NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

16 January 2019

December 2018 Quarterly Report

Last quarter we wrote that greater market volatility was expected given elevated values in some markets and the potential for a higher interest rate rise outlook. The quarter turned out to be even more volatile than we expected with a sharp market retreat triggered when the US Federal Reserve Bank suggested interest rates may need to be higher than markets were expecting. Conditions deteriorated further into the quarter with negative sentiment coming from the escalating US / China trade war, daily Trump tweets unnerving markets, the Brexit impasse, US government funding stalemate and also sharply lower energy prices. To add to the pressure high-volume market trading programmes exacerbated daily volatility particularly, in the US.

Portfolios values fell through the quarter and are now also slightly negative for the year. Major sharemarkets and commodities were sharply lower over the year. High quality bonds performed very well and provided some portfolio protection while several of the active international share managers in the portfolio also took more defensive positions. The NZ dollar was higher over the quarter additionally impacting offshore returns though our hedging strategy assisted.

In contrast to the very poor market performance, global economic conditions while slightly softer, still remain robust though no longer as synchronised as they were it was in early 2018. We expect the presently long global economic cycle to extend through 2019 and be market supportive.

From here, market volatility will likely quieten down as trading positions unwind and the economic outlook becomes clearer. Valuations are very attractive at these levels and we are rebalancing portfolios to take advantage. While there are no signs of recession on the horizon, we remain wary of central bank misjudgement and as always, the many geo-political risks.

Kind regards,

Wayne Ross
Director Investments

T 09 377 5777 | PO Box 2683 | Shortland Street | Auckland 1140 |www.newtonross.co.nz

ECONOMIC AND MARKET SUMMARY

Traditionally the final quarter is a good period for investment markets, particularly the final month. This year December proved an exception with the US Dow Jones index down -8.7% (at one stage was down -19.8%), its worst month since 1931. Bearing in mind the 1931 December fall occurred during the Great Depression it is hard to see the economic backdrop justification for the recent correction as we are not even in a recession.

All major sharemarkets finished in negative territory for the quarter and most were well down over the year as well. The exception was the NZ market which returned +4.9% for the year which is remarkable given its small size, lack of liquidity and expensive valuations. Kiwisaver flows and the high dividend yield nature of our market once again provided surprising price support. Elsewhere over the year the Australian market was down -3%, China -28%, Europe -11%, UK -9% and Emerging Markets -15%. Commodities also had a difficult year with oil weaker -25% and copper prices -20%. Property markets did not entirely escape either with residential prices down in for many major cities over the year (Sydney -10%, London -3%, NYC -2%). NZ property was more resilient though Auckland residential prices are lower. High quality bonds provided better returns over the year with NZ bonds providing a +4.7% return and global bonds +2.7%.

Market Volatility Jumped Sharply in the Quarter

Why the sudden correction in markets? The key trigger for the correction came on October 2nd when the US Federal Reserve Bank suggested interest rates may need to be tightened further given record US low unemployment numbers. There is however, still no completely convincing theory behind the voracity of the drop. There have been a range of negative factors overhanging markets for some time including, relatively high valuations, higher interest rate prospects (higher borrowing costs) on reducing central bank accommodation, the many and varied geo-political risks (US/China, Brexit, Trump, Russia) and a general sense that the global economic cycle is desynchronizing, and after 10 years is due for a recession. Added to this mix, market traders have been progressively positioning (short the market) for increased volatility which has been historically low. Intraday volatility was extraordinary, an example was Apple which fell -10% one day on slightly weaker earnings prospects then recovered +10% in the next 2 days.

Was the sell down justified? The recent market correction is effectively pricing in the high chance of a global recession and we think this is an overly pessimistic view. There will of course be a recession at some time in the future as part of the natural cycle, but consensus economic views have the probability as less than 20% in 2019 and more likely several years away yet. Though there has been some recent and not unexpected softening, the global economic framework remains in good if not robust shape.

Where to from here? We expect markets will form a base and recover some ground as investors take advantage of attractive valuations. For the longer- term, there are reasons to expect the economic cycle will extend and for markets to perform well including:

- Stable and contained inflation (technology impact, lower commodity prices vs higher wage growth)
- Consequently, central bank accommodation
- Supportive fiscal policy settings (China, US, Europe, NZ)
- Resistant company earnings growth
- Historically strong company balance sheets
- Increased takeover and merger activity
- Better returns vs still low cash rates.

The potential headwinds? The US Federal Reserve. We expect moderating language from the Fed given market conditions and recently softer economic data, but any near-term inflation jumps or dogged commitment to higher rates would be the major headwind for global markets. There will be some US/China relationship accommodation but no resolution on the big issues and a hard Brexit outcome would put the UK in recession and create additional uncertainty in Europe. At home, government policy uncertainty, tax changes and resource constraints will be un-welcome though increased Government spending is positive.

We continue to manage portfolios as we always have through periods of volatility and the different parts of the economic cycle; careful alignment to portfolio strategy of securities and asset allocation weightings and hold only resilient high-quality assets.

