

# Wealth Weekly

## Level 2, Here We Come!

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Markets around the world continue to take the likely dramatic economic impact of COVID-19 and renewed threats of a US-China trade war in their stride. Investors seem to be focussing on the easing of pandemic containment measures and the return of business activity to more normal levels. Locally, the move to Alert Level 2 from Thursday has been keenly anticipated. Apart from large events and international tourism, most of the economy will be able to operate. Given that markets have already recovered the majority of their pandemic-induced losses, it will be interesting to see how they (and governments) respond if there are "second wave" outbreaks of the pandemic as some health experts fear – which might bring renewed restrictions.

**What business wants from the pandemic Budget**

The Budget is due out this Thursday. The Minister of Finance has indicated further support for the economy will be forthcoming, but has been playing his cards close to his chest as to what form that might take. In our proprietary survey of New Zealand businesses, undertaken last week, **the most requested policy response from government was a continuation of wage subsidies, followed by cuts to company/income/sales taxes, and taxpayer-sponsored rent subsidies.** The challenge for the government (and/or the Reserve Bank) is how to fund the fiscal response, not least given the desire from businesses for tax relief.

Our survey quantified the challenges domestic businesses have faced. **The recovery path after the pandemic ends is likely to be a long one.** Surprisingly, larger businesses are more pessimistic on the time to recovery than small businesses, and appear to be responding to COVID-19 in a more aggressive fashion with more capex deferrals, redundancies and pay cuts than small businesses.

**Themes of the week**

**The government's guidelines on Alert Level 2 appear less restrictive than initially envisaged.** The key area of relaxation is to permit domestic travel, providing a unique window of opportunity for New Zealanders to explore their backyard without international tourists. Companies under our coverage that we expect to benefit most from a shift from Alert Level 3 to 2 are **Abano Healthcare** and the non-food retailers including **Michael Hill, The Warehouse Group, Briscoe Group** and **Kathmandu.**

The post COVID-19 world will be subject to lower economic and earnings growth, and continued low interest rates, in our opinion, which will create scarcity value among higher quality income and growth companies. This is reflected in our portfolio positioning. We continue to favour COVID-19 immunity in the form of lower-risk defensives such as utilities (**Contact Energy, Genesis Energy, Meridian, Mercury NZ**) and telcos (**Spark** and **Chorus**), and selective growth companies (**a2 Milk, Mainfreight, Arvida**).

Looking across the Pacific, the US Presidential election, due on 3 November, creeps closer. **The tight election race and rebounding share market may tempt Trump to reignite a trade confrontation with China** to emphasise his global heft to voters. **Tariffs are unequivocally bad for economies, and they matter for consumer and investor sentiment too,** as we saw in 2018 when the combination of a trade war and the withdrawal of stimulus led investors to spit the dummy and dump stocks to the tune of a -20% decline in the fourth quarter. A resumption of the trade war is a threat to keep an eye on.

**Looking ahead**

The Reserve Bank of NZ will release its interest rate decision on Tuesday and the government will present its Budget on Thursday. Commonwealth Bank reports results on Wednesday and Tencent on Thursday.

# COVID-19 business impact survey

## Feedback from business; U rather than V

Between 1–6 May we ran a survey of Forsyth Barr contacts in the New Zealand business community, asking how their businesses are being impacted by COVID-19, what they expect the recovery time frame to be when the pandemic ends, and what additional policy responses they would like from the government.

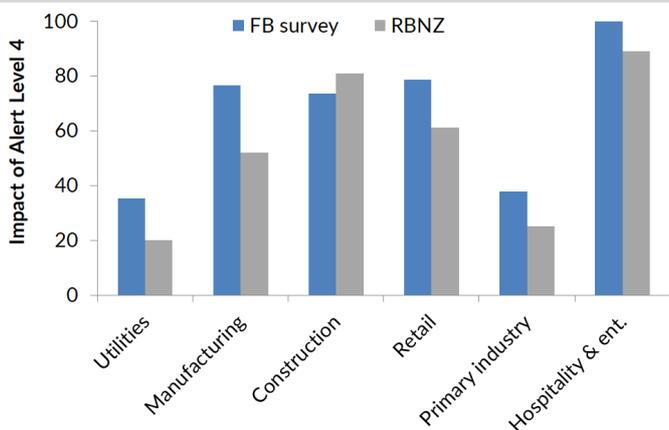
We received 271 responses, predominantly from owners, directors and executives. Almost a quarter were from businesses generating more than NZ\$100m annual revenue and around half were from small businesses with less than NZ\$10m.

