NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

16 January 2018

December 2017 Quarterly Report

It has been a very strong quarter for share markets, commodities and listed property investments while fixed interest bonds also provided a more modest contribution.

Client portfolios outperformed most of their respective investment sectors for the period though bonds were slightly under due to our more conservative positioning. All but conservative portfolios registered double digit net returns for the year.

2017 has proven to be an excellent year for investment markets despite the many geopolitical risks that were present and that occupied the daily headlines. Synchronised global growth, low inflation levels and accommodative policies from central banks supported market returns and reduced volatility to some of the lowest levels on record.

Looking to 2018, the forward economic indicators are supportive for global business conditions. US tax cuts and accommodative central bank policy settings will assist growth. Inflation spikes, technology disruption, trade friction, Brexit negotiations and potential central bank misjudgement remain the key risks.

A faster rate of global growth may bring some inflation surprises and could lead to greater market volatility given the relatively high valuations in some markets such as New Zealand.

On behalf of the team at NEWTON ROSS, thank you for your support over the year and we wish you the very best for 2018.

Kind regards,

Wayne Ross
Director Investments

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ECONOMIC AND MARKET SUMMARY

2017 was a very positive year for investors as markets continued to rise on improving and synchronized global economic activity. Stubbornly subdued inflation has given central banks the room to keep interest rates lower for longer while tax cuts and government spending have assisted economies to expand. Forward economic indicators suggest the outlook remains supportive for growth which should assist markets further. Several commentators have referred to 2017 as being a "Goldilocks" environment for investors and this seems true given the surprisingly low level of market volatility despite the many geo-political risks that made daily headlines.

The chart below from Bloomberg shows a volatility measure for the US share market since the GFC. 2017 was a record low for this index.

Strong global economic and business conditions underpinned global share markets which rose just over 20% for the year while our local market was up 22% on improving company earnings but also some valuation stretching. Big individual performance contributions from A2 Milk (+279%) and Xero in particular assisted this overall return. The Australian share market was more subdued being up 11.8% as their mining sector recovered strongly on better commodity prices while the retail sector retreated on fears new entrant Amazon would impact business margins. The banks came under increasing regulatory pressure. Commodity prices recovered on better global demand led by stronger Chinese activity while bonds delivered positive but lower returns due to the prospect of rising long term interest rates. Listed property assets performed well though the "Amazon" effect impacted some Australian retail centre owners. Global residential property had a more muted year including in NZ which had its slowest growth rate in more than 5 years.

Looking ahead, 2018 has started well and we expect markets will continue to perform on broadening global growth and easier fiscal policies (US tax cuts). That said there will be challenges, particularly if central banks unwind their supportive settings faster than expected. This could happen if inflation starts to rise more quickly than planned with wages growth the likely driver (wages have been suppressed for years).

Other themes and challenges for 2018 include Brexit, rising populism, trade friction, technology disruption, cyber security risks and continuing geo-political pressures including deteriorating Sino/US relations and greater Russian interference.

Brexit negotiations should complete by the end of March. There is an increasing risk of failure. A hard exit would have far reaching economic consequences for the UK.

The US is pushing harder on trade issues with China who is seen as 'value detractor' by Trump. China is also increasingly projecting its global position with its leadership secured for the next 5 years.

Cyber security created more headlines in 2017 while converging technological development is accelerating and disrupting in all business models reducing costs and margins particularly, for services providers. Technological disruption could suppress wages growth for longer than expected and deliver some disinflationary surprises.
At home we face some additional challenges as the new coalition government seeks to more directly influence migration levels, foreign investment, infrastructure spending, residential housing construction and minimum wages. Policy uncertainty and the nature of the coalition arrangement has impacted business confidence (lowest level since 2010).

Despite some challenging themes, earnings growth for global businesses are forecast to be 6% to 9% which will be supportive for further share market improvement. The US Federal Reserve is targeting 3 small rate increases this year, but the NZ Reserve Bank is likely to remain on hold as our economy moderates. This means low cash rates at home until 2019. Bonds should deliver only modest returns as offshore long term interest rates rise but they remain and important risk tool for portfolios. NZ property may soften further on lower immigration, foreign buyer restrictions and improving supply.

The table below shows the gross returns (before tax) from the benchmark index for each asset class.

Market Returns	Dec Qtr.	1 Year p.a.	3 Yrs p.a.	5 Yrs p.a.
$NZ v TWI	**-2.7**	-4.4	-2.1	0.2
$NZ v $US	**-1.7**	2.3	-3.3	-2.9
$NZ v $AUD	**-1.1**	-5.2	-1.7	2.7
NZ Cash	**0.5**	1.8	2.4	2.6
NZ Fixed Interest	**1.7**	5.5	4.8	4.0
Intl Fixed Interest 100% hedged to $NZ	**0.9**	3.1	4.4	5.5
Australasian Equities 50/50 Indexes	**6.4**	19.1	12.4	11.4
NZ Listed Property	**6.5**	12.8	9.9	11.4
Intl Equities 50% hedged to $NZ	**6.5**	20.6	11.7	13.7
Commodities $NZ	**6.4**	-0.3	-2.0	-5.7

SECURITIES RETURNS FOR THE QUARTER

The following tables show the returns from the securities recommended by NZ DIMS. Depending on your investment strategy you may hold all or only a portion of these securities and the returns for the securities held may also differ slightly depending upon cash flows and transactions in your portfolio over the quarter.

