15 July 2019

June 2019 Quarterly Report

Portfolios continued to perform well over the quarter despite significant investment market angst over the US/China trade war, rising middle east tensions, broadening Trump trade war rhetoric and increasing concerns for global economic growth.

With global activity slowing and inflation remaining supressed, central banks are once again either easing or considering easing their monetary policy. Several central banks cut rates over the quarter (including the RBNZ) and more cuts are expected over the second half of the year. Markets have responded favourably to the prospects of lower interest rates and also the ceasefire in trade war escalation as the US and China resume talks.

The fallout from the trade dispute is certainly impacting business confidence with global manufacturing the weakest in 3 years. Central banks are now riding to the rescue and many governments are introducing stimulatory fiscal policies as well. A global recession in the near term remains unlikely.

Valuations are high for several investment markets, but with record low interest rates and further cuts likely, investment funds will continue to flow into higher risk assets that offer investors better earnings prospects.

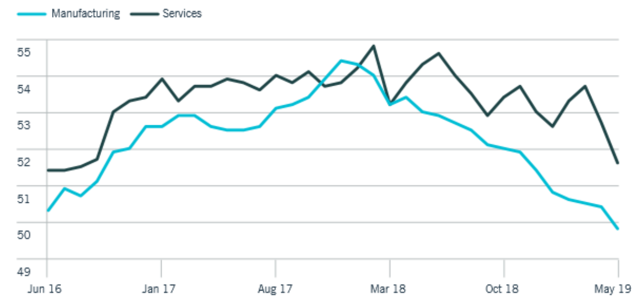
We remain vigilant about risk and are keeping investment portfolios in line with their target asset and securities allocations and only investing in high quality assets. We expect markets will be more volatile over the second half of the year.

Kind regards,

Wayne Ross
Director Investments

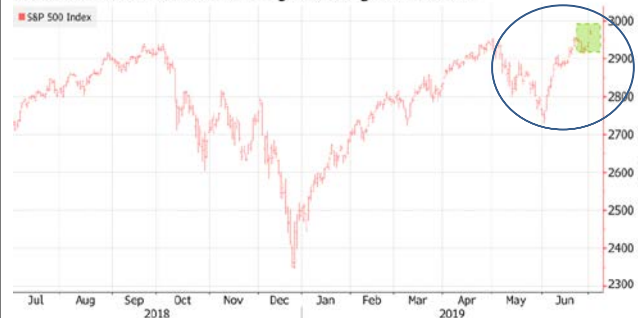
ECONOMIC AND MARKET SUMMARY

Following a bounce in economic growth earlier in the year, global activity weakened in the June quarter as trade war uncertainty, rising Brexit risks and geo-political tensions took their toll on confidence. The chart below shows that global manufacturing (the blue line) is the weakest in 3 years and further contracting primarily due to trade war uncertainty.



These concerns also weighed on investment markets during the middle of the quarter before markets rallied sharply in June as the US Federal Reserve indicated it would cut rates if required to support the US economy and hope remained for a US/China trade resolution. Though a resolution has not been achieved, both sides are talking again which should prevent a further escalation. This appears to be satisfying markets for now. The impact of the trade dispute is most evident in China where industrial activity slid to its lowest level in 17 years. China also has much weaker import numbers indicating domestic demand (car sales) is softening. Property prices and construction are falling in some areas providing a real concern for banks. Chinese authorities have responded to the slowdown with old style stimulatory policies including low cost funding for state enterprises and local government for investment. This stimulus is expected to offset the decline in export activity and stabilize growth over the rest of the year. The People's Bank of China Governor Yi Gang said his country has "tremendous" monetary and fiscal policy space to make adjustments to the economy should the trade war worsen again.

US manufacturing was also down over the quarter, but other US economic data was better including stronger employment numbers. US growth though lower, is still running above trend (1.75%) at 2.5%. With benign inflation, ongoing trade tensions and slower global growth, the US Federal Reserve may cut interest rates in July and markets are expecting another 2-3 cuts later in the year. The chart below shows the jump in US sharemarket prices in June on a cooling in the trade war but also on the prospects of easier monetary conditions.



Other central banks are either easing or considering easing monetary conditions including NZ, Australia, Europe and the UK. This has been supportive for investment markets in those economies with both shares and bonds rising. Perversely, bonds have risen due to a weaker economic outlook while shares have risen on the prospects of lower borrowing costs and stabilizing earnings. Some commentators refer to this as a 'Goldilocks' environment. The perpetuation of the low inflation, low interest rate outlook is driving many investors into potentially higher risk assets including junk bonds, longer term bond investing, structured investments, property (particularly syndicates) and shares. This 'creeping' of risk taking reflects the growing frustration investors have with the lower yields on term deposits and on high quality, shorter term bonds. It should be remembered however that though these yields are low, so is inflation and even after-tax NZ investors are receiving a real rate of return on these safer investments. With strong global employment, resilient consumer spending and stimulatory policy action we believe global economic growth will improve and stabilize over the second half of the year. Pending any significant trade deterioration or geo-political shock, this historically long global economic cycle will extend further. This is positive but we are also keenly aware that asset prices have been driven to very high levels in some markets anticipating better times ahead. Some form of price correction or certainly increased volatility is likely – especially as company earnings decline.

