NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

Economic and Market Summary

Global share markets fell -13.3% in the June quarter suffering their worst quarter performance since the Lehman Brothers collapse in 2008. This decline extends losses back to October 2009. Commodity indexes fell -7% and lower quality bonds were also impacted (-7 to -15%) globally. Only higher quality bonds and currencies rallied as money sought safer assets.

Several factors including a re-focus on global financial system stability driven by the European sovereign debt crises, pending US bank regulation, friction on the North Korean peninsula, a misguided ban on short selling in Germany, the BP oil spill and new economic data showing the sharp global growth recovery was weakening all impacted investor conviction.

Of these concerns the European sovereign debt crises was the most damaging. While an emergency ECB and IMF bailout package contained the short term problem, it highlights that while the liquidity issues of the Great Financial Crises have been addressed, there remain serious country debt imbalances around the world that need to be worked through. This is a long term issue that cannot be addressed overnight.

The cost of rescuing developed countries from impending depression in 2008 and 2009 has been very high with governments sharply increasing their borrowings to stabilise asset prices, their banking systems and to fund economic stimulation in the face of a retreating and de-leveraging private sector. This has left many countries finances too exposed.

We have discussed in prior newsletters that the euro zone countries and the US are approaching their capacity to take on further public debt which is likely to limit their ability to keep artificially stimulating economic growth. Markets now want to see indebted countries reign in their debt levels over the mid-term while minimising the short term risk of tipping their economies back into recession.

Despite this large structural debt concern, the world economy will continue to grow for the rest of this year albeit at a slower rate than the last 3 quarters. The IMF has a global growth outlook for 4.25% in 2010. This might be ambitious if the US slows further in the second half of 2010 which leading indicators suggest is likely.

In NZ, our economic recovery continues to be driven by stronger export commodity prices but more recently better manufacturing data suggests our recovery is now becoming broad-based. Consumer spending remains subdued as households focus on debt reduction. While the recent budget will be mildly stimulatory given greater personal tax rate cuts than GST increases, we expect these funds to be used by households to further reduce their debt. The Reserve Bank forecasts NZ economic growth at + 3.5% over the next two years. This looks ambitious with Consensus Forecasts suggesting a slower but still positive + 2.8% in 2010 and + 3.4% in 2011.

Share market valuations are now looking inexpensive despite the background of slower growth. World share markets are now trading on an average price to earnings ratio of 12 times current earnings and 12.4 times forecast earnings (against a long term average of 20 times). This suggests a very marked slow down in global company earnings growth is required to justify these present prices. Indeed markets are effectively pricing in a 50/50 chance of a double dip recession for developed countries. Various analysts reports suggests markets are being too pessimistic and shares represent good buying though currently poor sentiment may send prices down further in the short term.

Working our way out of the Great Financial Crises was never going to be easy and recent turbulence serves to remind us that we have some way to go. While the recent retracement in markets is certainly frustrating for investors, the key to investing in these conditions is to ensure portfolio asset allocations are appropriate to your risk and return objectives, are well diversified and only hold high quality assets that have the ability to recover value and deliver to long-term target returns.

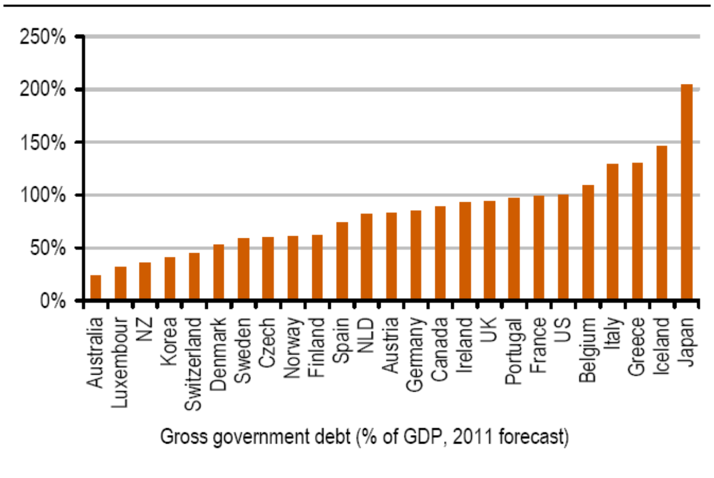
Weaker but still positive outcome

We have previously referred to 2010 as the year of economic transition where global growth has to move to a self sustaining footing driven by private sector activity taking over from Government stimulated growth. Through late 2009 and the first quarter 2010, economic data continued to sharply improve as firstly inventory re-stocking took place then further signs of business investment, consumer spending and confidence rose implying the transition was underway.