AUSTRALASIAN EQUITIES

Company	Sector	Quarterly Performance In NZ$ terms
New Zealand Equities		
Auckland Airport	Ports	2.9%
F&P Healthcare	Healthcare	13.2%
Fletcher Building	Building	-4.7%
Freightways	Transportation	-1.4%
Meridian Energy	Energy	2.7%
Port of Tauranga	Ports	15.7%
Stride Property	Property	9.5%
Trade Me	Consumer	5.9%
Vector	Energy	6.1%
Australian Equities		
APA Group	Energy	3.3%
BHP Billiton	Resources & Energy	14.7%
Brambles	Professional Services	12.8%
IAG	Financials	13.1%
National Australia Bank	Financials	-1.6%
Scentre	Property	7.9%
Sonic Healthcare	Healthcare	10.2%

- This quarter signalled the end of an era for Westfield as the long term owners accepted a $36 billion takeover deal from Unibail-Rodamco, Europe's largest listed commercial property company. The deal represented a significant premium to the recent share price and will end Sir Frank Lowy's 57 year reign at the head of the international property empire. Westfield represents premium brand shopping centres and property developments with the company split in 2014 into Scentre (NZ and Australian) and Westfield Corp (mainly UK and US).
- Auckland Airport announced its 5 year plan which involves spending a further $1.8b on infrastructure while cutting international passenger charges by 1.7% and increasing domestic fees by 0.8%. A start to earthworks for the second runway is proposed, along with more contact gates for international aircraft, a new domestic jet terminal, upgrades to international check-in and an expanded border processing area. Boosting retail revenue from the ever increasing passenger numbers will be key to medium term revenue growth. This work will be partially funded by the sale of its 25% holding in Cairns and Mackay airport for NZ$403m, almost 3 times what AIA paid for the holding 8 years ago.
- Meridian Energy is keeping a close watch on the progress of the new coalition Government's policies as several are expected to impact the NZ electricity sector. In particular, the commitment to convert the government car fleet to electric by 2025/26 where practical, establishing an independent Climate Change Commission with carbon reduction targets and a full-scale review into retail power pricing where the large number (29) of network suppliers is seen as inefficient and costly.
- Brambles has estimated that the change in US tax legislation will provide a one-time benefit of between A$125-155m as it lowers its deferred tax liability as a result of corporate tax rates being lowered from 35% to 21%. However there remains uncertainty around potential restrictions which may yet be placed on

Westfield Corporation	Property	22.5%
Westpac	Financials	2.5%
Woodside Petroleum	Energy	13.7%
Woolworths	Consumer Staples	8.5%

- Vector announced a new contract to provide advanced metering services to EnergyAustralia with an initial 3year deployment period. Vector is focused on maximising revenue from its tech intellectual property and in 2018 now expects to be deploying advanced smart meters on behalf of at least 4 leading electricity retailers across NSW, Queensland, South Australia and ACT. The company also announced the appointment of Rod Snodgrass to the new executive role of Chief Customer Officer with responsibility for the customer experience and product and service delivery. Rod has extensive experience in the NZ telco, media, internet and digital sectors including CEO of Spark Ventures where he helped build brands like Lightbox, Skinny and Morepork.

foreign companies operating in the US and BXB have subsequently announced the sale of their recycled whitewood pallets business in North America to a US private equity firm for $115m.

- Following a rebound in both LNG and oil prices the subsequent lift in the Woodside Petroleum share price saw Shell sell its remaining 13.28% stake in the company. It is estimated that Woodside's valuation increases 1.4% for each US$1/bbl rise in the oil price and it is the long term value of oil which is a key driver for the company despite recent share price moves seemingly more closely related to the rise in LNG spot prices.
- National Australia Bank is cutting 6000 existing jobs and creating 2000 new roles over the next 3 years as it simplifies its business and increases its use of digital and automated banking products. NAB will halve the number of products it sells and retire 15-10% of its IT applications. The bank made a full year profit of A$5.3b and expects their 21% market share in business banking will help offset any weakness in the residential housing market.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	5.1%	The fund produced a positive return but underperformed the market benchmark due to not holding A2 Milk and Xero who drove much of the NZ market benchmark performance. The 279% rise over the year in A2 Milk has seen it become our 5th largest listed NZ company by market capitalisation which is extraordinary growth. One of the strongest contributors to fund performance was Oil Search which has moved to diversify their business by signing a deal to operate what is potentially one of the largest US onshore oil discoveries in decades. Westfield provided the strongest boost however after receiving a takeover offer from Unibail-Rodamco, Europe's largest listed commercial property company. The manager notes that the bid is not surprising given that the market has largely failed to recognise the intrinsic value in this company. Westfield has been actively selling lower quality shopping centres and reinvesting in flagship properties which have been somewhat insulated from the move to online shopping. Many customers still want to enjoy the physical retail experience and entertainment value provided by shopping centres and top online retailers such as Tesla, Apple and Amazon recognise such and retain a high quality physical presence.