To counter risk, we continue to maintain a disciplined investment approach by ensuring client portfolios are invested closely to their target asset and securities allocations and only into high quality assets.

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

Market Returns	Jun. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-0.9**	1.0	-1.3	-2.1
$NZ v $US	**-1.3**	-0.7	-2.0	-5.2
$NZ v $AUD	**-0.1**	4.6	0.0	0.4
NZ Cash	**0.4**	1.7	1.8	2.3
NZ Fixed Interest	**1.9**	8.2	4.2	5.8
Intl Fixed Interest 100% hedged to $NZ	**2.9**	7.3	3.0	5.5
Australasian Equities 50/50 Indexes	**7.4**	12.0	14.1	12.0
NZ Listed Property	**12.1**	31.1	12.8	15.0
Intl Equities 50% hedged to $NZ	**3.9**	5.2	12.8	10.0
Commodities $NZ	**0.3**	-6.0	-0.3	-4.2

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	20.6%
Contact Energy	Energy	9.3%
F&P Healthcare	Healthcare	-0.3%
Fletcher Building	Building	-2.0%
Freightways	Transportation	2.1%
Meridian Energy	Energy	11.9%
Port of Tauranga	Ports	16.8%
Stride Property	Property	10.4%
Vector	Energy	5.4%
Vista Group Intl	Software	24.0%
Australian Equities		
BHP Billiton	Resources & Energy	7.1%
Brambles	Professional Services	9.2%
CSL	Healthcare	10.4%
IAG	Financials	7.7%
National Australia Bank	Financials	10.6%
Scentre	Property	-6.5%

- The Auckland Airport share price achieved an all-time high despite reporting softer than expected domestic and international passenger growth. Investors favoured the relative high dividend yield and remain confident that passenger numbers will recover and that the company is well positioned to leverage its non-aeronautical initiatives.
- Meridian Energy was another company which was sought out by yield hungry investors. The company has experience 20% profit growth over the year as wholesale electricity prices rose and input costs were helped by strong hydro dam production due to favourable weather conditions. The company share price is up 60% in the last year.
- Vista Group rallied strongly as investors became increasingly confident of the earnings potential from their Movio Media division. This cinema data platform allows movie studios to better connect with their audiences. Movio grew revenue by 47% last year and expanded its operating margins resulting in net earnings growth of 72%.
- APRA, the Australian banking regulator, softened its capital buffer requirements for Australasia's largest banks after they argued there wasn't sufficient market capacity for them to raise the necessary funds and any change would adversely impact profitability. Despite this softening requirement, banks will still need to raise an additional $12-$13bn each in additional Tier-2 capital. This level of the capital structure is required to convert to equity or is written off if in the worst situation. Meanwhile APRA has also told the banks to set aside an extra $500m-$1b until they have finished remediating customers from problems highlighted in the Royal Commission. NAB for example has ring fenced A$1.1bn for issues to do with insurance, advice and wealth management services.
- Woolworths has issued 3 billion fewer plastic bags over the year since the single use plastic ban was put in place in most Australian states, which is a massive 5000 tonnes of plastic kept out of circulation. Competitor Coles has

Sonic Healthcare	Healthcare	10.5%
Westpac	Financials	13.4%
Woodside Petroleum	Energy	5.1%
Woolworths	Consumer Staples	8.6%

- Scentre was the weakest performing stock in the portfolio over the quarter. The company operates retail shopping malls in Australia and NZ. The weaker economic outlook and prospect of lower consumer demand in both countries has created some concern for investors. However, the stock is attractively valued at its current share price (unlike many other stocks) and the company has just sold 3 Sydney office towers which will further strengthen their balance sheet.
- National Australia Bank has pledged A$2bn over the next 5 years to boost high growth tech companies by providing support via loans, advice and assistance with capital raising. Eligible companies will need to demonstrate a strategic advantage over competitors and disruptors, along with strong management and existing backing from credible investors.
- Fletcher Building provided a market update confirming NZ operations were performing well but Australia operations continues to struggle. Despite the promise of a $300m share buyback, investors were hoping for better results and remain concerned about the capital investment that may be required to turn around the Australian business in a weakening property market at this stage of the economic cycle.

also used 1.7 billion fewer single use bags and research shows 7 out of 10 customers now bring a reusable bag, many of which are "community bags' which are sold as fund raisers and to date have raised $2.5m for charity.

- Woolworths has also continued to refocus on its core food and retail businesses with an announcement that they have taken the first steps towards separating and demerging the drinks and hotels operations which together have an enterprise value of A$11bn and contributed 30% of WOW total profits last year. Rating agency Standard & Poors have said that while the demerger would reduce the company's scale and diversity it is unlikely to affect creditworthiness and the reduced exposure to hotels and gaming will reduce significant regulatory and public perception risks.
- Contact Energy is to invest $10.7m for a 49.9% stake in Simply Energy. Simply Energy provides hedging and tariff services to commercial and industrial power users and the new relationship will facilitate delivering new technology and a reduced carbon footprint to that part of the market. CEN makes more than 80% of its power at dams and geothermal fields and is planning to increase that further in order to reduce CO2 emissions by 60,000 tonnes by 2022.