Since April, economic data while generally still supportive for global recovery, has been patchier and less consistent than prior months. While it was not reasonable to expect the strength of the recovery to continue its “v” shape markets have been disappointed by the weaker data in May. We were expecting this weaker data to appear in the first quarter and when it did not it, suggested economic growth might surprise on the upside. The weaker data however was just slower to come (due to government stimulus).

On top of weaker economic data from the US, UK and China the sovereign debt imbalances (long the elephant in the room) came into sharp relief with the threat of default from Greece and possibly Spain & Portugal serving to remind the world that the Great Financial Crises is not over yet and merely contained. The concern of another domino affect on the global financial system truly put the frighteners into funding markets and investors alike. Further financial rescue packages were put in place (courtesy of the European Central Bank and IMF to provide several years of cover for these weaker Euro members) to assuage markets and buy time to assist more indebted members get their deficits in place. The IMF and ECB funding support came with a requirement that members implement immediate austerity measures. Following the recent G20 meeting EU members have agreed to cut their deficits in half by 2013 which runs the risk of actually stalling growth and recovery in these countries. Markets remain very concerned about this risk. Greece is already financially terminal and will require debt re-structuring in 1-2 years time.

Public sector debt-to-GDP ratios, by country, 2011 forecasts



Source: IMF/OECD

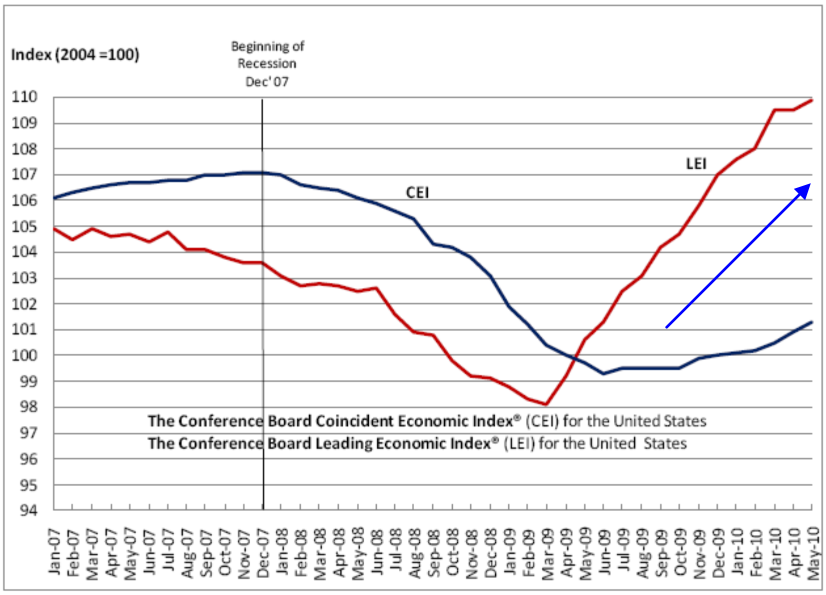
While recently weaker economic data points to lower growth for the second half of 2010 and into 2011 it does not mean a return to global recession though investment markets are currently pricing in a better than 50% chance of this happening. The IMF is still forecasting global economic growth of + 4.25% (OECD forecast + 4.6%) for 2010 though we expect this will be revised down to + 3.5%. This is a still a far better environment than 2009 where world output was - 0.6%. Economic growth is patchy and happening at varying speeds with some regions and countries doing well while the euro zone is struggling.

The rebalancing between debtor and lender nations has begun with indebted developed countries continuing to de-leverage (mark down assets, repay debt and reduce capacity) while surplus nations like China look to internal / regional demand to replace weaker exports. Overall this will be a fine balancing act. Reducing the risks through this process will take careful and co-ordinated management and we are starting to see G20 and G8 countries, Euro country members and the US developing historically tighter regulatory frameworks and controls around financial markets operations. While intended to provide stability these policies equally run the risk of reducing credit availability and increasing funding costs.