Harbour Australasian Equity Focus Fund	9.2%	The fund outperformed the market benchmark. Strong contributions came from holdings in Scales Corp (market earnings re-rating despite a poor apple growing season), F&P Healthcare (inclusion in global market index), Oil Search and A2 Milk. A key change for the market in December was the removal of Xero from the NZX benchmark. The Xero share price has fallen 10% since announcing their move to the ASX and the reallocation of sale proceeds from index aware investors has supported the share prices of other NZ companies. Toll road operator Macquarie Atlas Roads was added to the portfolio. The company has infrastructure assets in the US, France and Germany and is benefiting from above average earnings as improved economic growth in those regions drives light vehicle traffic on toll roads higher. Looking forward the manager believes local equity markets will remain supported during 2018 by robust company profitability. The NZ and Australian economies are expected to continue to grow steadily and businesses to invest in disruptive technology to boost profit margins. Despite the historically high valuations, equity market returns are expected to be lower than 2017 but still offer attractive return prospects relative to cash and bonds. The key risks to this scenario include a) a rapid tightening in monetary conditions (unlikely given the slow emergence of inflation and steady hand by central banks) and b) any changes to local government policy which negatively influence growth such as migration, housing policies and business confidence.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	e9.9%	The fund was up +7.0% in A$ terms for the quarter and +25% year on year (yoy) versus a 15% rise in the world index. Key to the outperformance has been positions established back in mid-2016 when the manager decided to overweight North Asian companies and underweight the US. Across sectors the fund moved away from the technology sector and over-priced 'safe haven' dividend paying stocks, and invested more heavily in the unloved Energy and Materials sectors where better opportunities were evident. Successful Chinese internet plays like Baidu, Tencent and 58.com were sold down to fund purchases in companies such as Siemens, a 150 year old firm that started as a telegraph co. and is now a global leader in power generation, industrial automation, rail transport and healthcare equipment. Looking forward to 2018 the manager notes that high valuations and long bull runs do not by themselves cause the onset of a bear market, the key is company earnings growth and on that score the markets still look satisfactory. Particularly in Asia where values are lower and markets are becoming less reliant on the large Western economies to flourish so adverse movements in the US dollar are becoming less relevant over time.

Monks Investment Trust	11.8%	The fund was up +5.4% in GBP terms (+24% yoy). Despite the strong outperformance the manager does not believe markets are too expensive. By their reckoning the US market is close to what you would expect on the basis of its 90 year trend of making 7% a year for investors, while Europe, Japan and Emerging Markets are all well below trend. A range of companies contributed to fund performance across a range of diverse markets and sectors, but with similar traits of strong competitive positions and flexible management. The manager builds their portfolio from the bottom up (i.e. focus on the best companies rather than top down themes or regional bets) but greater opportunities in Asia is reflected in the increased exposure there since taking over the fund in 2015 (now 21% of assets vs 14% prior). An example is life insurance company Prudential which might initially be considered boring compared to the high flying tech companies but is estimated to be trading at a substantial discount to its value. In fact the manager noted that the current share price reflects business that has already been written, with no growth assumed at all. Prudential is increasingly focused on Asia which is 30% of the business but 80% of the value and valuing the company on the same basis as its Asian peers would increase its current GBP47bn market valuation by more than GBP36bn.
Magellan High Conviction Fund	10.3%	The fund was up +8.1% in A$ terms (+23% yoy). The largest contributors to performance included Apple (popular iPhone X launch) and Google's parent Alphabet (earnings up 32%). Alphabet is the dominant global search business and is leading the race in artificial intelligence and digital assistants. A key investment strategy for the manager is to try and identify the winners and losers from the rapid disruption of existing business models by technology. This is not always easy as disruption can be widespread and includes both first and second order effects. An example they quote is the automated supermarket checkout where the obvious first order impact was fewer checkout workers, the less obvious second order impact was lower chewing gum sales as people were not waiting in line as long. The manager believes the incredible power of digital platforms has yet to be fully realised in industries such as television (especially advertising revenue and content rights), and retail (e.g. Amazon entering the fresh food sector), and watching for both negative and positive second order impacts will provide plenty of exciting opportunities for active investors.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	5.7%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The NZ dollar fell slightly over the quarter and therefore the hedge reduced the benefit to investors. Regions to do well included Japan and the UK which hit a new record high. The US market gained 6% in USD terms and its 21% gain for the year was the best since 2013 with the broad market index hitting 62 record highs during the year and having only 8 days where values fluctuated by 1% or more, the lowest level of volatility since 1964. During the quarter the Energy and Materials sectors outperformed while Technology was only slightly positive as the sector took a breather from the 50% gain over the rest of the year. Despite investor concerns at the start of the year, 2017 was the first year on record where the MSCI All Country World Index had month with a negative performance (in local currency terms).