### "How much has your business been impacted by Alert Level 4 [Alert Level 3] lock-down?"

Our survey suggests the revenue impact of COVID-19 averaged -60% for our respondents at Alert Level 4, and -40% at Alert Level 3. The hospitality, tourism, person transport and retail sectors have unsurprisingly been most impacted. Healthcare providers have also been significantly impacted. Manufacturing and construction have seen the biggest relative increase in activity following the shift to Level 3.

Our survey doesn't include the public sector, which has been less impacted, so shouldn't be seen as a proxy for the hit to GDP. Even so, on a sector-by-sector basis, our respondents expect bigger impacts than the Reserve Bank estimated in a report released this week.

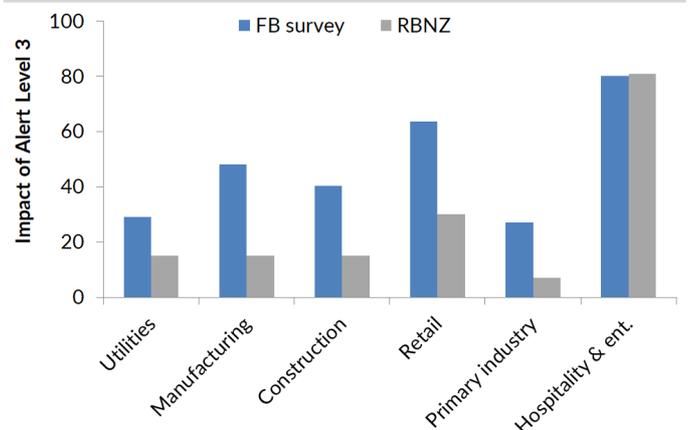
**Figure 1. Impact of Alert Level 4 on various industry sectors**



Source: RBNZ, Forsyth Barr analysis NOTE: The RBNZ data reflects proportion of pre-COVID-19 GDP. The Forsyth Barr survey data is from respondents answering the question "How much has your business been impacted by Alert Level 4 lock-down?" Survey answers may also reflect perceptions/views rather than actual economic output.

Source: Forsyth Barr analysis

**Figure 2. Impact of Alert Level 3 on various industry sectors**



Source: RBNZ, Forsyth Barr analysis NOTE: The RBNZ data reflects proportion of pre-COVID-19 GDP. The Forsyth Barr survey data is from respondents answering the question "How much has your business been impacted by Alert Level 3 lock-down?" Survey answers may also reflect perceptions/views rather than actual economic output.

Source: Forsyth Barr analysis

### "How will COVID-19 impact your business during 2020?"

Around 70% of respondents' businesses claimed government wage subsidies. The next most common impacts (in order of frequency) were: capex deferral, executive pay cuts, receiving rent relief, reviewing funding arrangements, cutting dividends, and redundancies. (Figure 3).

Depending on the sector, between 20% and 80% of businesses are deferring capex. Sectors in which more than half of businesses are deferring capex include tourism, freight/logistics, retirement villages, hospitality and entertainment, utilities, person transport and manufacturing.

Job losses look likely across the board, but particularly in the tourism, consumer transport, freight/logistics, hospitality and retail sectors.



## Themes of the Week

### Equities

#### NZ Equity Strategy – Relaxing Restrictions; Looking to Alert Level 2

The move to Alert Level 2 this week is broadly consistent with the Treasury's best case scenario for economic recovery (one month at Level 4, one month at Level 3 and then 10 months at either Level 1 or 2).