United States - Lower contribution to world growth

Through 2008 and 2009 US companies secured their businesses cutting overheads, reducing inventory, reducing staffing, reducing plant capacity, re-paying debt and building cash (US companies hold US$1.84 trillion in cash reserves – their highest cash ratio on balance sheets since 1952) to weather the recession and prepare for worse. This lean and mean approach put them in a great position to flow any improvement in revenue straight through to bottom line profits. As demand started to return in mid 2009 businesses scrambled to replace inventory and get capacity on-line. This process resulted in a very sharp level of economic growth in the US in the last quarter 2009 (+ 6% p.a. annualized) and contributed to the "V" shaped bounce. This typical bounce out of a recession is not sustainable at that rate of improvement. The "spurt" certainly excited investors and was robust through to April (March quarter +3% GDP annualised) suggesting a positive surprise might be in store for 2010. Momentum however stalled in April as withdrawing US Government stimulus impacted an already weak housing (tax credits ending) market with existing home sales falling sharply -30%. Unemployment is also remaining frustratingly weak at 9.5% (slightly improved) but with lower participation rates. This is impacting consumer spending – weaker by -1.2% and business and consumer confidence (sharply down in June to 52.9 from 62.7).

***The Conference Board Leading Economic Index®* (LEI) for the U.S. Increases**



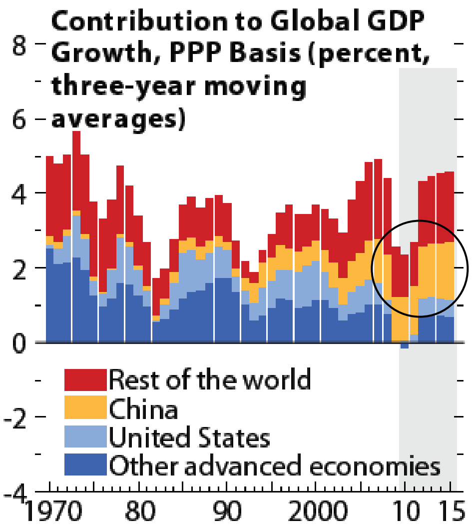
On a more positive side, US industrial production remains in firm territory (PMI at 59.1 - anything over 50 is expansionary), employment trends are higher (jobs advertised) and exports are higher. The Conference Board Leading Economic Index for the US suggests that while the rate of growth is slowing, it is still likely to be positive at + 1% to + 2% in the second half of 2010 with growth of + 3.5% in 2011. These growth rates are well below the capacity of the US and reflect their economy will have the drag of household, state and Federal debt and deficits for many years. Longer term, the US remains a highly flexible and resilient economy with excellent corporate resources for investment and a young demography. While their contribution to world growth is likely to be weaker than the past, the US remains critical (at 25% of world GDP) to global recovery.

Japan – Possible surprise contributor to global growth

As the second largest economy in world (9% of world GDP) Japan has provided an underwhelming contribution to global growth for the last 20 years battling its own de-leveraging economy caught in a difficult deflationary cycle. More recently Japan has been on a recovery path led by a resurgent manufacturing sector. Japan put in a strong (+ 5% GDP annualised March quarter). While their public debt levels are high as a consequence of long failed Government stimulation attempts, household and importantly business balance sheets contain record piles of cash and a recent Tankan Survey suggested business confidence is rising as exports and domestic consumption (modestly) improve. After years of low or negative contribution to global growth the IMF are forecasting Japan to growth at 1.9% in 2010 and 2% in 2011 which would provide a valuable contribution to global recovery.

China – Critical to global recovery

China has now moved into 3rd place with 8.5% of global GDP. While there has been substantial and justifiable focus on the sovereign debt and economic issues of Europe, a slow down in China poses a greater risk to global growth. Its contribution to global growth has been staggering (30% of growth) and without its resilience during 2008 and 2009 a deeper global recession was certain. The IMF World Economic Outlook graph opposite shows starkly the importance of China to world growth as it also shows the declining role of the US and other advanced economies.



While China has successfully managed high (official) growth rates of 9% to 10% p.a. over the last 10 years recent rates have been nudging 12% driven by increasing domestic demand and a surprisingly sharp pick up in export growth (+48% mom in May). Though more recent softer export orders suggest manufacturing numbers will weaken. Strong inflationary pressures resulted in the Government tightening reserve bank requirements and discussing a tax on property (now on hold) and raising exchange rates. The dampening impact from this policy action (possibly -1.5 to -2%) was a contributing reason for the recent sell off in global share markets.