iShares Russell 2000 Index Fund	4.9%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. The positive momentum across most global markets helped smaller company shares to post solid gains over the quarter. Asian, European and UK companies were particularly strong with improved sentiment surrounding Brexit, European merger and acquisition activity building and improved geo-political risks. US small caps lagged slightly in the quarter and expectations for 2018 are mixed despite the positive enactment of tax reforms with some investors concerned about expensive valuations and the potential for tighter credit conditions.
Vanguard FTSE All-World ex US Small Cap Index Fund	6.0%	
Vanguard Emerging Market Index Fund	8.4%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets outperformed developed markets during the quarter and the year, rising +7% and ending the year up +36% in USD terms. China (+7%qtr, +54%yoy) and Korea (+11%qtr, +47%yoy) were standout performers with Latin America the only weak spot (-2%qtr, +24%yoy). 60% of gains over the year-long rally in Emerging Markets was driven by gains in technology and financial companies, although investor enthusiasm for these sectors began to wane in December. Looking forward emerging market company valuations have recovered significantly from the weak period between 2012 and 2016 but are coming from a low base and should remain supported by global growth, low inflation and improved profitability. Emerging markets are currently valued at a 25% discount to developed markets despite better growth prospects and reform momentum leading to projected earnings growth of 13% for 2018.
iShares S&P Global Infrastructure Index Fund	1.7%	The fund provides passive index exposure to listed infrastructure assets and is valued in USD. Global infrastructure stocks rose for the 4th consecutive quarter as companies reported healthy earnings but share prices generally lagged global equities as bond yields rose. Infrastructure companies offer an alternative source of reliable income to bonds and are therefore often used as a proxy, so any rise in interest rates makes the asset class less attractive to income investors. US infrastructure stocks in particular underperformed the broader market since they are deemed less likely to benefit from the lower US corporate tax rate.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	6.8%	The fund provides passive index exposure to commodities and is valued in USD. Commodities continued to recover ground over the quarter with Zinc at a 10 year high and oil prices are at their highest level since 2015 with China surpassing the US as the world's largest oil importer. There is a growing consensus that key commodities are now in a cyclical upswing after several years of losses. Synchronised global growth is providing healthy demand, demand for higher grade commodities is increasing, and voluntary supply reduction (such as in the oil industry) combined with lower capital investment has reduced supply for some hard commodities to the point where inventories are reducing quickly (e.g. industrial metals inventories are at their lowest level since the GFC). On the other hand many soft commodities (such as grains, livestock) have more

		than adequate supply after several years of rebuilding stock levels and will be reliant on sustained global growth or reduced prices to boost demand.

NEW ZEALAND FIXED INTEREST

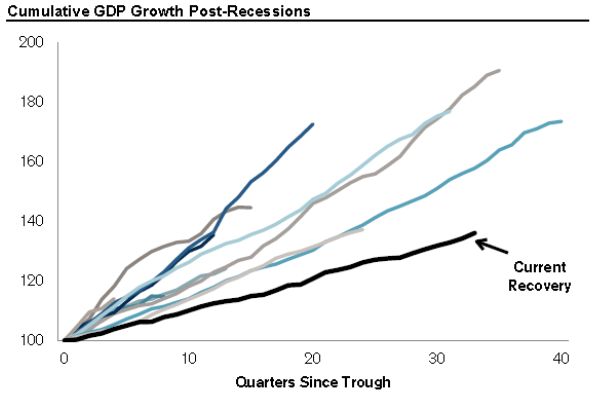
Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	1.7%	In December the US Federal Reserve delivered its 3rd interest rate rise for the year as expected (and as they had forecast). They are forecasting another 3 rate rises in 2018 (to 2.1% from 1.5%) however the market is still betting that the lack of inflation pressures will curb their enthusiasm to reduce their balance sheet and move rates back to more normal long term levels. The Fed however will be keen to unwind the distortionary impact of QE and in the absence of any exogenous shock it is hard to see the Fed changing its view, especially since the fiscal easing provided by recently announced tax cuts and infrastructure spending are expected to add around 1% to GDP which will offset the negative impact of rate increases. In Europe, how quickly the ECB decide to unwind QE may be a trigger for bond yields to rise (Greek 2 year bonds currently trade below US 2 year) while recent comments from China and Japan that they intend to slowly reduce their purchases of US treasuries just adds to the general upward direction (albeit slowly) for both short and long term interest rates. Analysis by global investment manager Wellington Management highlights that small, open economies which have seen sharp rises in house prices and household debt over recent years are the most vulnerable to rising interest rates. This includes countries such as Norway, Sweden, Canada, New Zealand and Australia. They point out that central banks in these countries are more likely to resist raising rates as long as possible, especially in the absence of wage growth. Interestingly this makes bonds in those markets more attractive to global investors (at least until the tide turns and everyone rushes for the exit!). The Reserve Bank NZ has indicated they are in no hurry to raise short term rates and this should continue in 2018 under new RBNZ Governor Adrian Orr who is likely to be operating under a revised Policy Targets Agreement, potentially with a dual mandate which includes a full employment objective alongside their current 1-3% inflation target.
NZ Corporate Fixed Interest Investment Grade Rating	1.4%	

ECONOMIC COMMENTARY

Global

The global economy is experiencing its first synchronised upswing since 2007 with growth momentum improving sharply over the quarter for most developed economies. The recovery since 2007 has been one of the longest and there are currently no recessionary indicators on the horizon. This period also marks one of the slowest recoveries suggesting this recovery cycle will be longer. The chart opposite from Credit Suisse shows the number of quarters of recovery from recession troughs since 1949. Global growth remains on track for circa 3.6% for 2017 with some bank economists picking a faster growth rate in 2018. JP Morgan Chase & Co. is predicting around 4% global growth in 2018 based on the recent surge in manufacturing activity. See the chart below from Bloomberg showing global factory orders near a 7 year high. This economic momentum provides a favourable environment for business earnings which are being more frequently revised. We discuss some key themes and risks for 2018 below:

Slow and Long Recovery



Source: Standard & Poor's, Federal Reserve, NBER, ISM, Census Bureau, Haver Analytics®, Credit Suisse. Note: 1949 to present; Cumulative nominal GDP since trough indexed to 0