Alert Level 2 will see most businesses re-open, albeit with meaningful restrictions. It will see bubbles dissolve, schools re-open, domestic travel recommence and the return of a range of social opportunities (shopping, eating out, sport, public places).

However, restrictions around physical distancing, gathering numbers and health & safety measures will likely increase business costs. While the new guidelines are clear, how consumers will behave in the new environment is not. There is likely to be some level of pent up demand on re-opening, at least initially (evidenced by the rush to takeaways on re-opening during Level 3). But the consequences of lockdown (actual or perceived risk of business failures, salary reductions, job losses) and consumer caution will have a meaningful impact on the recovery slope.

The winners from steps down in Alert Levels (Figure 6) include the following:

- Alert Level 3 to 2: Key beneficiaries are consumer facing companies given the re-opening of stores, malls and dental practices, albeit with meaningful restrictions. Under our coverage this includes **Abano Healthcare** and non-food retailers (**Briscoe Group**, **Kathmandu**, **Michael Hill International** and **The Warehouse Group**).
- Alert Level 2 to 1: An expected removal of restrictions and lower risk perception should most benefit casino and hospitality operator, **SKYCITY**, and enable materially improved productivity on-site for the building sector.
- Alert Level 1 to 0: An eventual re-opening of borders will have a material impact for transport and tourism players **Auckland Airport**, **Air New Zealand** and **Tourism Holdings**.

Figure 6. Our analysis of Alert Level winners

Alert Level 4 to 3		Alert Level 3 to 2		Alert Level 2 to 1		Alert Level 1 to no alert	
Restaurant Brands NZ	8	Abano Healthcare Group	8	SKYCITY	4	Auckland Airport	7
Fletcher Building	6	Michael Hill Intl	7	Fletcher Building	4	Air New Zealand	6
Metro Performance Glass	6	The Warehouse Group	6	Metro Performance Glass	4	Tourism Holdings	6
Steel & Tube Holdings	6	Briscoe Group	6	Steel & Tube Holdings	4	Refining NZ	5
		Kathmandu Holdings	6				

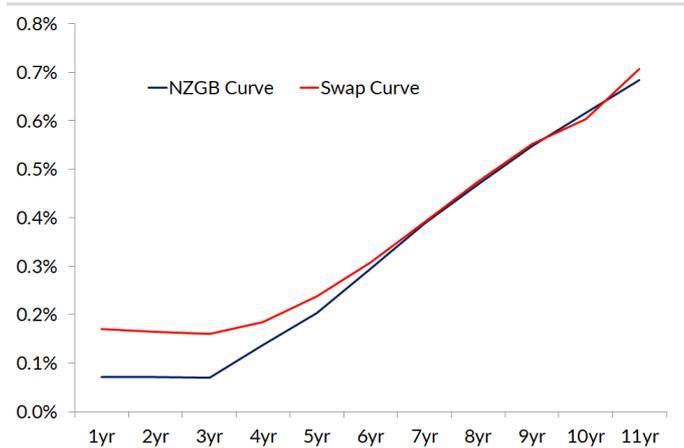
Source: Forsyth Barr analysis NOTE: refer to Figure 2 for full analysis . Numbers represents change in company exposure to COVID-19 between each alert level.