With more than $US 2.5 trillion in foreign currency reserves China plays a critical role in working with indebted developed countries to address their long term imbalances. China announcing its continued support for Eurozone government bonds stabilised a panicking bond market in May and demonstrated the financial firepower they have. For the second half of 2010 China will need to raise their exchange rate and continue to support western world debt issuance while working harder on transitioning their economy to be more domestically oriented. More recently Chinese workers are winning significant wage rises and employment condition demands. We expect this will be an increasing trend in the second half of 2010 and 2011 signalling the rise of the working class and rising domestic demand.

India, Brazil, Developing Asia and the Commonwealth of Independent States

These emerging countries and regions will all make a significant contribution to global growth for the second half of 2010 and 2011. Brazil, India and CIS account for 8% of global GDP and together with developing Asian countries they are expected to achieve growth rates of between + 4% and + 9%. Recent declines in commodity prices, particularly energy may impact the growth numbers for CIS and Brazil through the rest of the year while India and Developing Asia continue to leverage fast internal and regional demand supported by a wall of foreign capital seeking higher returns.

Europe – The handbrake

While the US (and UK as well) moved quickly to repair their financial systems through asset write-downs, capital injections and nationalization (by increasing public debt), the Europeans have been slow to do the same for their embattled financial system. Subsequently Europe and particularly peripheral Europe remain at the starting gate for reform. Euro zone members are increasingly reliant on the savings of productive and thrifty Germans while peripheral countries rely on euro zone banks and the IMF support. The European Central Bank recently warned member banks face up to €239bn in write-downs this year while some commentators put the size of required write-downs closer to €800bn. This is bad news for bank balance sheets implying less credit will be available going forward unless they can raise new capital. There is also the obvious potential for greater claims on central government financing and bailouts for those already indebted governments.

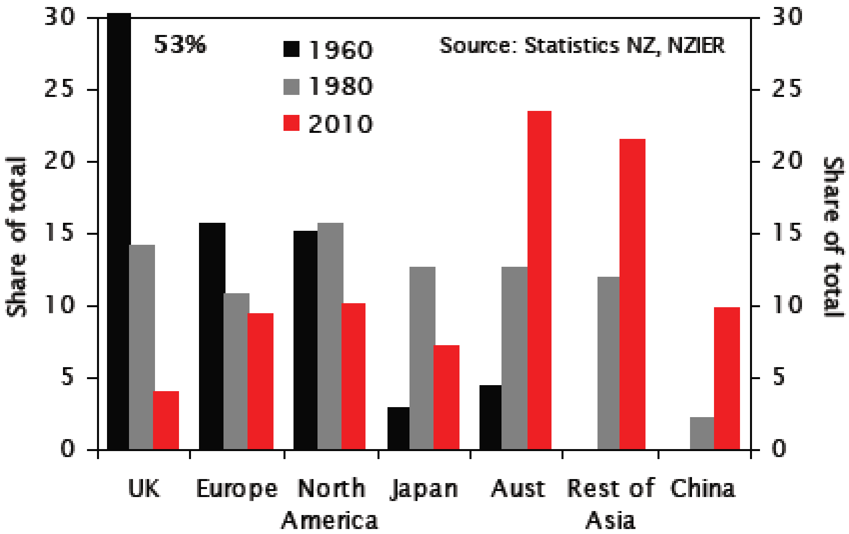
The European Commission (led by a strident Germany) and IMF have set the agenda for austerity reform to get their government operating deficits back to 3% of GDP. Bear in mind these are still deficits meaning overall debt levels will still rise further (surpluses of + 2-3% would needed to begin paying down debt). Achieving these deficit reductions requires €400 billion to be cut from EU budgets each year and recovered from higher taxes, cuts to public servant salaries, welfare benefits, pensions and the lifting of pensionable ages. Many would argue these countries have simply been living beyond their means and this has to stop while others might argue ordinary workers are being asked to pay for the cost of propping up failing financial institutions.

Either way, a reduction in Government spending will have an impact on European economic growth which in turn impacts countries supplying Europe. While a sharply weaker Euro and GBP will certainly help exports (particularly for Germany, France, UK and Italy) and provide some cushioning, weaker countries look like they are in for a very tough time and sharply lower standards of living. As the pressure builds in these weaker countries (Greece, Spain, Ireland and Portugal) there will be a need to restructure their debt to enable them to grow or they will have to leave the Euro.