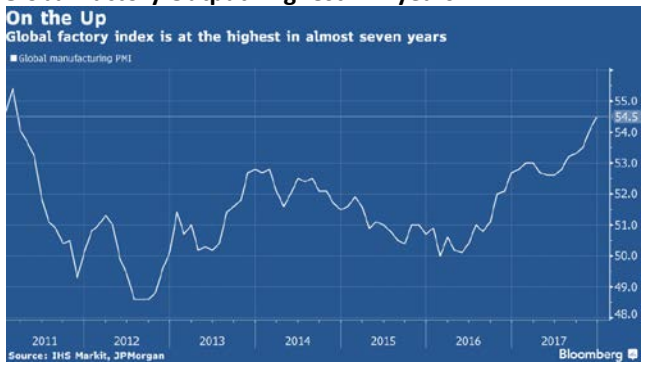
Key Themes and Risks

- **Surprise Inflation.** The greatest source of surprise in 2018 is likely to be inflation. Central banks continue to ponder the multi-year enigma of rising economic activity and low core inflation. Capacity constraints are rising and output gaps are closing. This may lead to sharper inflation spikes. Presently markets are pricing in only 2 more rate rises from the US Federal Reserve this year while the Fed itself is suggesting 3 might be appropriate. If 4 rate rises are required 10 year bond rates could go to 3%. This would be disruptive for equities and bonds.

- **Central Bank Misjudgement.** Central banks have been ultra-cautious in unwinding extreme policy settings preferring to let growth fully embed at the expense of inflation. A more aggressive response may be required (particularly by the ECB) that would unsettle markets, by now well used to slow and smooth policy decisions.

- **Technology Disruption.** Technology is disrupting at a faster rate, reducing production costs, compressing margins and increasing efficiencies in all aspects of our lives. Online, Artificial Intelligence, Energy, Robotics, Electric Cars (see chart next page) Bio-Sciences, etc. The convergence of technology is also accelerating exposing structurally weak industries and business. This offers opportunity but also rapid redundancy for those that can't respond. Active investment management is becoming increasingly important to identify both winners and losers from disruption.

Global Factory Output. Highest in 7 years



- **Cyber Attack/Security.** State sponsored cyber-attacks are rising sharply each year and more recently heralding a new form of cold warfare. From political interference, intellectual property and identity theft to embedding malware in operating systems and internet connected infrastructure and big data abuse. The rise of "fake news" is also creating dissonance and fracturing public opinion at an accelerating rate. Greater instability and increased geo-political risks can be expected. It will be interesting should the private sector (aka Google or the like) rather than governments start counter-attacking.

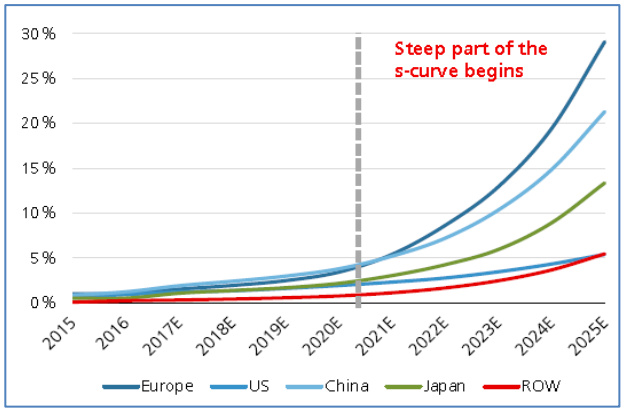
- **Trade Wars**. Trump will increase US pressure on trade imbalances this year. While China is the main focus, the withdrawal from the TPP and rumours of a withdrawal from NAFTA point to increasing anti-globalization trends. We can expect to see new US tariffs on imports and increasing trade restrictions on targeted countries. Though tighter trade policies have been well signalled, Trump in making America Great Again, will surely over step the mark damaging global trade activity and relations.

- **Brexit.** Despite Prime Minister May suggesting a resolution on negotiations will be achieved by the end of March, the process to date has been anything but smooth with a rising chance of a hard Brexit outcome. May is preparing for this with a Cabinet reshuffle to appoint a Minister for "No Deal" outcome. A hard Brexit would be tumultuous for the UK and lead to significant political and economic disruption and hardship for years.

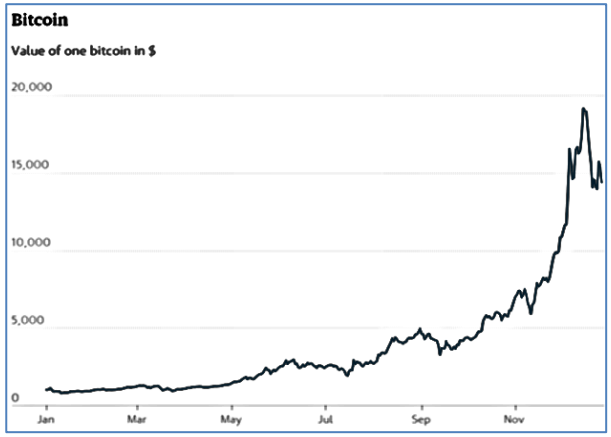
- **Geo-political.** North Korea remains the greatest source of risk this year with flow-on effects to Sino and Russian relations. China under Xi and Russia under Putin (a successful re-election makes him the longest leader since Stalin) will likely see a rise in regional and global ambitions creating further sources of stress this year - particularly for the China Sea, Eastern Europe and the vacuum following the defeat of ISIS.