## Fixed Interest

### Government more risky than corporates?

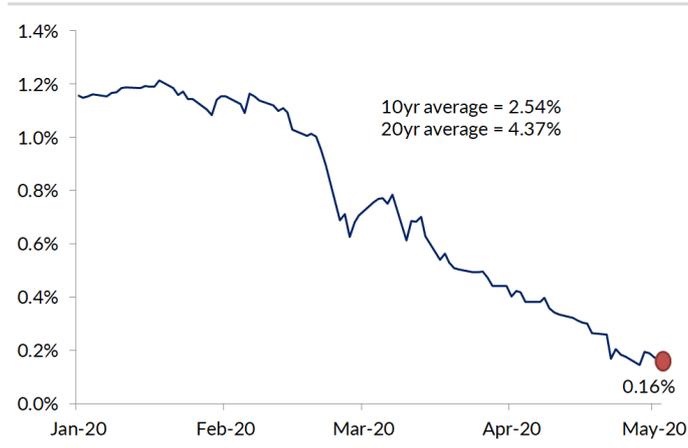
As was the case during the Global Financial Crisis (GFC) when the government stepped in to support the financial markets and economy, the swap spread (the difference between the swap yield curve and New Zealand Government Bond [NZGB]) yield curve is negative at the longer end of the curves (Figure 7). In 'normal times' there is a spread of 20–40bp between the two (the swap curve is usually higher than the "risk-free" NZGB curve). What this suggests is that with the government standing behind so much of the economy by underwriting loans to businesses, the market believes there is less risk at a corporate level and more risk at a government level given the billions in new debt it is taking on. For fixed income investors it means the spread over the risk free rate (NZGBs) is contracting. Fixed income funds have been positioning themselves to benefit from expected interest rate declines by engaging in swaps to "receive fixed/pay floating", which has also driven swap spreads in.

**Figure 7. NZ Government Bond and Swap curves**



Source: Forsyth Barr analysis, Thomson Reuters

**Figure 8. One year swap rate (YTD)**



Source: Forsyth Barr analysis, Thomson Reuters

### Annual reset securities sector

The annual reset securities sector has been around in New Zealand debt markets for many years now, however, in general the sector has not always been a great place to be for investors. The recent sharp falls in wholesale interest rates (see 1yr swap rate in Figure 8 above) highlights one of the difficulties for the sector. Coupons/dividends that are reset annually fall along with falling interest rates:

$$\text{Coupon/dividend} = \text{benchmark interest rate (often the 1yr swap rate)} + \text{the reset margin (set when the security was issued)}$$

If we were forecasting interest rates to rise then it may be a different story, but that is not likely to be the case for a long-time.

So one part of the equation (benchmark interest rate) is falling, what about the other part: the reset margin? The reset margin not only provides one part of the coupon/dividend calculation but it is also supposed to reflect the credit risk of the security.

### As always, we must ask ourselves 'are we being appropriately compensated for the risk?'

Almost all the securities in this sector (except IFTHC) were issued before the GFC. The reset margins reflect the lower risk environment that prevailed at that time. With credit spreads (margins) having widened after the GFC and COVID-19, the reset margins look tight. If these securities were being issued today then an investor might want an annual reset margin in the order of 5.0% or 6.0% in some cases. The only two securities with appropriate reset margins based on current credit spreads (margins) in our view are Nufarm (NFFHA) and Works Finance (WKSHA). Even if interest rates go to 0% then the dividends on these will be 3.90% and 4.05% respectively.

The latest to issue in this sector was Infratil with IFTHC, albeit not a perpetual but a 10-year security, which does have a clause that the benchmark interest rate (1yr swap rate) could not go below 0% when the coupon was reset annually. This effectively means that if interest rates were to go negative then the minimum coupon rate would be 2.50% for IFTHC.

**WKSHA** remains the pick of the sector given the \$200m on issue, the 4.05% reset margin and the investment grade credit rating of the Issuer (Downer); WKSHA itself is not rated. Nufarm (**NFFHA**) is a silver medallist here, given its 3.90% semi-annual reset margin, but liquidity is an issue alongside increased risk and volatility given its low ranking position in Nufarm's capital structure.

## Macro

### Keeping a weather eye on Trump

US weekly jobless claims number in the millions and the unemployment rate reached 14.7% in April. How long the environment remains this dire depends on the duration of lockdowns – numerous States have begun planning to ease social distancing measures – and whether there will be a second wave of infections and renewed restrictions.