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

Market Returns	Dec. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**1.9**	-1.1	-0.4	-1.0
$NZ v $US	**0.9**	-6.3	-0.4	-4.1
$NZ v $AUD	**4.3**	4.9	0.5	0.6
NZ Cash	**0.5**	2.0	2.2	2.7
NZ Fixed Interest	**1.5**	4.7	4.5	5.4
Intl Fixed Interest 100% hedged to $NZ	**2.3**	2.7	3.8	5.5
Australasian Equities 50/50 Indexes	**-8.9**	-0.4	9.1	9.2
NZ Listed Property	**2.0**	9.8	8.4	12.6
Intl Equities 50% hedged to $NZ	**-13.5**	-6.1	6.7	7.4
Commodities $NZ	**-10.4**	-5.9	1.0	-5.0

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	0.5%
F&P Healthcare	Healthcare	-12.7%
Fletcher Building	Building	-25.4%
Freightways	Transportation	-5.9%
Meridian Energy	Energy	3.5%
Port of Tauranga	Ports	-4.3%
Stride Property	Property	0.5%
Trade Me	Consumer	21.7%
Vector	Energy	-3.5%
Vista Group Intl	Software	-3.1%
Australian Equities		
BHP Billiton	Resources & Energy	-5.2%
Brambles	Professional Services	-10.7%
CSL	Healthcare	-11.6%
IAG	Financials	-7.2%
National Australia Bank	Financials	-13.1%
Scentre	Property	-5.8%

- Trade Me received an initial offer for the business from APAX Partners, a UK Private Equity firm, at $6.40 a share which was a 25% premium to market. This was a reasonable offer based on expected future earnings but it was hoped there might be other parties interested and subsequent due diligence by rival bidder Hellman and Friedman did push the price up by 5 cents. The revised APAX Partners bid at $6.45 values the company at $2.56b and has been unanimously supported by the Trade Me board. The offer will be voted on in April with a likely settlement date being mid 2019.
- Sonic Healthcare announced the acquisition of Aurora Diagnostics for US$540m. Aurora is an anatomical pathology provider in 19 US states and has more than 100 hospital contracts which provide some opportunity for cross-selling other SHL services. Growth in anatomical pathology is driven by the aging population, prevalence of chronic diseases and increased spending on out-patient services. SHL is funding the purchase by way of an institutional share placement and a share purchase plan which we will be taking up on behalf of investors.
- Fletcher Building downgraded profit guidance from $685m to $655m due to a slowing Australian property market and a temporary shutdown of its cement business. There were no further issues with the Building and Interiors provision, but investors took the news badly and the share price dropped sharply. Subsequently FBU announced the sale of the Formica Group to a Netherlands based Broadview Holdings for US$840m and will reinstate dividends from 2019. The Formica sale was welcomed and marks the end of FBU selling non-core assets as part of its 5 year business realignment to focus on building products and distribution in NZ and Australia. As part of that strategy FBU is planning to build a new $262m Wallboard factory in Drury and also offered to buy Steel & Tube as an add-on to its steel business but the $1.90 offer was rejected as too low and FBU walked away from the deal rather than pay more.

Sonic Healthcare	Healthcare	-14.8%
Westpac	Financials	-10.6%
Woodside Petroleum	Energy	-22.2%
Woolworths	Consumer Staples	-0.4%

- Woolworths continues to recover ground against its competitors with sales revenue increasing. An interesting trend for the industry is the margin/cost pressures associated with slowing in-store purchases and the growth in online purchases. Big W is the discount brand for Woolworths and 100% of its sales growth came from online purchases in the last quarter. While this poses a risk from the likes of Amazon entering the local market, it also is likely to help major brands like WOW and Coles put pressure on smaller independent stores who can't fund the required spend on new store designs, automation and data.
- IAG completed its capital management initiative which returned A$592m to shareholders by way of a capital return (19.5c) and a special dividend (5.5c). At the same time every 1 ordinary share was converted into 0.9760 ordinary shares to ensure proportionate ownership remained the same.
- BHP has completed the sale of its US onshore oil and gas shale businesses to BP and Merit Energy for a total US$10.4bn. BHP is looking to simplify and strengthen its portfolio and has sold US$18bn of assets in the last 6 years. Half of the sale proceeds will be used to buy back shares and the other half will be repaid to shareholders by way of a US$5.2bn special dividend.
- Stride Property reported a strong profit result with improved occupancy rates (98.9%), solid rental growth and revaluation gains. The company is selling non-core properties and undertaking smaller projects to upgrade, refurbish and expand existing properties which offer better prospects. After lagging the broader market for most of 2018 the listed NZ property sector had a positive quarter with investors attracted to the relative safety and gross yields.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	-9.4%	The fund outperformed the market benchmark over the quarter due to holding overweight positions in Trade Me and Meridian Energy with no allocation to poor performers: ANZ, Z Energy and Ryman Healthcare. Most of the market drop was felt in October when large cap stocks led the way down, with the NZ market largely avoiding the further carnage in December. The Retirement Village sector was hit hard (Ryman dropped 22%) as investors took note of the weaker house prices starting to emerge. Positive cash flow in this sector are largely driven by capital gains made on the sale of units and the cash management fees collected when units are vacated so profits are at risk in a weaker housing market. The manager notes that the NZ market valuation remains at much higher price multiples than either Australia or the US. Given both these markets are now much cheaper than they were; they expect to see some rebound (we have seen signs of this in early Jan) with reasonable corporate profitability, stable low inflation and interest rates expected to remain flat for some time - which helps both debt servicing and consumption. Key to returns for the year ahead will be the interest rate path taken by the US Fed and China's approach to slowing growth and given the uncertainty around both of these the manager remains defensively positioned.