- **Crypto Currencies.** Though processing capacity is hindering transaction volumes, crypto currencies are expanding in number and gaining acceptance as a form of exchange. The political, social and regulatory issues arising from this technology are immense (great for money laundering and illegal activities). Central banks and governments alike have been unsure how to respond or what it all means for the global financial system (no systemic risk at this early stage). Investors have charged into crypto currencies in 2017 with an enthusiasm comparable to the Dutch tulip mania of 1637.

The take up of Electric Cars is Accelerating!



Bitcoin: A Volatile Currency! **$1,000 to $20,000 to $15,000.**



New Zealand

Our new coalition government is focussing its policy initiatives on changing and reducing the immigration mix, addressing the housing and infrastructure imbalance, raising minimum wages and reducing foreign investment activity. To date, business confidence has fallen on these policy headlines but this is most likely due to the lack of detail rather than the policy itself. Increased government expenditure and rising minimum wages are likely to be stimulatory in the long term but the latter will hit business profitability while the prospect of a more directly involved government is causing angst. Work will need to be done to improve business confidence or there is a real risk of reducing investment. Household consumption is steady due to still rising but stabilising house prices and relatively full employment, while flattening net migration (off to Australia again) and capacity constraints in the construction industry is slowing economic activity despite strong underlying structural demand. Tourism remains strong though no longer accelerating while dairy farmers are under pressure due to recently weaker prices and drier conditions. Economic activity is solid at around 2.7% (Q3 YoY), largely due to population growth, but may soften over 2018.

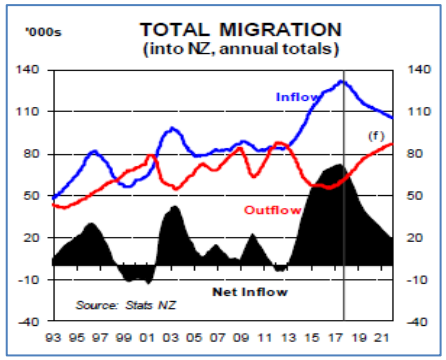
Australia

Despite having a politically torrid time, Australia's economic performance is improving on the back of higher commodity prices (Chinese demand), stronger employment growth and finally increases in business investment which have recently taken over from government infrastructure spending (see graph opposite). Inflation in Australia, like elsewhere, remains subdued with wages growth the missing link for lifting consumption. House prices are also flattening (Sydney in particular) leaving room for the Reserve Bank to keep interest rates on hold until later this year or possibly into 2019. Recent Q3 figures show GDP growth of 2.8% year on year and improving into 2018.

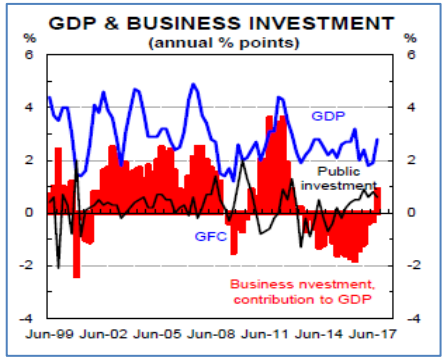
US

US economic activity continues to rise with GDP coming in at over 3% annualised for the last 2 quarters. Leading and co-incident economic indicators (see Conference Board Index opposite) show the increasing trajectory of activity likely to carry on into 2018. With $1.5trillion of tax cuts, potential repatriation of corporate offshore cash hoardings (circa $2trn) and now additional moves to increase infrastructure spending there is now the stimulus that was missing in early 2017. However, there are risks that this stimulus could overheat their economy. To date inflation (as elsewhere in the world) remains relatively subdued but with recent producer price increases (3.1%) higher than expected. The US Federal Reserve raised rates again (to 1.5%) in the quarter for the 3rd time in 2017. The Fed has signalled for 3 further rises in 2018. If it is all about the economy, then Trump may deliver surprising mid-term election results in 2018. In the meantime, another budget deadlock approaches another deadline as wrangling continues over Mexican wall funding and the Democrats' reprieve for illegal youth migrants.

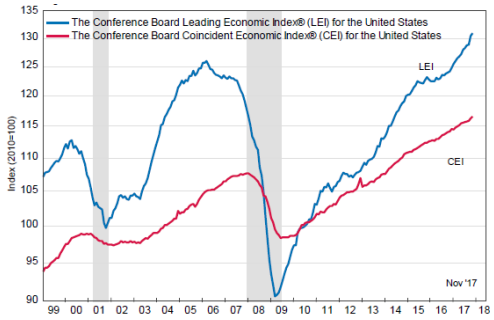
Net Migration Flattening



Australian Business Investment Rising (Source: CBA)



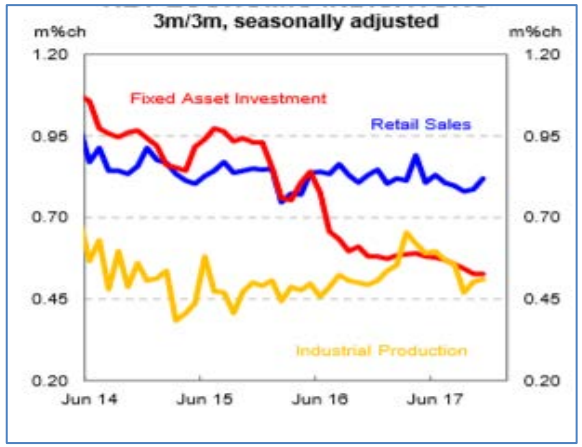
The Conference Board Leading Economic Index (US)