Any return to normality will have a potential sting in the tail. November 3 brings the US Presidential election. Trump will not have a buoyant economy to float him into a second term. Rebounding markets may embolden the self-styled Tariff Man to reignite hostilities with China. US consumers, who are dealing with some of the harshest economic conditions in many decades, are rightly worried about more tariffs making life even harder. A recent survey showed an increasing awareness of the impact of trade conflict on household budgets. A fresh trade dispute will test frayed resilience.

Ironically, one thing in investors' favour is the fragile state of the US economy, which may restrain Trump from acting on one of his worse impulses. We will be parsing Presidential language with watchful interest as November nears.

## Equity funds

### Worldwide Healthcare (WWH.L) – Manager update: All well in healthcare

We held a conference call on Friday with one of the managers of Worldwide Healthcare Trust (WWH.L). WWH is up +9.8% in NZD for the year-to-date, outperforming the sector index by around +1%, and significantly outperforming the broader market's -3.2% decline.

### Pandemic spring-clean

The fund managers used the volatility in March to focus the portfolio on the team's best healthcare stock ideas and on high quality stocks. While the manager expects the short-term financial impact of the pandemic to be minimal for the sector as a whole, the fund did sell some of the stocks that were expected to see temporary sales reductions due to the pandemic.

Speaking about the pandemic more broadly, the manager believes a "second wave" of COVID-19 outbreaks is a matter of "when", not "if", after lockdowns end. Therapies to reduce the severity of the disease could become available by the end of 2020, but it is questionable whether vaccines will become available soon enough and in sufficient quantities to supply the world by the end of 2021.

Scores of healthcare companies are involved in developing tests, vaccines and treatments for COVID-19. The manager has not been chasing these names (except where there is a broader investment case beyond the pandemic) and indeed has taken profits on some prominent COVID-19 plays, as such efforts seldom generate sustainable earnings.

### Political drag diminishing

The political risks that were a drag for pharma, biotech and health insurance companies for much of the last half decade appear to be diminishing. The sidelining of socialist Bernie Sanders in favour of the more moderate Joe Biden in the contest to be the Democratic Party's nominee in this November's presidential election has put an end to the Medicare For All policy. That policy would have obliterated the private health insurance sector and put pressure on prices in the rest of the sector.

The industry's constructive role in managing the pandemic and in searching for a cure for COVID-19 has burnished its media image, which makes it harder for politicians to bash healthcare companies. Even if there is further political rhetoric ahead of the elections, any actual reforms are likely to remain modest. Whoever wins the presidential election will require the support of what is likely to be a Republican-controlled Senate and a Democrat-controlled House of Representatives, which limits the scope for reform.

### Long-term tailwinds still blowing strong

Apart from some pockets of high valuations in tools and devices, valuations in the sector remain fair, while the long-term growth tailwinds remain intact:

- The technical innovation cycle in the industry is the strongest in decades.
- The US Food & Drug Administration is operating an industry-friendly regime which has supported record new drug approvals.
- Demand growth is being driven by ageing, obesity and rising wealth in emerging markets.
- Mergers & acquisitions activity looks set to resume in the second half of the year as big drug companies buy small innovative biotech companies to replenish their sales pipelines.

## Research Worth Reading

### New Zealand

#### **Power Points – Priced to Outperform**

We are upgrading Meridian Energy (MEL) and Mercury (MCY) to OUTPERFORM in a sector-wide call that we expect the electricity stocks to do well in the coming months. Relative to other quality yield stocks and record low interest rates, the electricity sector is trading at a record discount. We do not expect this discount to last as the market recognises and pays for the electricity sector's defensive characteristics. (Published by Forsyth Barr)

#### **Kathmandu (KMD.NZ) – Treading new tracks**

KMD has begun to reopen its store doors as its trading markets look to exit lockdowns and consumer activity begins to return; KMD offers attractive risk reward in our view and we reinstate with an OUTPERFORM rating. (Published by Forsyth Barr)