Harbour Australasian Equity Focus Fund	-13.3%	The fund underperformed the market benchmark over the quarter. Detractors were GTN, Summerset, Challenger, CSL and Macquarie while Mainfreight, a2Milk, Pacific Edge and Steel & Tube provide a positive contribution. Mainfreight is investing in 32 sites around the world and continues to grow earnings through the cycle as it rolls out its successful model into Europe. Challenger lost ground over the qtr. along with most financial stocks, but the Australian life insurer and fund manager is likely to be a longer-term beneficiary of Royal Commission proposals and has the potential to increase its 3% market share of the $60bn which transitions into retirement savings in Australia each year. Hub 24 is a new stock added to the portfolio. The wealth management platform is disrupting existing competitors and is a high growth beneficiary of financial sector change. The manager is cautious about the current macro environment but believes there are significant active investment opportunities given current secular trends such as disruption and technology, demographics (aging and consumption), climate change (price for carbon) and political influences (tariffs, Royal Commission fallout).

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	-12.3%	The fund was down -8.0% in A$ terms for the quarter. The fund benefited from short positions (where the manager sells a stock they don't own assuming they can buy it later at a lower price) in tech and bio-tech stocks as those sectors were sold down sharply. Detracting from performance however were oil related holdings which fell as the oil price dropped by -40%. Longer term these oil service companies are expected to recover as the industry requires additional capital expenditure. Despite China being the worst performing market in 2018 and making up 28% of the portfolio, the Chinese holdings in aggregate only fell 3% which reflect the difference between the broad market and the performance of individual companies. Chinese authorities have moved to ease tightened credit conditions by reducing banks' reserve requirements to free up liquidity, encouraging lending to private enterprises, increasing infrastructure spending and cutting taxes. The manager has been buying stocks at attractive valuations during the recent sell-off (including adding General Electric which is down 80% since 2016) and reducing exposure to those companies which have done relatively well. Given the current uncertainty however, the fund continues to hold a high cash weighting (20%) and remains conservatively positioned at 69% net invested.

Monks Investment Trust	-17.0%	The fund was down -13.8% in GBP terms for the quarter. Technology, disruption and innovations are key themes in the portfolio and the manager retains great enthusiasm for Asian growth prospects. They have recently added two new insurance holdings to the fund with the companies based in China and India. The longer-term potential is evident with an Asian middle class population which is around 6 times the size of the G7 countries combined - but where spending on social welfare is only one-sixth of western levels. The manager can also invest in private companies (an example was music streaming company Spotify) and notes that this is a growing trend. Historically, companies listed to gain access to initial capital to build a factory, design new products, buy a retail shop, etc. Many new disruptive tech companies are not capital intensive however and remaining private for longer avoids unnecessary complexity and lets them focus on building a business without the distraction of daily share price movements which often do not reflect underlying business value.
Magellan High Conviction Fund	-12.6%	The fund was down -8.8% in A$ terms for the quarter with 10 of the 11 broad market sectors falling (worst was Energy which fell -22% while Utilities rose +0.5%). Portfolio stocks that struggled most included investments in Apple, Facebook and Kraft Heinz. Apple tumbled after earnings downgrades by key suppliers raised concerns about the strength of demand for Apple's latest devices. Facebook fell after media reports attacked how top executives handled fake news and privacy issues, while Kraft Heinz delayed cost cutting measures to support better short-term sales growth. The only stock to make a meaningful contribution was Starbucks which surged after faster than expected sales growth. Despite the -17% drop in the IT sector Microsoft became the worlds most valuable company having tripled its share price since 2014. Key to the company's success has been the move to target business users with productivity software tools and cloud-based storage and solutions. For the established technology company, the result of strategic decisions made several years ago are impressive with net income for the most recent quarter up 34% to US8.8bn.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	-13.3%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The fund is hedged to the NZ dollar which means values were not adversely impacted by the strong rise in the NZ dollar against the AUD (+4.3%) and GBP (+4.4%). This was the weakest quarter for global share markets since March 2009 and the weakest December month since 1931. Volatility increased significantly and markets were sharply lower across the board with the US falling -14%, Japan -17%, UK -10% and Europe -11%. This quick reversal of market sentiment occurred despite there being no recession, war or other economic shock.
iShares Russell 2000 Index Fund	-20.7%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. Small companies in the US, particularly those in the tech and bio-tech industries were sold down heavily. Earlier in the year smaller US companies did relatively better than large cap stocks as investors bet domestic focused companies would be immune to trade tensions. Sentiment however, has shifted to concerns about slowing US growth and the impact higher interest rates will have on smaller companies which typically have more debt. The Russell 2000 index was down more than 20% from its peak in August this year.
Vanguard FTSE All-World ex US Small Cap Index Fund	-14.6%	

Vanguard Emerging Market Index Fund	-6.0%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Potentially weaker US dollar prospects and already depressed share valuations saw investors begin to reallocate funds back into emerging markets over the quarter. The MSCI Emerging Markets index currently trades at around 10x earnings whereas Developed Markets trade at 18x earnings which provides the opportunity for bargain buying especially in markets such as China, Brazil, Argentina and Russia.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	-11.4%	The fund provides passive index exposure to commodities and is valued in USD. The oil price fell 40% as the US decided to effectively defer sanctions on purchases of Iranian oil. As OPEC producers had been increasing production to make up for the potential shortfall, and US onshore producers had also expanded output in response to higher prices, the result was an unexpected deterioration in the supply-demand balance in the oil market. Metal prices declined on slower global growth prospects and trade war issues negatively impacted agricultural prices.