China

Following the 19th Party Congress, Xi Jinping has consolidated power for at least another 5 years becoming the paramount leader again and reaching a status similar to Deng Xiaoping and Mao Zedong. Xi is likely to accelerate his reform programme including removing inefficient capacity, encouraging domestic demand and tackling pollution, high house prices and corruption. His most difficult task will be stabilising China's financial system which would likely have failed in any other country by now. Recent reform stories include a reduction in tariffs on household consumables, removing foreign ownership limits on banks and allowing foreign majority stakes in local securities ventures. The graph opposite shows the shift from relying on fixed asset investment to rising domestic activity and steady industrial production. Over the quarter, manufacturing and services activity was still positive but slightly weaker and credit growth is the weakest on record suggesting economic growth may slow into 2018 from its current 6.8% p.a. to a forecast 6.5%.

China Key Economic Indicators (Source: CBA)



Europe

Possibly the success story of 2017, the Euro Area surpassed all growth forecasts as manufacturing and new orders rose to their highest levels in 17 years. Q3 data showed Germany tearing away at a 2.8% annualised growth rate, France at 2.2%, Spain at 3.1% and Italy at 1.8%. Unemployment across the region fell to 8.7% (Germany 5.6%) with youth unemployment also coming down. The ECB is now forecasting 2017 growth at 2.4% which will be the highest since Eurozone formation. Given inflation is within the target zone, the ECB is maintaining an accommodative stance for now - particularly with a strengthening Euro.

Euro Area Growth Rising, Unemployment Falling

UK

A weak pound has kept the UK economy humming along this year with surprisingly robust manufacturing, consumer spending and exports delivering GDP of circa 1.5% for 2017 (recent Q3 data was a surprising +0.6%). Though a far cry from the potential recession Brexit could have triggered, the outlook remains difficult particularly as the BOE had to lift rates on sharply rising inflation (3.1% with the weak pound being the primary cause). It's all about Brexit now and whether a deal can be struck before the end of March as indicated by PM May. This is also the date business leaders say is a point of no return for hard exit industry decisions. Without a financial services passport equivalent with EU, the BOE has estimated 75,000 jobs will be lost in the financial services industry and Paris looks to be the migration target for most of the exiting institutions. Despite a low 4.3% unemployment rate, no wage growth is leaving UK workers languishing behind the rest of Europe (including Italy and Greece).

Japan

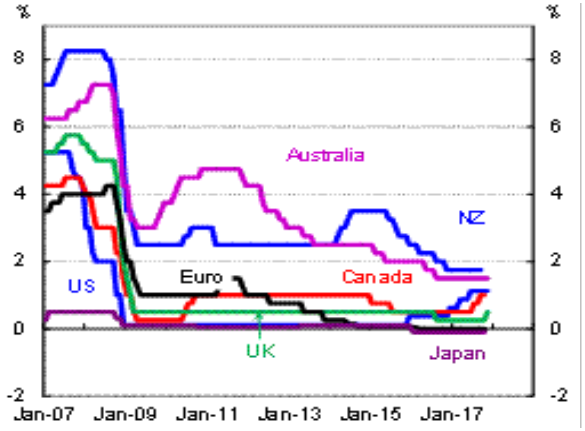
Japanese growth jumped sharply during the quarter with Q3 GDP surprising markets at 2.5% annualised (1.4% forecast). Strong in-bound tourism and rising exports and manufacturing activity due to the weak yen are the main drivers. Despite a 2.8% unemployment rate, wages growth remains a structural reform headache for the Abe government which they must address in 2018 to spur domestic consumption.

MARKET COMMENTARY

Cash

Global inflation data continues to run below central bank targets though clearly economic activity has accelerated. Weak inflation (excess capacity, technology disruption and weak wages) has provided room for central banks to set a slower tightening path. During the quarter the RBNZ, RBA and BOJ chose to keep rates on hold due to moderate growth data while the BOE, US Fed, and Canada lifted their rates, and the ECB announced further reductions in their bond buying programme. As the chart opposite shows, the interest rate cycle has finally turned. Given flattening house prices, relatively high NZD and slower growth outlook in the medium term, it would take an inflation surprise to see the RBNZ raise rates in 2018. Higher offshore funding costs may however provide the opportunity for higher term deposit rates.

Official Cash Rates Rising (Source: CBA)



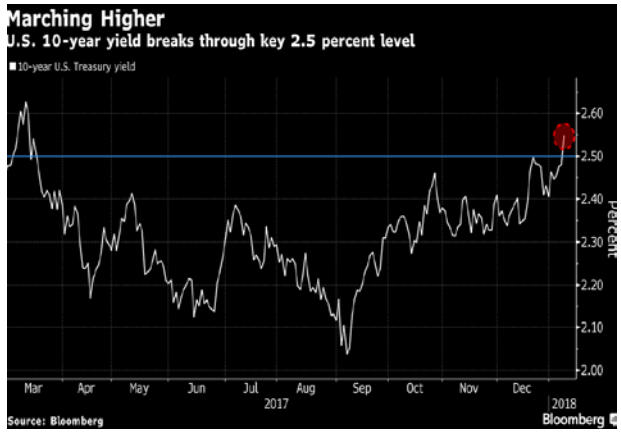
Currency

Benign inflation saw the US dollar pare back its gains in the quarter against most currencies including the NZD while the Australian dollar was also softer on slightly weaker Australian economic data. Revisions during the quarter to NZ GDP numbers were better than expected providing a lift for the NZD. The GB pound deteriorated further on Brexit uncertainty while the EUR strengthened on their surprising burst of economic activity. We expect the USD to recover on stronger growth data in early 2018.