Changes to the Australasian Portfolio

During the quarter the private equity purchase of Trade Me was completed and sale proceeds were reinvested in Contact Energy (CEN). Contact Energy is primarily a New Zealand electricity generation business. CEN generates 28% of NZ's electricity needs and has the lowest cost, largest and most economic renewable generation options in the market comprising a well-diversified portfolio of gas, geothermal and hydro assets. CEN has 400,000 electricity customers and 60,000 gas customers and at the time of purchase was providing an attractive and sustainable dividend yield of approximately 5.8%.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	7.9%	The fund outperformed the market benchmark over the quarter due to strong contributions from Sydney Airport, Atlas Arteria, Meridian and Aristocrat Leisure. Aristocrat posted a 30% revenue gain due to market share growth in the US premium gaming market and the outlook is positive with strong reviews for new games released by the digital division. Following the surprise win by the centre-right coalition government, the Australian share market outperformed most markets including NZ (+6.7%), with the ASX200 index up +8%. The move was led by Telecoms, Financials and Healthcare while Energy, Utilities and Technology were the worst performing sectors. The Australian centre-right coalition win meant there would be no change to capital gains and negative gearing rules which is seen as positive for the housing market, particularly when combined with the first interest rate cut by the RBA since 2016. Devon has reduced holdings to Australian banks after a research trip confirmed for them that bank earnings remain at considerable risk from further RBA rate cuts, regulation and remediation costs. Given the increased volatility and disparity between bond and equity market values, and in the absence of any meaningful recovery in global growth or a trade deal (unlikely given political value to Trump), Devon believes share prices can only be sustained with the forecast central bank interest rates cuts being made.
Harbour Australasian Equity Focus Fund	4.6%	The fund underperformed the market benchmark over the quarter. Strong returns from Mainfreight, Aristocrat, Vista, Xero and CSL were offset by negative returns from Summerset (slower property market), Pacific Edge, GTN (profit downgrade), Oil Search and Hub24 (increased competition). The fund does not hold many of the low growth bond proxy stocks which did particularly well. The largest holding (14%) is a2 Milk which is transitioning through a changing Chinese regulatory structure which included a June and announcement that Chinese authorities wish to become 60% self-sufficient in the infant milk formula market. Rather than seeing this as a negative, the manager believes it provides a2 with a competitive advantage due to its strong brand positioning and they added to their position when the stock sold off -10%. During the quarter, the manager also participated in several equity raisings including global payments company AfterPay, healthcare company Volpara and graphite miner Syrah resources. Given the current financial market environment, there is an expectation that corporates will continue to actively look to manage their capital and this provides opportunities for active managers such as Harbour. The manager hosted 2 roundtable presentations with NZ company directors and executives on the results of their carbon research work. This research highlighted the lack of disclosure from NZ listed companies as well as limited carbon offsetting initiatives and climate organisation involvement. The good news is for those companies that did disclose their data the majority showed a declining trend in emissions.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	1.7%	The fund was up 1.6% in A$ terms for the quarter which was less than the market. The manager reacted to the Huawai tech ban and the reignited US-China trade war by moving in early May to their most cautious fund positioning since 2008. Cash was increased and short positions (which profit if a share price falls) were taken in export orientated markets such as Japan, Hong Kong and Germany along with the tech heavy US Nasdaq. The effect of this was that the fund was only 56% net invested. As tensions eased and markets rebounded some of this safety net was unwound however the net cost to the fund was 0.5% over the period. The manager remains cautious and prefers to retain their investment in leading global energy and materials companies with high yields, and avoid many of the very expensive tech, heath care and consumer companies which have been the key drivers of recent market performance. In fact, over the past year around 50% of the total world share market return came from just 40 companies out of 2800 in the index, and 34 of these were listed in the US. During the quarter the manager added to existing positions in companies that had been sold off in the semi-conductor and auto related businesses. They also added new positions in Ryanair (European budget airline), Owens corning (US building materials) and BRF (Brazilian producer of pork and poultry).
Monks Investment Trust	8.2%	The fund was up 7.6% in GBP terms for the quarter which was ahead of the market. The manager has increased their exposure to unquoted technology stocks by taking a stake in a new Baillie Gifford trust which raised GBP364m to invest in rapidly growing tech-backed disruptors. With companies staying private for longer due to lower capital and regulatory requirements, the new investment provides a diversified exposure to this important growth area and leverages the specialist capabilities of the investing team. Monks already had a small exposure to private companies including Grail, a gene sequencing business, so has increased its limit on private company exposure from 2% to 5% to accommodate the new opportunities.
Magellan High Conviction Fund	5.9%	The fund was up 5.8% in A$ terms for the quarter which was ahead of the market. The manager considers there are 2 big issues facing investment markets currently and the first is whether there is a trade deal or not. The short term will be influenced by Trump's political ambitions but longer term the core issue is that China now presents a significant economic and military foe for the US and has been growing its position on unfair terms thanks to government industry subsidies designed to take global market share and stealing or transferring intellectual property. China has clear objectives to dominate areas such as quantum computing, artificial intelligence, aircraft and autonomous vehicle production. This will have both short term and long term implications for investors who have to decide how best to participate in these initiatives (it is difficult to find the right investment vehicles) and also how to gain exposure to the enormous consumer demand wave as a further 300 million Chinese move into the ranks of the middle class in the next 10 years.