NEW ZEALAND FIXED INTEREST

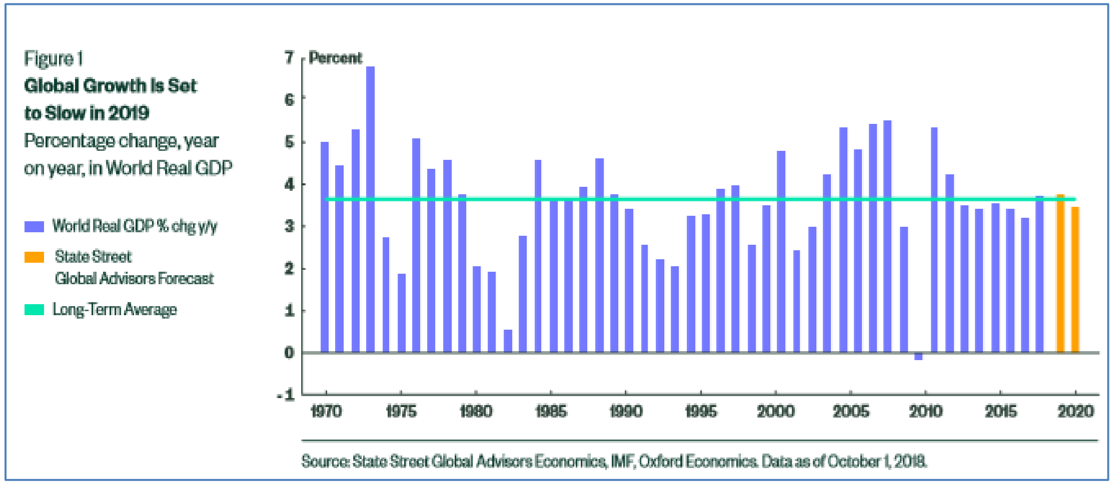
Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	1.5%	The US Federal Reserve raised cash rates for the 9th time to 2.25-2.5% and continues to reduce its holding of US treasuries (which acts to also tighten monetary policy). Despite more cautious comments from the Fed on the outlook, investors were disappointed that they only reduced their forecasted rate increases in 2019 from 3 to 2. Investors were hoping for none. The subsequent sharp selloff in equity markets saw risk averse buyers climb back into the bond market, reducing US 10 year bond rates from 3.25% to 2.75%. The yield curve even hinted at moving inverse (where long-term rates are lower than short term rates) which has historically flagged a recession. While this didn't happen, the very flat yield curve does reflect investor uncertainty about growth and inflation. While sovereign bonds were in hot demand; lesser quality

NZ Corporate Fixed Interest Investment Grade Rating	1.2%	corporate debt struggled to find favour and this left many corporates having to pay more to borrow. Yields on debt issued by US blue-chip companies rose 1% during 2018 to 4.3% (high yield debt was up+1.5%) - still relatively low but the highest level this decade. The Reserve Bank of NZ remains on hold at 1.75% and is likely to remain there until at least 2020, clearly indicating a preference for growth and full employment over the potential for higher inflation as part of its new dual mandate. A key announcement in December was the proposed higher capital requirements for NZ banks which will require them to retain an additional $20-25bn. There are a number of ways they might achieve this including; retaining more profits, raising equity, selling assets or rethinking the size of their loan books. Capital is more expensive for banks than debt so the RBNZ proposal will increase their cost of doing business. It is likely banks will address this through some combination of higher lending rates, lower term deposit rates and potentially lower profits. Higher lending rates are likely to reduce investment and lower NZ economic growth which supports the RBNZ keeping cash rates lower for longer.

ECONOMIC COMMENTARY

Global Growth – Slower but still robust

Last January we wrote about the synchronised nature of global growth and that it provided a strong positive setting for markets - only to then see markets sell-off sharply in February as investors became acutely concerned that central banks would remove easy monetary conditions faster than expected. Over the year growth became de-synchronised with the US economy continuing to expand, being further stimulated by Trump's fiscal initiatives and record low unemployment. Elsewhere, growth has moderated, particularly in China - which is also in the long process of engineering a different economic platform and some slowing was not unexpected. A consequence of the de-synchronisation is the variance in policy challenges faced by central banks. This leads to changes in capital flows and currency fluctuations between economies as different monetary conditions and economic growth prospects play out. Global activity has decelerated since the start of 2018 but the basic framework for growth remains intact. The IMF forecasts growth to slow to 3.7% from 3.9% with many economists predicting slightly lower levels of 3.4 to 3.5%. None the less, this is still strongly expansionary.



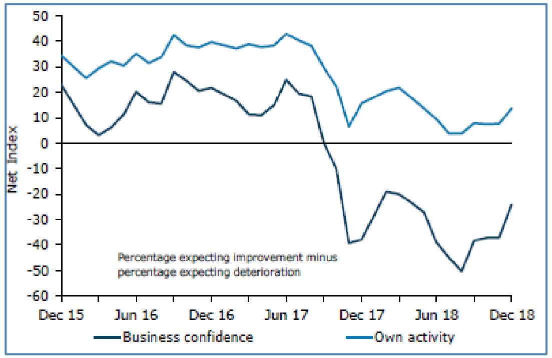
Where the US Federal Reserve Bank is fretting about resource constraints (low unemployment and wage inflation) and unwinding monetary accommodation, central banks elsewhere are maintaining easier settings in the face of less than desirable growth. Markets have subsequently become increasingly volatile trying to factor in growth prospects and the likely policy responses against a backdrop of a record long economic cycle that logically requires some period of consolidation and recession. While the shape of global growth is changing this year, there is sufficient momentum to provide support for company earnings and market returns.