#### **New Zealand King Salmon (NZK.NZ) – Diverging Channels**

NZK is facing difficult market conditions, although strong operating performance is expected to offset near-term sales disruption. NZK's key foodservice export market is likely to be under pressure into FY21E in our opinion, as COVID-19 weighs on freight availability impacting margin. However, medium-term growth, underpinned by current consents, remains attractive in our view. Although not captured in our forecasts, we see significant upside should NZK be successful in gaining additional water space, particularly offshore, where volume uplifts could be meaningful. OUTPERFORM. (Published by Forsyth Barr)

#### **Property For Industry (PFI.NZ) – 1Q20 Update Dividend Confirmed**

PFI confirmed its 1Q20 dividend. It is providing some relief to tenants on a case by case basis, which could potentially be entirely offset by benefits from lower floating interest rates and higher building depreciation allowances. As such, we see potential upside risk to our FY20 DPS of 5.8cps. PFI remains one of our preferred exposures in the listed property vehicle sector given its defensive attributes, internal management structure, and strong track record throughout a number of cycles. OUTPERFORM. (Published by Forsyth Barr)

#### **Pushpay (PPH.NZ) – COVID-19 pulls forward digital giving**

PPH delivered an FY20 result that was in-line, or slightly ahead, on all key guidance metrics, largely due to a positive COVID-19 impact, which essentially pulled forward digital donations. Had churches not closed in mid-March, the result may well have looked different. What didn't positively surprise was the front book. Key data points (net adds and incremental sub growth) continue to suggest lacklustre momentum, particularly considering the land grab opportunity COVID-19 has presented. SELL. (Published by Ord Minnett)

### Australia

#### **Goodman Group (GMG.AX) – Q3 Update: developments maintained with plenty more to come**

Structural trends driving GMG's business were stronger than anticipated in a period of unprecedented uncertainty. Concerns from the market regarding maintaining development WIP have been largely negated as GMG stated it continues to progress \$3-4bn in development transactions. Timing of development earnings from these projects is less clear given the longer-dated development schedule, but given the expected size of the development book, GMG has increased flexibility. NEUTRAL. (Published by UBS)

#### **James Hardie Industries (JHX.AX) – Business update**

JHX's revised FY20 net profit guidance and the suspension of dividends and capex guidance for FY21 were all in line with Ord Minnett's estimates. The near-term outlook for demand appears weak and uncertain, but Ords believes JHX has sufficient liquidity to generate positive cash flow in FY21, aided by its decisions on dividends and capital expenditure. BUY. (Published by Ord Minnett)

#### **Macquarie Group (MQG.AX) – Overwhelming firepower**

A strong balance sheet combined with near zero rates should see MQG successfully manage the current COVID-led downturn. The FY20 result showed real underlying strength ex-provisioning. However, there is a material blip coming in FY21. MQG's balance sheet

strength provides medium-term upside if good quality assets become available at reasonable prices (there haven't been many in recent years). Transformational opportunities are uncertain and it is too early to have confidence in a quick economic recovery, so we think investors should be cautious about overpaying until the impacts are better understood. NEUTRAL. (Published by Citi)

#### **Origin Energy (ORG.AX) – Origin gets 'Kraken' on transforming its retail business**

ORG acquired a 20% stake in UK-based Octopus Energy and expects its customer relationship management and billing platform 'Kraken' will transform the customer experience in its retail business. ORG expects Kraken to deliver pre-tax cash savings of \$70–80m in FY22e, increasing to \$100–150m (UBSe \$100m) annually from FY24. BUY. (Published by UBS)

#### **Qube Holdings (QUB.AX) – Strap in for the next leg of the journey**

QUB's \$500m entitlement offer reduces its net debt/EBITDA ratio to 4.5x in FY20e and provides headroom for its growth plans or M&A in what is an attractive market for a buyer. Major share price and return on capital catalysts include new tenant announcements for Moorebank and/or progress in securing a development partner for the project. BUY. (Published by Ord Minnett)