		The second key issue is US monetary policy and how this affects the discount rate professional investors use to value the future earnings from a company. A lower interest rate supports a higher share price and if global interest rates stay at these historically low rates then a company that appears overvalued based on historical measures could in fact be a bargain today. The manager has lowered their assumed discount rates since the GFC but only slightly and the target portfolio mix remains approximately 50% invested in tech/growth companies and 50% in cash or defensive companies.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	3.6%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD which means values were not impacted by movement in the NZ dollar against the AUD (-0.1%), GBP (+1.3%) and USD (-1.3%). The key developed markets were all positive over the quarter as investors preferred the perceived safety of large real estate, utilities, infrastructure and consumer staples companies and those growth stocks considered immune to trade issues. Growth stocks can be categorised as having a high share price relative to their book value, while value stocks have a low price to book. This quarter growth stocks outperformed value stocks as they have done in most years since the GFC. In fact, the relative outperformance of growth over value has not been this large since the height of the tech bubble in 1999-2000. Although absolute valuations remain only half of what they were back then it is worthwhile remembering that since 1975 growth and value have both had long periods of relative outperformance but over the full period have actually provided near identical total returns. This index fund provides exposure to both growth and value stocks.
iShares Russell 2000 Index Fund	3.5%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD which provided a benefit over the quarter. Although positive over the quarter, smaller company shares returned less than larger companies in local currency terms and were significantly more volatile as investor appetite was whipsawed by trade issues and movements in the US dollar.
Vanguard FTSE All-World ex US Small Cap Index Fund	3.2%	
Vanguard Emerging Market Index Fund	2.0%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets failed to bounce back fully from earlier tariff concerns, despite the resumption in China-US trade talks. Markets such as Argentina and South Africa benefited from market friendly political developments while the higher oil priced helped Russian sentiment. Dragging down the sector was South Korea and China, the latter not fully recovering from the increase in tariffs on $200b of US imports and blacklisting of telecoms company Huawei.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	-0.6%	The fund provides passive index exposure to commodities and is valued in USD. Slower global growth reduced returns from industrial metals such as Zinc (-14%) and Copper (-8%) and the oil price fell almost 5% despite efforts by OPEC to keep a lid on supply. By contrast gold recorded a +9% gain as investors sought safety and iron ore prices were up 35% largely due to concerns of a slow recovery from the latest Brazil disaster by Vale who produce 25% of total world supplies.

NEW ZEALAND FIXED INTEREST

<table>
<tr><th>Security</th><th>Quarterly Performance In NZ$ terms</th><th>Commentary</th></tr>
<tr><td>NZ Government Fixed Interest</td><td>1.9%</td><td rowspan="2">Global bonds performed strongly over the quarter, broadly reflecting expectations that central banks would keep monetary policy loose for the time being. Despite strong growth and a 50-year low in unemployment, the lack of wage inflation has provided space for the US Federal Reserve to hint at lower interest rates due to trade negotiations adversely impacting global growth. With the US domestic consumer accounting for almost 70% of the US economy it could be argued that the weaker global story is a convenient ‘way out’ for Governor Powell as he continues to find himself under political pressure. The Fed has shifted market sentiment considerably since the end of 2018 and we are now in uncharted territory for financial markets with many countries sitting at record low interest rates and more than $13 trillion in global debt trading with a negative yield. The Fed is now talking of ‘prevention rather than cure’ and investors are convinced this means as many as 3 rate cuts. Typically, a rate cut helps the share market to a positive gain in the following 12 months but not always, and history is not a good guide when rates are already this low.

NZ bonds which were expensive last quarter became even more expensive as the Reserve Bank of NZ also cut the official cash rate, moving the OCR to 1.5% in May with the possibility of more to come if growth continues to falter and with one eye on other central banks as they all seemingly engage in a race to the bottom. The Reserve Bank of Australia for example just cut to a new record low of 1.0% when at the depths of the global financial crisis their rates fell to ‘just’ 3.0%. The RBNZ has come under increasing scrutiny around the current Bank Capital Review and progress on this will be an important factor in banks proving credit for growth moving forward. This is especially important for NZ investors who are faced with fewer and fewer lower risk investment options. To date term deposits have offered a considerable 1-2% premium over other similar quality fixed interest securities as banks have fought to attract sufficient retail cash to meet their obligations. There is a real risk that if the RBNZ changes the rules, retail bank deposit rates will drop sharply and leave more retail investors taking on additional risk to meet their income requirements.</td></tr>
<tr><td>NZ Corporate Fixed Interest Investment Grade Rating</td><td>1.9%</td></tr>
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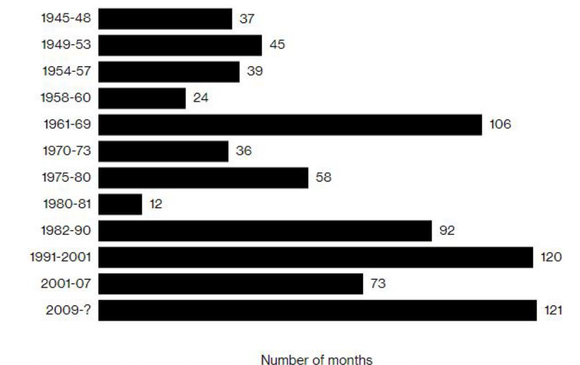
Global Outlook