The IMF forecasts the euro zone will grow at +0.8% in 2010 (Germany +1.2%, UK +1.3% and France+ 5%). This may be too optimistic and there is good chance they could return to recession. Increasingly Europe (as Japan did) looks like it may act as a drag on world growth for several years.

New Zealand – Recovery gaining momentum

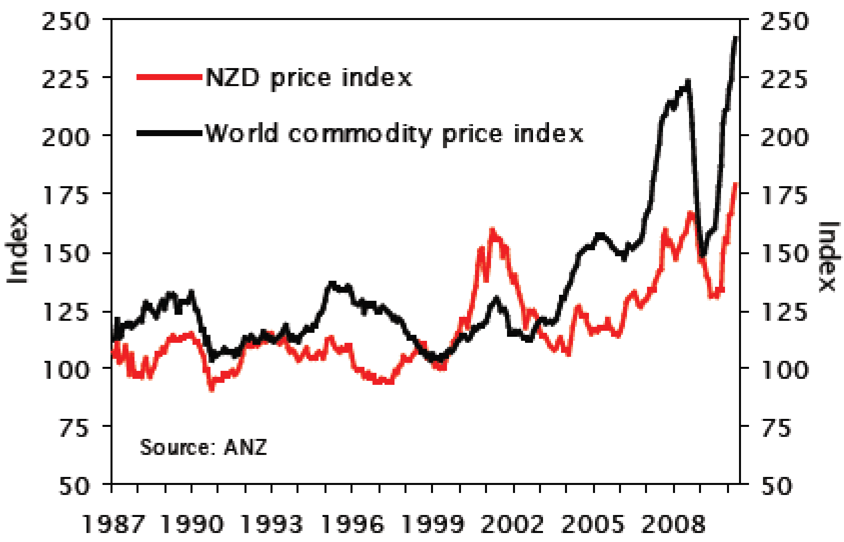
Our economy has been expanding for more than a year now and after a two-speed start with exporters providing the initial momentum and domestic activity muted, the recovery is poised to become more broad-based. Higher export prices, stimulatory monetary and fiscal policy have all provided support for our recovery that is however slower out of the blocks than after previous recessions. The Reserve Bank is forecasting NZ economic growth of 3.5% for 2010 and 2011 which would be sufficient to support business investment, further job growth and residential investment. The first Official Cash Rate rise of 0.25% to 2.75% in June confirms the interest rate cycle is now back in tightening mode in anticipation of price pressures rising as growth improves. However, rates are likely to rise only slowly and in careful consideration of the fragile global recovery.



Recent weaker growth signals in Europe, UK and the US are not likely to spoil our recovery too much as the world has firmly changed for NZ exports. A recent Agribiz report from Westpac highlights the changing nature of our export patterns. The chart opposite shows the change in share of our exports to different trading partners since 1960. The emergence of China and the rest of Asia since 1980 is stunning and as economic growth rates for these regions including Australia are likely to be far stronger than from the weaker western countries, the future for NZ exports looks promising. China now takes 10% of all our net exports.

Westpac also points out that New Zealand is running a trade surplus with Australia and Asia (ex Japan) with 55% of our exports going to this region and 54% of imports originating there. This has translated into an annual net trade surplus for NZ in the year to May 2010 of $91million.

Higher interest rates, strong commodity prices and relatively good public finances have supported the NZ dollar which remains above its 25 year average against our trading partners. Since April the NZD has risen sharply against the AUD (+ 5%) which may provide some headwinds for exports to this crucial market in the near future. Overall though, world commodity prices have been rising faster than the NZD.