#### **Sonic Healthcare (SHL.AX) – Covid testing under the microscope**

Polymerase chain reaction (PCR) testing for COVID-19 (which UBS estimates will generate ~A\$233m of revenue for SHL in CY20) is unlikely to offset the ~A\$258m decline in routine lab work during the pandemic. The net EBIT impact is expected to be more significant since the COVID-19 testing likely has thinner margins than the routine work that has been lost. UBS currently forecasts Australian pathology revenue to normalise by the start of January 2021. SELL. (Published by UBS)

#### **Transurban Group (TCL.AX) – Elevated valuation despite dividend uncertainty**

Overall, Citi believes that TCL's traffic outlook may be improving from a very low base, but uncertainty on revenue and distribution policy and elevated valuation keeps Citi cautious on the stock. TCL's traffic update indicates a small recovery in traffic in the last week of April. With various Australian states indicating a slight easing in restrictions, traffic growth may rebound, albeit Citi expects traffic to stay below pre-COVID-19 levels at least until December 2020. SELL. (Published by Citi)

## **International**

#### **Amazon.com (AMZN.US) – Updating Model; Maintain \$2700 TP**

Citi expects a near-term revenue tailwind owing to a surge in ecommerce demand, partially offset by near-term headwinds in Amazon's more profitable AWS (cloud) and advertising segments. Combined with COVID-related expenses, Citi sees near-term margin pressures, but expects these expenses to be temporary and for these pressures to subside by 2021. BUY. (Published by Citi)

#### **Apple (AAPL) – What Goes Around Comes Around**

Citi expects 5G iPhones to be announced in September and available in the final calendar quarter of 2020. The launch is likely to be delayed beyond the traditional mid-September time frame given delays in testing due to travel restrictions. Citi believes AAPL deserves to trade at a +10-15% premium to the market multiple given Apple's unique product and service set and potential for strong cash flow generation and shareholder returns. BUY. (Published by Citi)

#### **Comcast Corporation (CMCSA) – Looking Towards A Better Tomorrow for Comcast**

Comcast's cable results continued to show resiliency as a core residential connectivity provider with higher free cashflow per subscriber, even as linear video penetration has fallen faster. Citi sees fewer financial risks in the core cable business than previously expected that should keep cable revenue and EBITDA near or above 2019 levels over the next two years. Citi believes Comcast's sum-of-parts valuation on normalised (2022) financial performance supports solid upside potential. BUY. (Published by Citi)

#### **Walt Disney Co (DIS.US) – F2Q20 Revenue In-Line; EBIT and EPS Miss**

DIS reported total revenue in line with expectations. Better-than-expected revenue at Media Networks (10% above the consensus forecast) was offset by lower-than-expected revenue in all other segments including Parks, Studio and Direct To Consumer & International (DTCI). DIS cancelled the 1H20 dividend. Management will evaluate future dividend payments as the timing and cadence of business resumption becomes clearer (including Parks and theatrical venues). BUY. (Published by Citi)

## Calendar

Figure 9. Calendar

Date	New Zealand	Australia	International
11-May	Electronic Card Retail Sales (Apr)	Home Loans (MoM) Invest Housing Finance (MoM) NAB Business Confidence (Apr) NAB Business Survey (Apr)	
12-May	FPI MoM (Apr) RBNZ Interest Rate Decision RBNZ Monetary Policy Statement	Westpac Consumer Sentiment (May) Wage Price Index (Q1)	
13-May	Migration Data (Mar)	Employment Change (Apr) Participation Rate (Apr) Unemployment Rate (Apr) Commonwealth Bank 3Q20	US: Core CPI (MoM) UK: GDP (MoM/YoY/QoQ) UK: Manufacturing Production (MoM) Takeda Pharmaceutical FY20
14-May	Business NZ PMI (Apr) Annual Budget Release		US: PPI (MoM) US: Crude Oil Inventories Tencent Holdings 1Q20
15-May		CFTC AUD Speculative Net Positions CFTC NZD Speculative Net Positions	US: Initial Jobless Claims EU: German GDP (QoQ) CH: Industrial Production (YoY)
16-May			US: Core Retail Sales (MoM) US: JOLTS Job Openings (Mar)

Source: Forsyth Barr analysis

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