The key risks for 2019 include central bank misjudgement, (particularly in the US), followed by the risk of a considerably weaker than expected Chinese economy (less than 4% growth) and the potential of a hard Brexit (recently looking more of a possibility) creating a recession in the UK and sending negative shockwaves into Europe. A sharp drop in Chinese demand will affect global growth and would certainly put further pressure on already soft commodity prices. This would have a significant negative impact on many emerging economies. While US/China trade relations create headlines, they are not likely to have a material impact on those economies - though negotiations and tactical spats will add to the noise affecting daily market volatility. With the Democrats now taking control of the House in Congress, the Trump administration and the man himself will become more isolated and reduced to what he can influence with his executive powers. There is risk of him becoming increasingly erratic as he desperately tries to remain relevant for 2020 election campaigning. We expect the US/China discussions currently underway will result in some trade agreements and potentially force technology transfer relief for foreign companies in China. The bigger picture of cyber theft and intellectual property rights remains intractable.

New Zealand

With a wider set of policy responsibilities, the RBNZ has so far played a prudent hand by holding off further rate tightening in the face of greater inflationary pressures as government spending increases and the labour market tightens. Recently, weaker energy prices and the stronger NZD have provided some room for patience and the easier policy settings should assist the country in better managing the recently softer conditions. Business confidence finally improved in December on lower petrol prices and easier credit, but confidence remains at multi-year lows and is likely affecting investment decisions. The stronger NZ dollar (on better government accounts and debt ratios) is negatively impacting our terms of trade - as are lower global prices for our commodities though export volumes remain solid. Household demand is picking up supported by lower mortgage rates, strong employment conditions, rising wages and increases in government support under the Family Package. Construction activity is strong in both commercial and residential markets while residential property prices are expected to get some support from recently reduced LVR restrictions though new tax rules may counter this somewhat. With the key drivers for our economy largely in place, growth is forecast to stabilize at current levels but also possibly improve from 2.7% this year to 3% in 2019. Potential headwinds for that outcome include erratic government policy (watch the tax policy space), slower trading partner growth, sharply higher inflation, weak investment and lower net migration. Aside from a tightening labour market and some materials resource constraints, conditions generally remain favourable for company earnings this year.

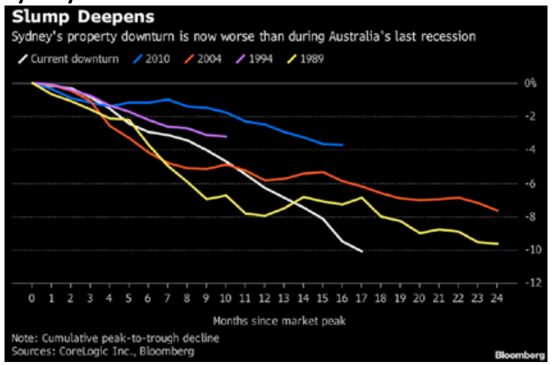
ANZ Business Confidence Index



Australia

After a strong start to 2018, there has been some recent softening for the Australian economy with falling export commodity prices and a fall in house prices - most noticeably in Sydney and Melbourne where average home values have fallen -10.1% and- 5.8% respectively since 2017. The impact of falling prices on household spending is not yet known but strong employment and recent wages growth should help offset this to a degree. Both the manufacturing and services sectors finished the year on a weaker note, but PMI data was better in the last quarter and new orders were also strong with lower fuel costs which will help reduce costs. Home construction is slowing, though both commercial and infrastructure activity is very strong with several major state government projects set to commence in 2019. Various forecasts have the Australian economy decelerating this year from 2.9% to 2.6% growth on weaker export concerns (Chinese demand) and the political uncertainty of elections this year. Like the RBNZ, the RBA has kept rate increases on hold despite the rising wage pressures and has recently indicated a preparedness to ease if required.

Sydney House Prices

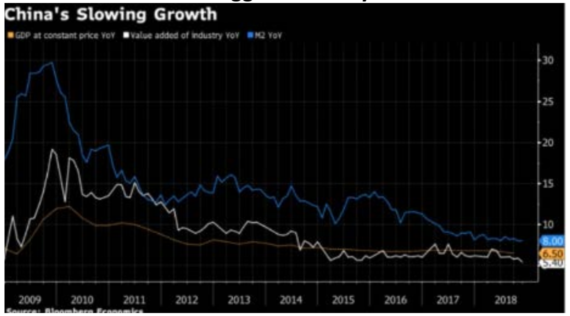


US

The US grew above the global trend rate in 2018 (near 3%) with strong domestic demand driven by record employment levels, rising wages and stable house prices. Trump tax cuts have added additional fiscal stimulus while planned infrastructure spending (including "The Wall") and the potential for further tax cuts are yet to impact. Inflation to date has stayed just above the Federal Reserve target range with full employment (unemployment ~3.7%) and rising wages a concern. However, recently lower energy prices and a strong US dollar are currently keeping core

inflation in check (~2.1%). Despite the strong labour numbers, recent services and manufacturing data has been softer though hiring intentions are still firm. The US / China trade conflict is expected to continue though not have a material impact on broader US activity although some auto and agricultural exporters are hurting. The Federal Reserve changed its tone in late December to signal that it is watching and poised to respond to recent negative market indicators. This suggests that the Fed is prepared to pause tightening should markets become unstable and activity slows below trend. Consensus forecasts have the US economy growing at a slower but still robust rate closer to the global trend rate of 2.4% in 2019. This slowdown can be attributed to the waning impact of tax cuts and the tighter financial conditions that have lifted borrowing costs impacting construction, business investment and retail spending. Company earnings growth likely peaked in 2018 from already historically high levels but consensus forecasts still have them running at a robust +8.5% in 2019 though Q1 results are expected to be lower at +5%. This is still very supportive for markets from current valuation levels.