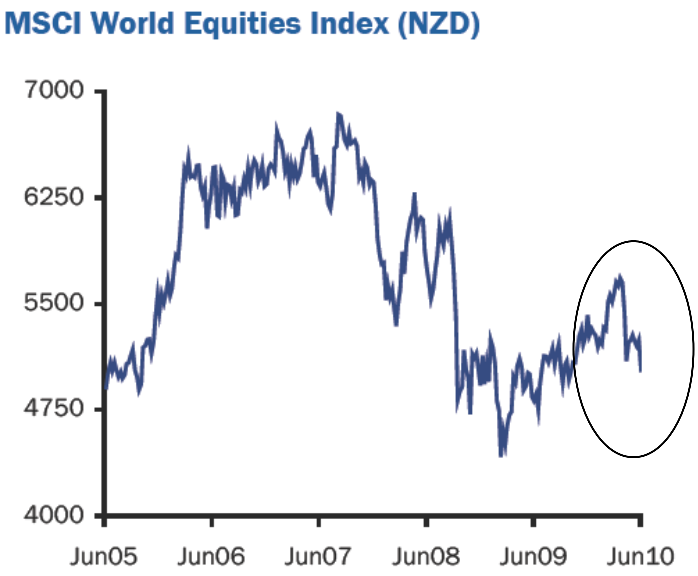
The recent National Bank Business Outlook survey for June showed a dip in the prospect for business activity from the May and April months suggesting that our expectations for economic improvement are slowing and possibly reflecting growing global unease. Own business activity, investment, employment and profit outlook measures were all slightly weaker but still within their long term average ranges.

Domestic activity remains relatively muted with retail sales volumes only slightly higher and primarily driven by higher vehicle sales. House sales, house prices and residential and non-residential construction are all weaker with sharply declining building consents in May. Some of this reduced property activity was a function of potentially draconian changes to investment property tax rules in the Budget as much as an outlook for rising interest rates. The Budget changes were relatively mild and with this uncertainty out of the way permits numbers may start to improve in the next quarter. Consumer spending is also likely to improve in the September quarter as purchases are brought forward in front of the GST increase to 15% on October 1st. It is debatable whether the new tax cuts from 1st October will be net stimulatory over the cost of GST. We expect households will probably use their new net earnings to reduce debt in the first instance though longer term it should support discretionary spending.

Global Shares

Global share markets put in their worst quarterly performance since the Lehman Brothers collapse in the September quarter 2008 declining -13.3% in the March quarter. The sharp reversal demonstrates the fragility of investor confidence as the sovereign debt crises and slower US and Chinese economic data turned investor concerns into a full scale retreat. The quarter's decline took markets back to October 2009 prices and valuations back to levels not seen since early 2009.

Indeed global share market valuations appear to be pricing in an even chance of a double dip recession. UBS research shows price to earnings ratios based on current earnings at 12 times 2010 forecast earnings and 11 times 2011 forecast earnings (15 times trailing earnings).

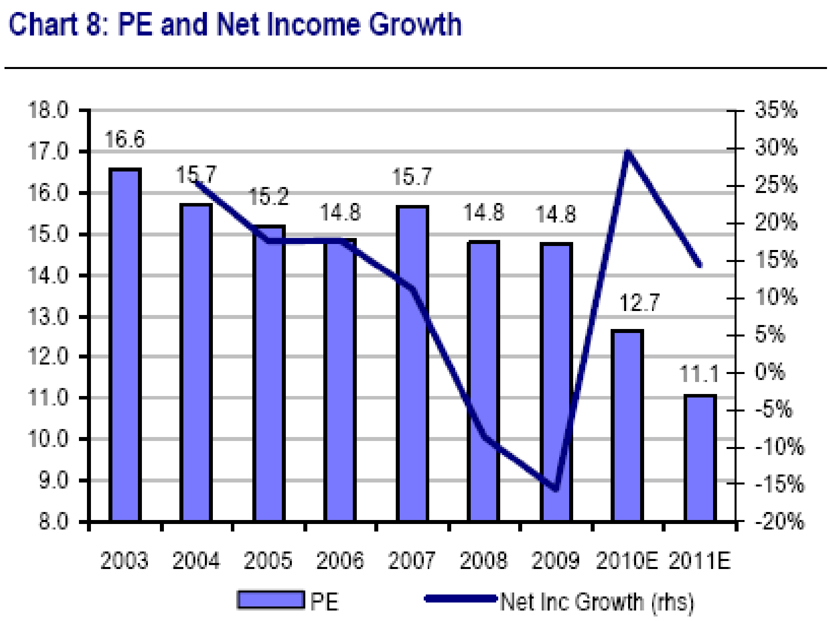


Source: Bloomberg

Economic data though weaker it is still currently positive and suggests markets may be too pessimistic on the outlook for earnings growth. The graph below from UBS investment shows their forecast net income growth and price earnings ratio valuations for the global share market compared with prior year valuations. Company earnings are expected to grow 30% this year (revenues +10%) with slower but still positive earnings growth of 14% in 2011. The contribution to this growth is expected to largely come from resource and technology sectors.