Media headlines have been obsessed with how long the present economic cycle has been running and surely it must come to an end soon particularly, given the US is now in its longest expansion period since 1854. During the quarter, US treasury pricing (2-year yields higher than 10-year yields) also suggested some type of recession is coming, if not imminent. While a recession is inevitable at some point, no one really knows when this might occur or how deep such a recession might be. The nature of this cycle is different as the expansion has been at a very slow rate while the global financial system, asset prices and economies slowly rebalanced and structurally adjusted from the Great Financial Crisis. With hindsight, the GFC was likely a depression which was ironed out through central bank accommodation into a below trend, but steady recovery. Along the way, there have been many mini-crises and periods of market overreach leading to bouts of volatility and corrections. But generally, the economic recovery and markets have been remarkably stable since 2009. Each time economic growth slips or a potential structural event occurs, central banks and or governments have stepped into save the day. This safety net has allowed investors particularly, those in higher risk assets (junk fixed interest, property and shares), to do very well with limited downside over the last 10 years. Can it continue? The answer is likely yes…for now. With inflation benign, central banks this quarter once again came to the rescue; cutting rates or indicating a preparedness to ease. China and the US governments (and NZ/Australia) have also set easier fiscal policies.

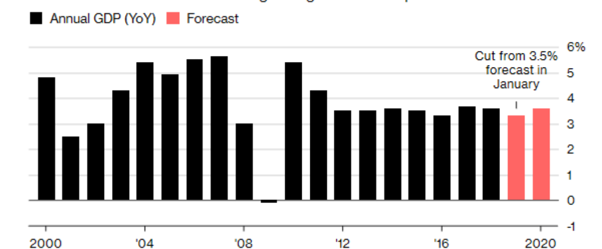
Many economies are running at record unemployment levels and worker participation rates continue to rise as more re-enter the marketplace (perhaps looking to supplement low investment incomes). The consumer, now such a large part of modern economies, has also proven to be resilient while also maintaining reasonable savings rates and their generally higher house prices have also given them the confidence to consume.

All this steady demand everywhere but no discernable inflationary pressures? Inflation remains the key to the extension of this expansionary cycle. Without it, low rates continue perpetuating capital flows into higher risk assets and stretching valuations which can be justified on steady economic growth and low interest rate settings. A spike in inflation will likely be the pin that bursts the bubble…but when and where will it come from? With full employment, central banks are closely focused on wage inflation data which periodically creeps up only to retreat again (the US unemployment rate is the lowest since 1968). We have been expecting inflationary pressures to impact interest rates for more than 4 years, but disinflationary forces continue to keep a lid on things. New technology, globalization and more open capital markets have combined to improve productivity but also continuously reduce costs even with tightening labour markets. While the technology disruption trend will continue, a trade or cold war escalation threatens de-globalisation, regionalization and even isolation. Tariffs on Chinese goods in the US (and in China) are already impacting US prices which can only be absorbed by businesses for so long and perhaps is why (ironically for Trump) the reason the US Federal Reserve has been so reluctant to ease rates. Perhaps the inflation surprise in the end won't come from wages but from trade pressures as import prices bounce.

US Economic Expansion Continues



Global Growth Outlook Lower



NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

New Zealand

Despite the reprieve from Michael Cullen's capital gain tax proposals, business confidence continues to deteriorate and is now at its lowest level since the Great Financial Crisis. The Government is failing to engage and build confidence with business who just see rising wages, higher fuel prices, greater regulations, poor spending decisions, tighter labour conditions and a lack of action on addressing the big issues such as RMA reform and infrastructure. Even the recent Prime Minister's Business Advisory Council recommendation for urgent, privately funded roading infrastructure has been dismissed out of hand by Government as 'bad policy'. The persistent downturn in confidence is a serious concern as it will be affecting investment and hiring intentions. Profits are also being squeezed with the inability of most to pass on price increases due to global pricing competition. The Reserve Bank cut the OCR in May to 1.5% citing global growth concerns, weaker house prices and lower business investment. Though the RBNZ stayed on hold in June it is likely we will see a further cut in August, particularly given the cuts to rates offshore and an inability of businesses to pass on price rises. The Government announced an increase in its spending plans in June. This additional spending (when actually made) combined with the recent lift in net migration, better regional performance and lower mortgage costs for households, should provide some support for our softening economy over the rest of the year. A lower 2.3% growth rate is now expected for 2019.

NZ Business Confidence at a 9 Year Low

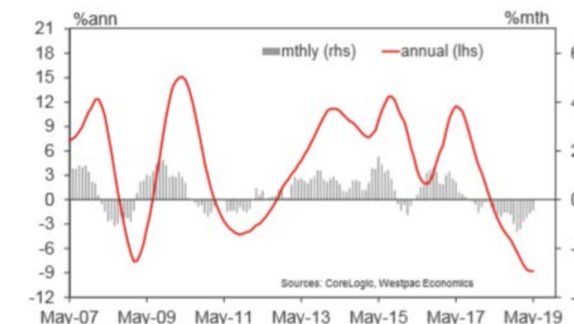
	June	May	Change
General business situation	-38.1	-32.0	-6.1
Own activity outlook	8.0	8.5	-0.5
Capacity utilisation expectations	5.3	5.4	-0.1
Pricing intentions	22.6	28.5	-5.9
Costs	49.7	49.7	0.0
Inflation expectations	1.87%	1.81%	0.06%
Investment intentions	2.5	2.9	-0.4
Employment intentions	0.0	-0.3	0.3
Export intentions	5.3	0.0	5.3
Profit expectations	-12.5	-9.6	-2.9