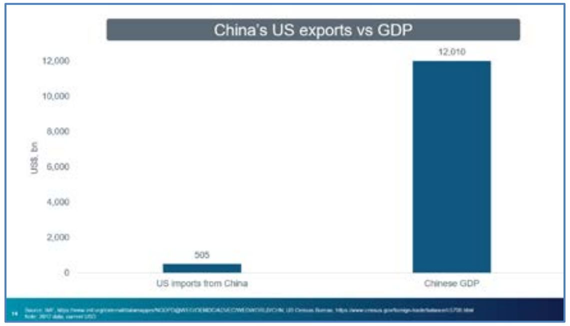
Slower Growth for a Bigger Economy



China

As their economy has grown (now US$12.2trillion), the annual Chinese GDP growth rate has declined from double digits in 2010 to a more sustainable target rate of 6.5% p.a. at present. The growth rate was also expected to reduce as China structurally reforms its economy, shifting to higher value domestic activity from low value exporting. Exports now only account for 18% of Chinese GDP down from 36% in 2007. Chinese authorities are also working on a cultural, environmental, political and nationalist evolution. These tasks are daunting but more achievable under the authoritarian regime established by Xi. Recent data suggests Chinese economic activity is running down faster than expected. The US trade war, financial deleveraging and slower investment is also taking its toll. To counter this, officials have responded in the quarter with additional fiscal stimulus; including tax and fee cuts and a reduction in bank lending reserve rates which should free up an additional US$163bn for lending. They are also relaxing the rules on foreign ownership and investment in the financial services sector. This will provide an estimated 1.5% annual GDP boost to their economy. Slower growth also gives China an additional incentive to reach a resolution on the US trade dispute. While the direct economic effect of the trade dispute is quite low (see chart opposite – less than 5% of Chinese GDP is US exports) the impact on market confidence and foreign investment is substantial. While some agreement is expected on trade and possibly forced technology transfer issues in Q1 2019, the bigger problems of intellectual property rights, cyber theft (Huawei network concern being a prime example) and rising Chinese imperialism are not easily and unlikely to be resolved. Forecast growth for China in 2019 is 6% to 6.2%.

Chinese Exports to US less than 5% of Chinese GDP



Source: Markit, Eurostat, J.P. Morgan Economic Research. November 2018.

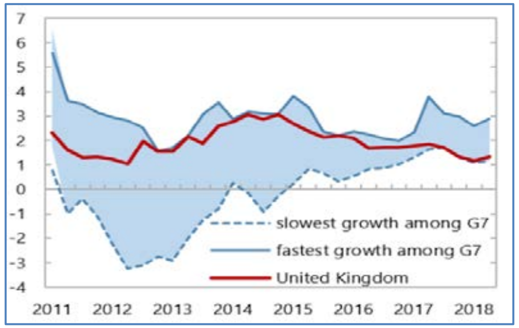
Europe

Eurozone growth is also likely to moderate from its peak in 2017 (2.5%) as export activity slows on global trade uncertainties and specific issues such as the French strikes while poor weather and political uncertainty weigh on business confidence and investment. However labour conditions continue to improve with better employment (10 year low of 7.9% unemployment) and wage growth (+2.5% in 2018) across the Eurozone underpinning domestic demand and creating a more stable economic platform. The sustainable nature of the Eurozone economy now means the European Central Bank can withdraw its extraordinary easing policies and indicates a possible interest rate hike late 2019. The forecast growth for Europe this year is 1.8% (1.9% in 2018) which is closer to its trend rate. The Italian government finally agreed to abide by EU budget deficit rules which removes a nagging source of concern.

UK

Despite the dark shadow of Brexit, the UK performed relatively well in 2018 (1.3% vs 1.5% in 2017) on the back of very strong employment, rising wages and partial recovery of exports in the second half of 2018. Meanwhile inflation is running above target due to the weak GBP. However, the Brexit uncertainties mean the UK is running well below its potential and pockets of real stress are appearing – most noticeably with lower London house prices and in financial services. Brexit is no closer to resolution and the runway to exit has all but disappeared. Prime Minister May is losing control as her recent package failed to pass Parliament. Though she has survived no confidence votes to date she has only days to put an alternative proposal to vote. Commentators are suggesting MPs will pass the next package as a hard Brexit is not acceptable. It is coming down to the wire and the Labour Party is playing a very dangerous game of trying to force a general election. The Bank of England's "disorderly" exit scenario suggests a possible 8% drop in GDP (hard recession) and 30% drop in house prices, an inflation spike and sharp rise in unemployment. Commentators are suggesting the opposition will cave in and accept the deal but the Bank of England, government ministries, industries and courts are now urgently preparing for a hard exit. Will the EU provide a deadline extension?