From here supporting factors for equities growth include:

- Excellent global corporate balance sheet health (with historically low levels of gearing and high cash levels)
- Robust emerging country growth with China still likely to produce + 10% growth



- Reasonable US corporate earnings and dividend growth in 2010 and 2011
- Low cash and bond yield alternatives
- Net defensively positioned investors.

The detracting factors include:

- Confidence failure impacting activity and creating a self-fulfilling outcome
- Austerity policy overkill in Europe that is politically motivated and strangles an already weak euro zone growth outlook
- Tight global credit conditions that could further contract as European banks in particular come under further pressure
- With US home sales down -30% in May additional weakness in real-estate prices in the US, UK and Europe could further retrench consumer activity.

Current share market pricing may have gone too far to the downside on sentiment rather than fundamentals. Given the current negative mood there may be further weakness in the short term but we are fast approaching the point where valuations will become too compelling and will support a rally.

Australasian Shares

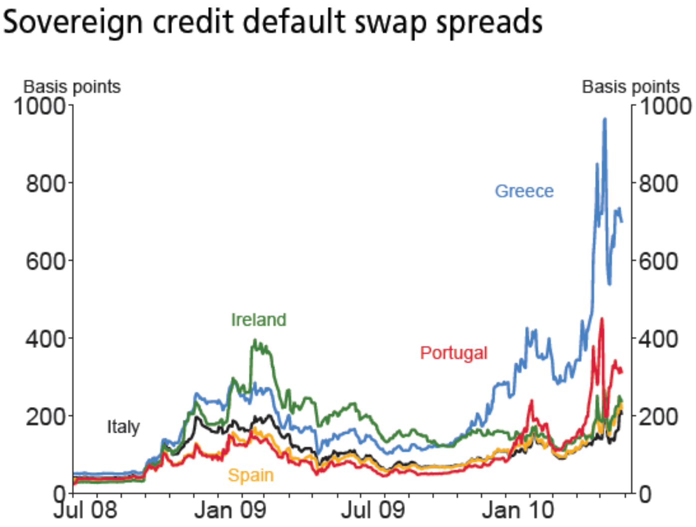
While the Australian and NZ economies remain well positioned to capitalise on strong trading partner growth negative global share market sentiment dragged both markets lower over the quarter with Australia down -11.9% and New Zealand down – 9.1% in local currency terms. These falls do not seem justified when comparing the relative performance of our respective economies.

Both markets suffered broad falls with financial and mining sectors being particularly affected. The financial sector was hit hard on fears of rising funding costs following the sovereign debt crises. While wholesale funding costs did rise about 0.5%, the impact overall has been marginal. More damaging was the proposed introduction of the super profits tax on Australian miners which in its original form looked to reduce the revenues and value of BHP and Rio by 12-14%. This weighed heavily on the market as mining sector share prices fell heavily. The recent compromise deal with Australia's new Prime Minister Julia Gillard sees a significant watering down of the original tax which has recently been supportive for prices.

Rising interest rates in Australia and now New Zealand are likely to act as a damper on activity and the Australian Reserve Bank may have overstepped the mark with their efforts to contain activity against what is clearly a weaker overall global growth environment. Share market valuations for Australia and NZ are back to early 2009 levels suggesting that our local equity markets also represent good value on a fundamental basis and offer particularly attractive dividend yields when compared to cash and a now over-priced bond market.

Global Bond / Fixed Interest Markets

The sovereign debt crises saw investors stampede out of speculative (junk) corporate, mortgage backed credit and weaker sovereign issues into safe-haven sovereign bonds. Risk aversion saw US 10 year treasuries rising to 14 month highs with their yields down below 3% to 2.93%. Closer to home, New Zealand and Australian Government bond yields came in sharply delivering a + 3.2% return for investors over the quarter. 10 year Australian Government Bonds are now back to 5.1% and NZ to 5.35% respectively.



Source: Bloomberg.