Source: Westpac Economics

Australia

The Reserve Bank of Australia recently cut the cash rate to a record low of 1% reflecting below trend growth concerns. Since 2018, economic activity has slowed sharply on falling house prices, a weaker consumer and lower residential construction activity. On the flip side, mining is holding up well as commodity prices continue to be supported by global supply issues and China ramps up infrastructure investment once again. A more stable majority government (another election surprise) has improved both business confidence while planned tax cuts will combine with lower mortgage rates (at 60-year lows) to provide some relief to highly indebted households and also provide property price support (see opposite). Given both the monetary and fiscal stimulus and likely stabilisation of house prices the outlook is better over the second half of the year though stubbornly low wages growth remains a structural impediment for consumption. With a large part of their economy reliant on exports, Australia is also anxiously watching the ongoing trade war (and increasingly cold war) for resolution. As an interesting aside, most new Australian retirees now have enough personal superannuation and savings to not rely on an aged pension with only 25% of new retirees drawing a full age pension (aged pensions are asset and income means tested in Australia).

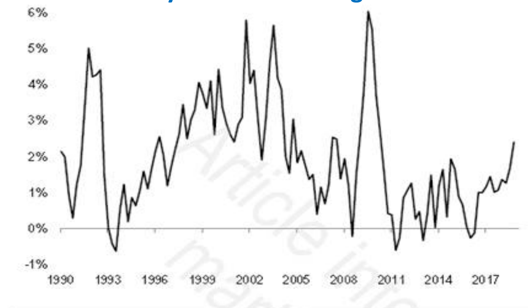
Australian Dwelling Prices



US

The US economy has not been immune from slowing global forces and increasing trade wars with US manufacturing hitting a 9-year low. Offsetting this slow down, services have been resilient with June numbers revised higher and the US consumer also remains robust keeping the US economy running at above trend growth rates (3.1% in Q1). Despite positive leading economic index numbers and very strong recent employment data, the US Federal Reserve remains cautious about the economy. Chair Jerome Powell said this week the central bank will "act as appropriate" to sustain the expansion as "crosscurrents" are weighing on the economic outlook. Following poor economic data and weak inflation numbers in May, markets have been pricing several rate cuts for the rest of the year commencing in July. A July cut is likely, but further cuts may not be warranted given stabilising conditions. Trump continues to put pressure on the Fed, looking to talk the dollar down and provide additional stimulus for the run up to the November 2020 election. Meanwhile, Democratic congressional leaders and Trump have reportedly agreed on a much bigger infrastructure spending package amounting to USD 2 trillion (from USD 1trillion) while productivity growth also continues to improve.

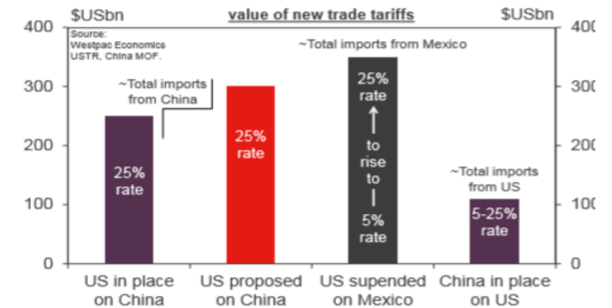
US Productivity Growth is Rising



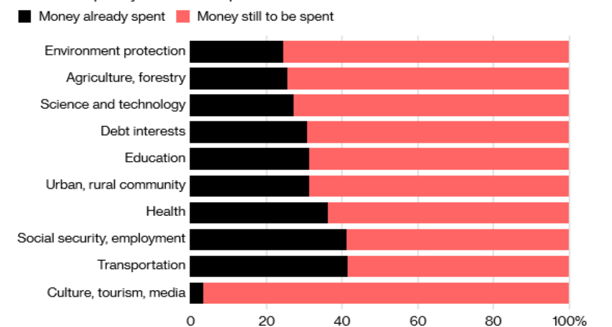
China

The US trade war continued anew over the quarter becoming more embedded and attritional. It seems China backed away from a deal reportedly agreed to by negotiators in late April. Authorities became concerned about US requirements for conditions to be codified into Chinese law. According to Vice Premier Liu He, China and the US are now disagreeing on 'matters of principle'. Xi is worried about loss of face and not willing to make changes to Chinese law that are seen to come from foreign pressure. Trump has bi-partisan support for his stance on China and a strong belief that tariffs on Chinese goods really don't do any damage to the economy. Following the G20 meeting in Japan, US and Chinese officials are back at the negotiating table trying to hammer out a deal. There is growing concern in China that waiting out Trump for the 2020 US elections may backfire and in fact it is to Trump's advantage to stay in the fight until the elections. It is also increasingly likely Trump may get a second term. Trade tariffs and in particular the US restrictions on targeted Chinese technology companies is sending a shockwave through the Chinese economy. China continues to double down on the rhetoric and confident it has the financial firepower to see off any manufacturing export impact through stimulating greater domestic demand. The graph opposite from Bloomberg shows central and local authorities having at least US$3.65 trillion unspent in their budgets this year. Bloomberg says that's more than China had last year to spend and equivalent to the entire annual output of Germany. In response to much weaker manufacturing flowing through from US tariffs (and lower domestic consumption), officials have resorted to massive monetary and fiscal stimulation. This is expected to recover growth in the second half of 2019 and back towards a 6% growth rate but still below government targets. In the meantime, the trade/cold war will rumble on and China will continue to juggle increasing domestic and external pressures.

