Capital now appears sufficient even for the worst case, and if APRA is satisfied, dividends are likely to resume at FY20 results. Earnings and credit quality will be impacted, but dilutive capital raisings are now very unlikely. Citi's new order of preference is National Australia Bank (NAB), Westpac (WBC), ANZ, and finally Commonwealth Bank (CBA). (Published by Citi)

BHP Limited (BHP.AX) — Attractive sustainable yield? Upgrade to Buy

BHP has declined -20% since February 2020 due to COVID-19 and the breakdown of OPEC+. In UBS's view, BHP is in a strong position with gearing at 17% and net debt of US$12bn (target range of US$12-17bn). This should enable BHP to continue to return surplus cash to shareholders at a time when other more traditional dividend paying stocks are not. BUY. (Published by UBS)

CSL Limited (CSL.AX) — It's a wrap — March Q low surprise, COVID-19 complicates outlook

UBS assesses quarterly financial performance and market commentary from key CSL competitors, suppliers and royalty contributors. BUY. (Published by UBS)

Origin Energy (ORG.AX) — Energy Markets earnings revisions

Following AGL Energy's earnings notice last week, Ord Minnett has trimmed its ORG estimates for the Energy Markets business. ACCUMULATE. (Published by Ord Minnett)

Sonic Healthcare (SHL.AX) — COVID-19 Impact will be largest in April. Quicker recovery expected in Australia than international markets

A number of data points from the pathology, imaging and GP sectors which indicate April testing volumes in the underlying business are down materially on pcp due to COVID-19. SHL's Balance Sheet remains strong. Citi maintains a Buy for this defensive business, and views these assets as critical national infrastructure. BUY. (Published by Citi)

Xero Limited (XRO.AX) — FY20 result slightly below expectations, outlook unclear

Xero reported a maiden full year profit in FY20 of $3.3m. While UBS remains supportive of Xero's strategy and highlights strong execution by management, uncertainty around near-term operating trends and an unfavourable risk-reward on a medium-to-long term basis lead UBS to maintain its Sell rating and $58.50 price target. SELL. (Published by UBS)

International

Alphabet Inc (GOOGL.US) — Updating Our Model and Target Price

Citi has updated its model to reflect 1Q20 results and latest post-COVID outlook. Citi now models +5% year-on-year growth in 2020, with full-year revenue reaching $169.6 billion, and expects a +20% year-on-year rebound in 2021, with full-year revenue reaching $203.4 billion. Citi maintains a Buy rating and has raise its target price to $1,600 from $1,400. BUY. (Published by Citi)

Apple (AAPL.US) — China Smartphone Data Suggests Release of Pentup Demand; Non-Android Mix No Longer Available

Monthly smartphone shipments in China were at levels not seen since December 2017, suggesting release of pent-up demand post COVID-19. UBS expects 2021 to be strong year for iPhone sales, driven by 5G and the increase in purchase intent among customers in the US; UBSs recent smartphone survey supports this notion. BUY. (Published By UBS)

ING (INGA.NA) — Strong Q1 results highlights value at 4.8x 2022E P/E despite asset quality uncertainty

ING delivered better than expected results in Q1 2020. Strength from net interest income and fee income is welcome and supports +1-2% upgrades to pre-provision estimates. UBS details in this report why it still thinks its assumptions are conservative. BUY (Published by UBS)

Roche Holding AG (ROG.S) — TGIT. We're Still Totally Digging it. Reiterate Buy

ROG's tiragolumab data in 1st line NSCLC (lung cancer) surpassed Citi's high expectations. Dependent on confirmatory phase III data, the chemo-free combination of tiragolumab + Tecentriq may represent the new standard of care for up to 33% of all 1st line NSCLC patients. Citi believes that there is little discounted in the share price of Roche for TIGIT. BUY. (Published by Citi)

Tencent Holdings (0700.HK) — 1Q20 earnings review: strong results more than just stay-at-home benefits

UBS continues to like Tencent for product driven catalysts beyond the near term stay-at-home benefits. In particular, UBS sees a ' strong games pipeline at least into 2021. Management's comments on the earnings call give more confidence, as they noted major upcoming titles in both China and abroad. BUY. (Published by UBS)

Calendar

Figure 7. Calendar

Date	New Zealand	Australia	International
18-May			JP: GDP (Q1)
19-May	PPI Input (Q1)	Home Loans (MoM)	UK: Average Earnings Index (Mar)
	PPI Output (Q1)	Invest Housing Finance (MoM)	UK: Claimant Count Change
	RBNZ Offshore Holdings (Apr)	RBA Meeting Minutes	EU: German Economic Sentiment (May)
		James Hardie 4Q20	
20-May	GlobalDairyTrade Price Index	MI Leading Index (MoM)	US: Building Permits (Apr)
	FPI (Apr)		UK: CPI (Apr)
	Argosy Property FY20		EU: CPI (Apr)
21-May	Credit Card Spending (YoY)	Manufacturing PMI	US: Oil Inventories
		Services PMI	US: FOMC Meeting Minutes
		Aristocrat Leisure 1H20	UK: Composite PMI
			UK: Manufacturing PMI
			UK: Services PMI
22-May	Core Retail Sales (QoQ)		US: Initial Jobless Claims
	Retail Sales (QoQ)		US: Philadelphia Fed Manufacturing Index (May)
			US: Existing Home Sales (Apr)
			UK: Retail Sales (Apr)
			EU: German Manufacturing PMI (May)
			NVIDIA Corp 1Q21
			Medtronic 4Q20
23-May	CFTC NZD Speculative Net Positions	CFTC AUD Speculative Net Positions	

Source: Forsyth Barr analysis

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