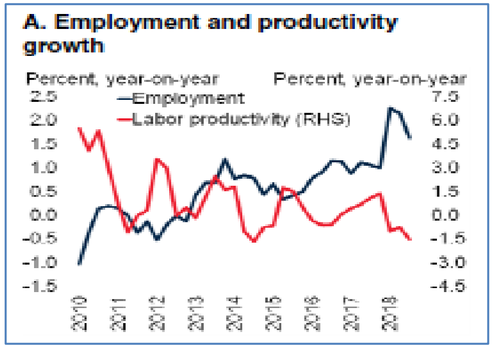
Brexit Threat Impacts UK Performance



Japan

Japan had a reasonable year in 2018 (+0.9%) given their production was buffeted by natural disasters including earthquakes, typhoons and torrential rains. Exports continued to perform well, and their labour market remains robust with unemployment down to 2.4%, rises in wages and higher participation rate. The Bank of Japan continues with extraordinary monetary easing while fiscal stimulus is also being applied. As a result, the Government is now running large budget deficits. A proposed consumption tax increase may have an impact on domestic demand in 2019 - although the Bank of Japan has previously eased conditions on such taxes. Like New Zealand, Japan's greatest challenge remains labour productivity, which continues to place a significant drag on their economy as does an aging demographic. Their economy is forecast to grow +0.8% in 2019.

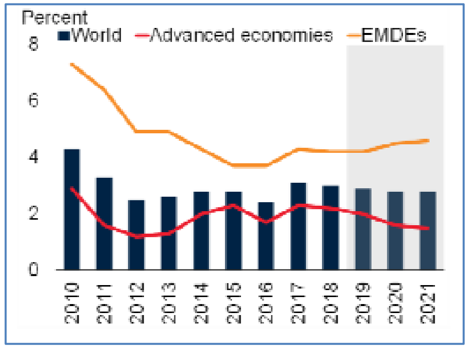
Japan's Labour Productivity Challenge



Emerging Markets

The weaker US dollar is finally assisting financially distressed emerging economies. However recently softer energy and metals prices will counteract the impact for those exporting countries; as will slower developed economy activity. The outlook for Emerging Market growth in 2019 is flat at 4.2% with the global contribution from EMs remaining below potential and possibly at additional risk this year from ongoing China/US trade wars. Countries like Turkey, Argentina, Brazil and South Africa are expected to improve on reduced financial pressures (lower borrowing costs and returning foreign investment). Emerging Asian economies such as India are doing better on manufacturing relocation (from China), significant infrastructure spending, rising wages and increased domestic demand.

Advanced vs Emerging Markets Growth



NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

MARKET COMMENTARY

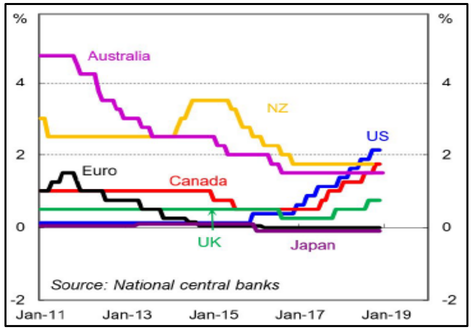
This quarter was the most volatile since 2012. The December month (traditionally a postive performance month) was the worst since 1931. This is despite their being no recession, war or other macroeconomic shock. There is no solid explanation for the rout which appears to be the result of a combination of events including market realisation that central bank accommodation may finally be ending – it was The US Federal Reserve comments on October 2nd that conditions may tighten even faster due to inflationary pressures that triggered the sell-down. Programme or machine trading excacerbated conditions; particuarly in the US where intraday volatilty (now up as well as down) was record breaking. While there has been much discussion (and certainly market pricing) for an impending recession, the weaker activity data only supports some slowing rather than an iminent contraction. Valuations have reached the point where sellers are wary and short positions are being squeezed in both share and debt markets resulting in sharp price bounces as seen in early January. I was reminded by a market commentator that share markets tend to go down quickly in elevators but only rise slowly in steps. Short of any additional macro surprises, steady though likely softer company earnings growth numbers will provide the support for these currently oversold markets.

Worst December for S&P since 1931

Cash

The US Federal Reserve raised rates again in December but the Federal Open Market Committee minutes revealed more cautious comments from several members regarding softer economic data. Recently the Fed's language has become even more cautious re-iterating that they are "listening to markets". They can afford to pause and be pragmatic as core inflation while slightly above target is likely to stabilise on lower energy costs; though their tight labour market remains a concern. Regardless, markets have to accept that tighter financial conditions are ahead, barring any macro surprises or unexpected growth hiccups. The NZRB kept the OCR at 1.75% in November while indicating a preparedness to stay on hold for a considerable period (through 2020) pending clarity on growth momentum. The combination of full employment and price stabilization mandates are providing the RBNZ with room to accept hotter growth and a top of the range inflation rate. Despite the "on hold" messaging, the NZ dollar was much stronger over the period due to a weaker US dollar and as as offshore investors place a premium on our declining and relatively low government debt levels.