US-China bilateral tariffs



China has plenty of fiscal firepower left



Source: Ministry of Finance
Note: Bloomberg calculations based on monthly general public budget data

At the time of writing, the Hong Kong government had removed the China mainland extradition treaty bill from parliament following continuous mass riots. The bill looks like a serious mis-judgement from Xi who is no doubt facing rising internal pressure over an increasing number of miss-steps including failed trade negotiations.

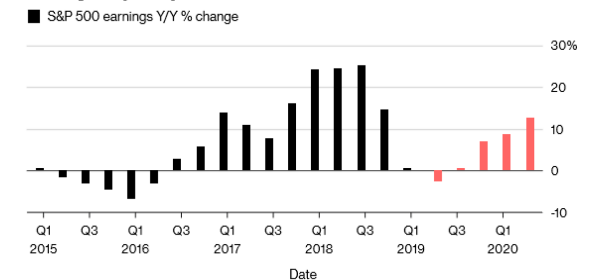
Europe & UK Euro-area economic sentiment fell sharply over the period to the lowest since 2016 while manufacturing hit its lowest level since 2013. Germany in particular, is showing the stress from collapsing manufacturing export activity as their order books shrink on the back of the trade war, potential US tariffs and sharply lower global demand (particularly China). The European Commission cut its growth and inflation outlook to 1.4% (from 1.5%). With inflation at 1.2% and well below the target 2% level, the ECB is likely to cut rates in September and possibly provide further quantitative easing. Germany along with Italy are projected to have the lowest growth rates in the Euro area this year.

UK business and consumer confidence are also falling and manufacturing contracting through services are holding up surprisingly well. Despite the dark shadow of Brexit, the economy has shown remarkable resilience with unemployment at a 44-year low and annualised GDP growth holding up around 1.8%. Boris Johnson looks like the new PM. Unless the EU agrees to renegotiate, a hard Brexit shock is coming for Europe in October.

MARKET COMMENTARY

Summary Against a backdrop of weakening global growth and rising trade and geo-political tensions, investors moved into bonds and defensive higher yielding shares. With central banks putting a new floor under markets and some potential trade escalation relief, investment confidence improved through June to underpin a decent rally in riskier assets. At the time of writing, latest data from the US and Europe suggests economic activity could be stabilising though the structural damage the trade war is causing will have long term repercussions. Supply chain disruption will be inflationary but for now languishing wages growth is keeping a firm lid on prices. With the prospects of further interest rate cuts but potentially stabilising growth, markets are caught between pricing for recession and pricing for continued expansion. Company earnings are under pressure and may go negative this coming quarter, but consensus analyst forecasts are expecting a re-bound and re-acceleration of earnings later in 2019 and into 2020. The prospects of lower borrowing costs and lower fixed income yields will continue to support higher asset prices (P/E expansion) for now though increased volatility must be expected over the second half of the year as economic prospects become clearer (for better or worse).

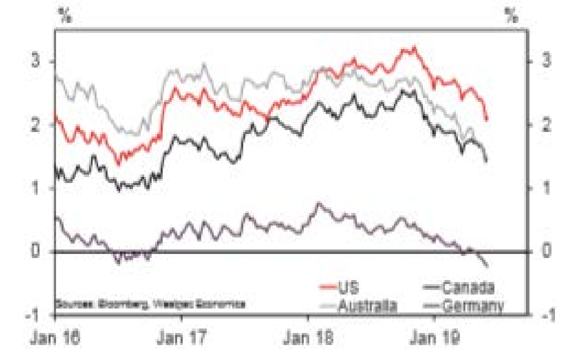
US Earnings to Recover?



Cash & Fixed Interest

Central banks are again accommodative suggesting that the present interest rate cycle has peaked and turned again. The US Fed has sufficient headroom to cut rates (likely July and possibly more) while other economies have less capacity to cut and moving closer to 0% rates (or indeed negative) leaving only room for unconventional policies once more. The RBNZ cut to 1.5% in May, the RBA cut to 1.25% in June and both are on track for further reductions. The ECB is also likely to cut in September while China has been easing as well. With lower rate expectations, bond yields sharply contracted in the quarter delivering investors a healthy return but adding to the puzzle of what bond position to take going forward. Negative yield spreads on short vs long dated US treasuries imply recession, while both Australian and NZ Government bond prices continue to trade at a premium to US bonds as global investors seek diversification over returns. The foreign exchange risk is certainly rising for such investors as US rate differentials and economic performance suggest a stronger outlook for the USD. Bond index durations are increasing and credit quality slipping as borrowers lock in cheap funding. We remain vigilant to the rising risk of investors extending duration and credit and prefer to accept lower returns from quality shorter dated bonds.