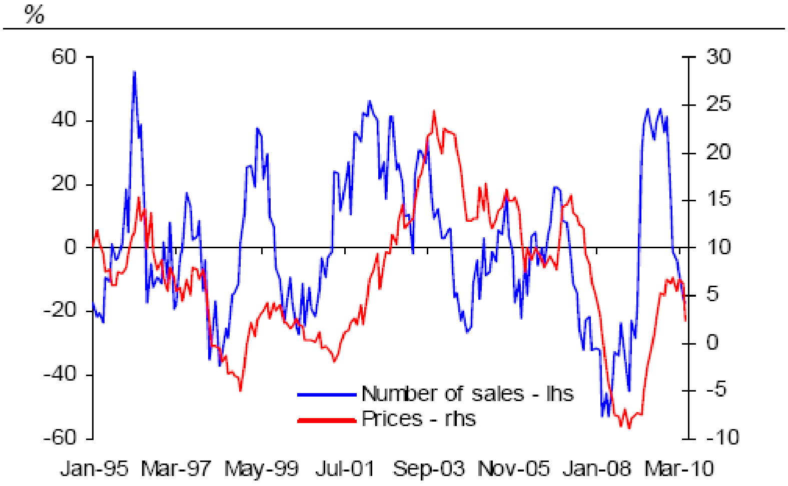
The most dramatic sell off in bonds came in the European markets where investors moved to safer German bunds driving 10 year bund yields down to 2.58% while Spanish bonds rose to 4.6%, Italy 4.1% and Greece a staggering 10.7%. Despite the higher yields and risk aversion, recent bond auctions have been well covered. Even Slovakia managed to sell EUR 66 billion in a new bond issue this month.

With high grade bond issues well bid and offering comparatively low rates of return any reduction in risk aversion in the June quarter will see a sell off in these bonds. At the shorter end of the yield curve NZ 90 day bank bill rates rose in anticipation of the Reserve Bank tightening finishing up 0.5% over the quarter to 3.15%. Investors continue to benefit from higher bank term deposit rates on offer (than bank bill rates) as banks continue to compete for a limited pool of local retail cash funds to improve their funding position (as required by Reserve Bank rules). This unusual situation looks to continue for the foreseeable future.

Real Estate

After stabilising in the March quarter the US residential real-estate market looks to be under considerable pressure again as an end to tax credits for home buyers triggered a - 30% slump in home sales. This was much worse than expected (-13%) with further weakness likely to show up in the June numbers. The US home market is already down -34% off its 2007 highs but further falls now look likely as buyers have all but disappeared in many areas. With an estimated 25% of all US homes in negative equity, the motivation for these home owners to battle on decreases by the day particularly, with unemployment levels remaining stubbornly high. Putting a floor under the US housing market is a priority for the US Government as these assets underpin the financial system and consumer confidence. Fortunately, the residential market in the US is not homogenous and many states and cities (particularly in the east) have stable and improving home prices. California, Nevada and Florida however all remain at further risk reflecting the fact further de-leveraging may still be required in these over geared and over supplied markets.

NZ Home Sales and Prices



Source: REINZ, First NZ Capital

While not as severe real-estate sales in New Zealand declined over the quarter with May numbers down -17.2% over the year. While sales are down, prices remain supportive with the May REINZ house price index up + 5.1% over the year. Prices have been supported by a low interest rate environment, higher net migration numbers and lack of new building supply. With an outlook for weaker net migration, rising interest rates, a reduction in tax benefits from rental property investment and a likely pick-up in construction permits house prices are likely to remain under pressure.

As the NZ economic recovery becomes more broad - based and employment levels tick higher we expect to see an improvement in the demand for industrial and commercial property in the next 12-18 months. Retail property is likely however to remain under pressure being significantly oversupplied and with NZ households focussing on repaying debt and keeping their spending under control.

Commodities

NZ export commodity prices continued their rise up +10.3% over the quarter against a back-drop of weaker global commodity prices (that were led down by weaker energy and metals prices). NZ commodities were let by a sharp + 32.1% lift in diary product price with most other commodities also registering a price rise. In particular Chinese demand for logs has lifted prices to a 17year supply with China now taking 55% of our log exports. Despite the outlook for slower world growth our key trading partner growth remains strong and should continue to underwrite high strong demand for our commodities.

Currency

With more recent risk aversion investors have moved back into USD selling the NZD down from a peak of 73c to 69c. The NZD was more resistant against the AUD rising 5% over the quarter attributable to lower metals and energy prices. After taking a battering over the quarter the EUR and GBP have more recently started to find their feet as European sovereign debt fears abate. The sharply lower EUR (-12.5% against the USD) will assist euro zone exporters and is likely to remain weak for some time. The outlook for the NZD and AUD is higher as global investor confidence returns and investors come looking for higher yields and exposure to commodity currencies.