Fixed Interest

After 7 years of unconventional monetary policy, stable global growth is turning central banks back on the path of policy normalisation. This means rising long bond yields and lower bond prices. Since the end of the year, stronger US growth and early inflation signs have seen US bond yields jump up sharply to 2.5% (last seen in March). At the time of writing, yields were at 2.58% and looking to move higher. Credit spreads are also widening as investors switch to higher quality issuers. While the US Fed has signalled 3 rate rises for 2018 the market has been under-pricing this view. This recent sell off is partly the market re-rating its view, some unwinding of long duration positions and the just announced reduced buying program from China. NZ bonds prices will follow this offshore sell-off. We continue to keep client bond portfolios shorter in duration in anticipation of these rising yields.

US Credit Risk Appetite Euphoric (Source: Credit Suisse)

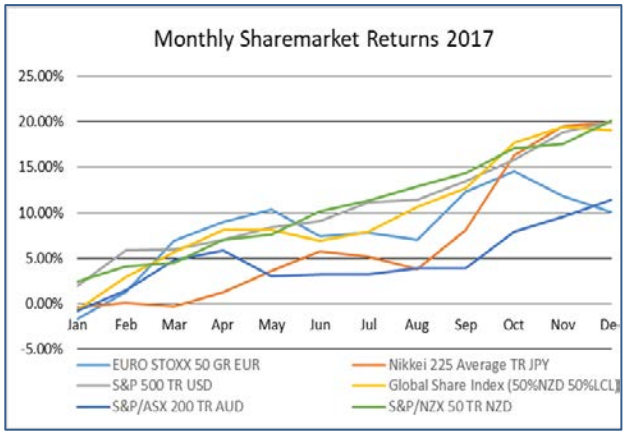


Equities

The recent rise in bond yields may temporarily unsettle share markets and lift volatility. However, unless inflation data surges sharply higher, we expect global share markets will have further room to improve over 2018 as the backdrop for company earnings growth remains compelling (revisions are consistent for stronger markets). After a strong run in 2017 some markets are expensive and priced for perfection. We expect greater volatility in 2018 as valuations are tested against actual earnings results. Japan, Europe and

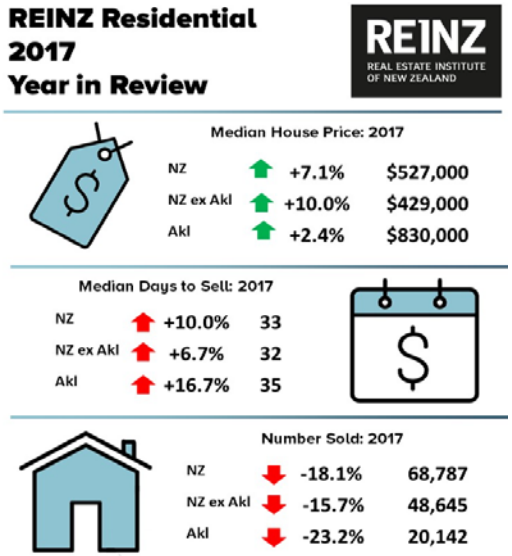
Emerging markets provide better value while the US, Australian and particularly NZ (market P/E 23 times) markets are more expensive on an historical basis. We expect returns will primarily be driven by earnings growth rather than any expansion of market multiples which may actually contract. With earnings growth numbers forecast in the high single digits for most markets, investors should be rewarded (but more modestly) from share investing again this year. Higher bond yields may weigh on some share market sectors (utilities and real estate) while accelerating technology disruption will be significant issue for all sectors with active management playing an increasingly important role.

A Strong Year for Shares



Property

Softening house data enabled the RBNZ to announce it will marginally ease LVR bank lending restrictions for 2018. This should provide some assistance for new home buyers. NZ house prices, particularly Auckland have moderated since the new coalition Government policy announcements on foreign home ownership while the Chinese Government's crack-down on capital flight also appears to have had an impact. A similar moderation of house prices is also occurring for the same reasons in Sydney, Toronto (down -15% over the year) and Vancouver. While our large housing demand & supply imbalance should support price levels over the longer term, the recent flattening of net migration numbers won't help. It appears more Kiwis are heading back to Australia again and particularly to cheaper Queensland property options while Asian immigration numbers are dropping. NZ residential consent numbers have been dragged down by falling apartment consents where construction capacity and cost issues are shelving projects. Non-residential construction consents remain robust. Losses for Fletcher Building and McConnell Dowell show how difficult the environment is becoming with intense competition for resources impacting building times and profit margins. Falling construction confidence could be a serious headwind this year.



Commodities

Energy, materials, industrial and precious metals all performed better over the quarter and the year while agricultural commodities have were more mixed. For NZ, Horticulture, Forestry, Meat and Seafood prices were better while Dairy has been more volatile. Rising global milk supply is negatively impacting prices with the Global Dairy Trade price index ending the year down 3.9% and may compromise Fonterra's $6.40 forecast. Our terms of trade reached record levels though the recently higher NZ dollar will have some impact.