Bond Yields Decline Again



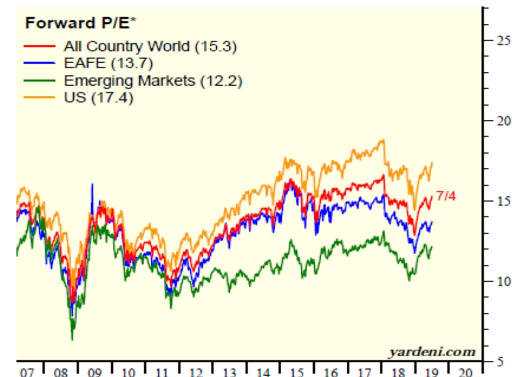
Equities

While some bond markets are pricing for recession, equity markets seem more immune with investors moving not only into higher yielding defensive shares (bond proxies), but also back into select growth stocks in June suggesting they are looking through the current soft economic patch to better conditions later in the year. Once again, our high yielding domestic market outperformed (+6.7%) in the quarter while the Australian market also did well (+8%) on better government stability, improving commodity prices and the prospect of tax cuts. NZ share market forward P/Es suggest stretched valuations leaving little room for earnings disappointments. With interest rates falling, we expect the P/E expansion to continue in our market particularly for utilities, infrastructure and property stocks.

Global shares also did well in the quarter (+3%) with Europe and UK doing surprisingly well on overly pessimistic market pricing. The S&P 500 reached new highs (+4.3%) while China continues to feel the pressure of the trade war -7%). Emerging markets were barely positive. Share market valuations are rising relative to earnings prospects but aside from our own expensive market are still reasonably compared with long term historical averages. The S&P 500 is now trading at 16.9x earnings and above its long-term average but, still less than 1 standard deviation above that average. The global, All Country World Index is trading at 15x earnings and as shown opposite has risen sharply this year but still below the highs in early 2018. Given the current uncertainty around global growth and weaker company earnings outlook we expect to see more volatility from sharemarkets over the second half of the year. A surprise growth or inflation number may negatively impact markets (higher rates) but may also signal a continuation of the long economic expansion we have had. Conversely defensive company earnings will continue to be in demand should activity slow further.

Figure 6: 12-month forward market P/E multiple

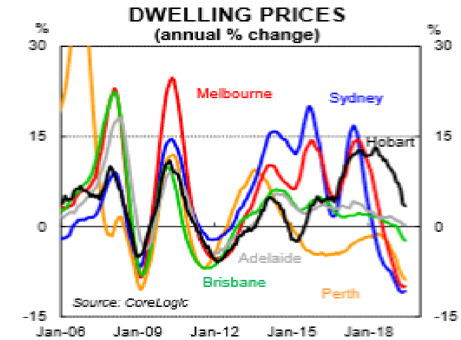
Source: Company data, FNZC estimates, Reuters



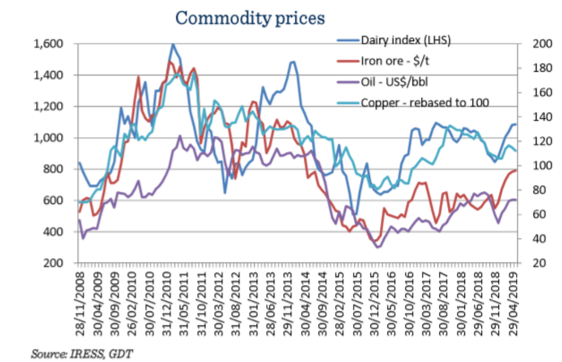
Source: Yardini Research

NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

Property Commercial property, especially industrial and office property prices continue to do well, and construction activity is also busy in those markets. Capitalisation rates continue to come down globally (including NZ) lifting valuations as interest rates also drift lower. Retail is not faring as well with rising online competition risks and overseas big format operators entering the market. Farm prices have also been weaker over the year to May. The REINZ Dairy Farm Price Index was -3.7% over the year and sales numbers lower. NZ residential property prices are higher over the year, but Auckland market is weaker (-3.5% REINZ data) and during the quarter Wellington, Christchurch, Tauranga, Rotorua and Whangarei were also down. More restrictive credit conditions, new tax rules, international buyer restrictions and outright affordability have impacted demand while supply in some markets (Christchurch) is catching up and closing the gap. With net migration rising, interest rates coming down and a relaxation of LVR rules for new home buyers, prices should improve in the second half of the year. Across the ditch, Australian home prices continue to remain under pressure in the major cities but some slowing in the price fall suggests buyers are moving back into parts of the market (not apartments) while lower interest rates should also assist.



Commodities The ANZ commodity index fell year over year to June with weaker dairy (-8%), forestry, horticulture and aluminium prices. The higher NZD is also hurting our terms of trade, but prices are still historically strong. Much of the recent price weakness is attributable to our own supply success (dairy and logs) but higher Chinese demand for meat is assisting beef prices. Oil and metal prices surged over the quarter due to tighter supply. Vale's massive Brazilian iron ore mine remains out of action and Iranian export sanctions impacting global oil supply. Chinese demand will ramp up on new construction stimulus with Australia well positioned to benefit.



Source: IRESS, GDT

Currency Despite best intentions from the RBNZ Governor to talk down our currency, it continues to remain in demand frustrating our terms of trade and rewarding offshore investors. With falling overseas interest rates, currency management is becoming a race to the bottom to maintain competitiveness – especially for export reliant countries such as NZ (30% of GDP). For our portfolios, we continue to maintain a partial hedge on global shares back into the NZD (approximately 45%) to provide some protection against the upside volatility of our currency.