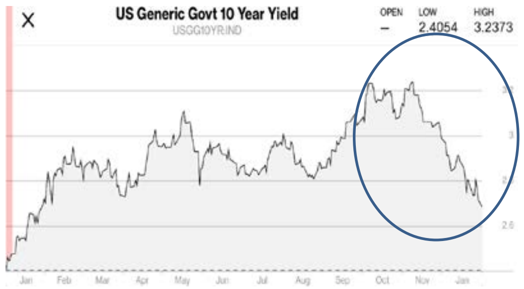
Official Cash Rates



Fixed Interest

Bonds delivered very strong returns during the quarter and over the year providing substantial protection for investment portfolios against sharemarket, commodity and property asset volatility. Investment grade bonds, particularly government stock, rallied very strongly in the reporting period with the US 10 year rate falling from a peak of 3.25% to 2.75% and NZ 10 yr bonds from 2.8% to 2.4% as capital flowed to safe harbour assets. Non-investment grade bonds (junk bonds) did not fare as well with credit spreads widening sharply on the same risk aversion. More recently junk bonds have recovered with credit spreads contracting as investors buy back into oversold riskier assets.

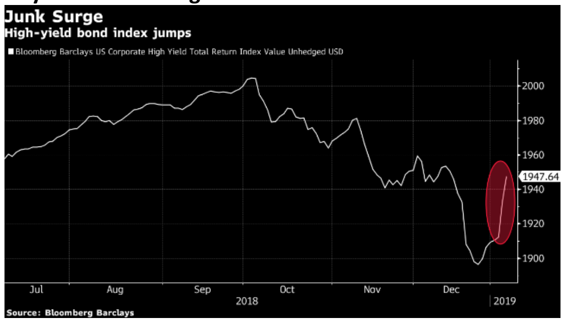
Bonds Perform Well as Yields Fall



NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

The widening of speads sends a clear message to corporates that the days of easy financing are past and that more prudent financial management will be required. We expect bond yields to move up again from here as the concerns of a near recession retreat and economic activity data stabilizes in 2019.

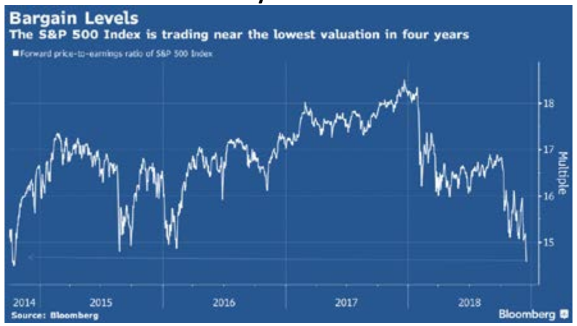
Buyers now moving back into riskier bonds



Equities

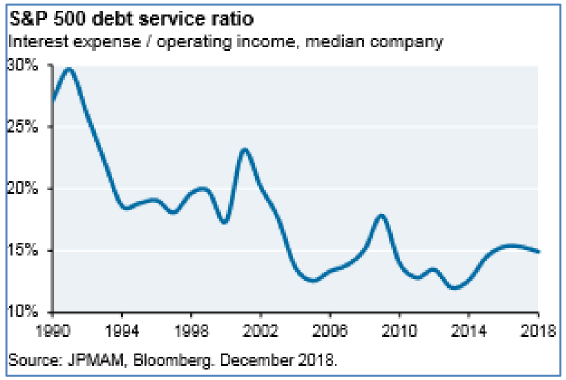
Equities dropped in 2018 despite very strong company earnings growth. Valuations were fair to overvalued in some markets (notably NZ and to a lesser extent Australia). Those overvaluations were caused by local conditions including superannuation contribution flows and investors chasing the higher dividend yields in those markets. Individual stock overvaluations, primarily tech growth stocks also got ahead of themselves ensuring that any earnings guidance misses, regardless of how small, were punished as illustrated by Apple. The sharp falls witnessed during February (later recovered) and December are excessive based on economic and company earnings fundamentals. Effectively markets are pricing in near term recession - or worse - which we believe is overly pessimistic. While there is no doubt economic activity has retreated from the very high early 2018 levels; growth still remains at or above trend levels and is expansionary. The risks of higher interest rate servicing costs and rising wages are present but company balance sheets remain in good shape and the graph opposite shows the debt servicing costs are still at historic lows. Even with much lower company earnings forecasts (US consensus earnings revisions are still very good at 8.5% in 2019 - but down from a heady 26% in 2018), market valuations remain at multi-year lows (P/Es: World 14x, US 14x, Japan 12x, UK 11x, Europe, 10.5x, Australia 15x and NZ). Ironically our small, illiquid and expensive NZ sharemarket still produced a postive return for the year, not being subject to the short selling and algorithm trading pressures of the larger markets. We expect international equities to improve as geo-political risks abate.

US Share Valuations at 4-year lows



Property

Global property markets were mixed over the year with residential markets weaker but industrial and commercial markets still performing well on supply constraints. NZ industrial and commercial property also performed well with Auckland industrial vacancy rates at 23 year lows (1.7%) and prime office vacancy declining below 4% - construction is not keeping up and rents are rising. Meanwhile residential prices are flat to falling in Auckland on lower net migration, offshore buyer restrictions, further brightline tax rules and better supply. The residential property market now also faces a new headwind from 1st April when ring-fencing of rental property tax deductibility begins. This will deliver a cash flow shock for the many geared residential property investors while new capital gains tax proposals will also be announced from the Tax Working Group. The RBNZ did announce some LVR relief for new home buyers.



Commodities

Excess global supply drove energy prices sharply lower in period culminating in a 24% drop in oil prices over the year. Metal prices also declined over the quarter on slower global growth concerns while agricultural prices were down due to trade wars (tarrifs and embargoes) combined with strong production volumes. NZ meat was the only category to record stronger prices while better milk volumes offset lower global prices for dairy.