NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

16April 2018

March 2018 Quarterly Report

After a positive and low volatility year in 2017, the last two months of this quarter have been hectic.

Higher than expected US interest rate prospects triggered a fall in global share markets in February though much of the volatility was attributable to high frequency programme trading. Markets recovered in late February only to sell down again at the end of March and early April on rising US/China trade tariff concerns.

Although global economic and business data continues to show a solid outlook, President Trump's erratic management style keeps creating surprises, rattling markets and impacting investor confidence. It has been a busy quarter for Mr Trump who has successfully pressured North Korea, fired more senior staff, sanctioned Russian officials and business leaders, fought Russian electoral collusion allegations, started a trade skirmish with China and pushed through a record budget deficit increase to fund infrastructure spending and tax cuts.

Recently the trade war rhetoric has cooled. With the markets recently consolidating, valuations are once again attractive and we expect prices will recover supported by steady global growth prospects, strong business earnings prospects, and still accommodative monetary policy.

Kind regards,

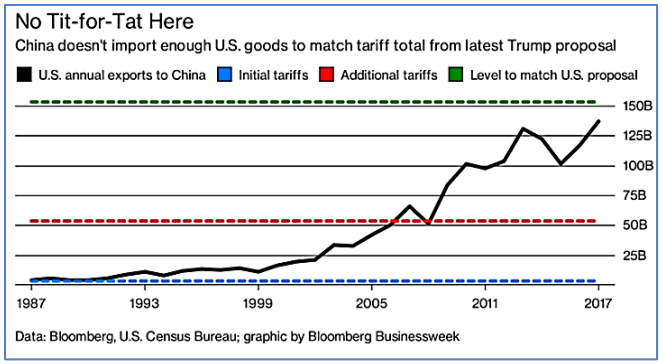
Wayne Ross
Director Investments

ECONOMIC AND MARKET SUMMARY

After a record low year for volatility, it returned sharply this quarter. Share markets fell as much as -5% to -11% from their highs in late January but recovered some ground to be down between -2% to -4% in various markets for the quarter. Property markets were also softer while bonds made a positive if modest contribution to portfolios. A stronger NZ dollar also negatively impacted overseas investments.

The initial share market sell-down was supposedly triggered by better than expected wages growth in the US. In reality, the extent of the sell-down was likely caused by traders trying to move the market lower and high frequency trading that seems to exacerbate short term market movements more often these days.

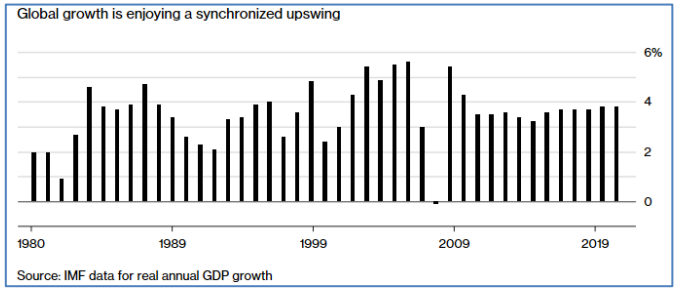
The sell down came amid a quarter of continuing global economic growth. More recently markets have weakened on growing fears of a global 'trade war'. This has been driven by US/China trade jockeying and tariff reprisals started by Trump. To be fair, the trade imbalance with China remains a fundamental risk for the US and Trump has started the negotiation process by threating to impose trade tariffs on Chinese imports. The chart below shows that China would have to tariff all US imports and then some to equal the tariff levels the US has said it will place on Chinese imports.



This is because the US has a $375bn trade deficit with China. So China does not have the tariffing impact capacity that the US does, but they do have other tools for retaliation. It is important to keep the current trade skirmish in perspective as the proposed tariffs on Chinese goods would have a 0.3% impact on Chinese GDP and those proposed on US goods would have a 0.1% impact on US GDP. China's exports to the US only account for about 4% of China's GDP. None the less markets remain nervous the spat could widen and impact global confidence.

Elsewhere, geo-political risks slightly improved over the quarter with North Korea agreeing to meet the South and apparently persuaded by China to discuss denuclearization with the US. The UK and EU have agreed to a softer longer term 2020 Brexit transition while Angela Merkel heads a new German coalition and Xi Jinping solidified his long term leadership goals. The Trump administration continues to lurch from crisis to crisis while Russia appears to be working hard to undermine western political stability. More recent tensions in the middle-east will make markets anxious.

The global economy in contrast, was robust over the quarter and has a steady growth outlook as shown below.



During the quarter China delivered stronger industrial production and fixed asset investment. US manufacturing indexes hit 7 year highs, consumer confidence reached 14 year highs and inflation flat. Europe's unemployment dropped to a 9 year low (8.5%) but activity slowed slightly from its strong performance. Despite freezing weather, the UK outlook will likely improve on a longer Brexit transition. Australia's construction was weaker but business investment sharply higher and mining is contributing again. NZ activity was slightly softer. Business confidence is improving slightly and consumer confidence steady on robust employment. Exports performed well despite our high dollar while we now have potential fiscal stimulus to come. The outlook for NZ remains steady though slightly weaker than last year.

The recent fall in prices has brought share market valuations back to more attractive levels again both on an historical basis and certainly better relative to the returns from bonds and cash. The very strong momentum in global business earnings will also be supportive for better prices. After a softer year we expect property will also start to improve on less restrictive credit conditions while the outlook for bonds continues to be a challenge in the face of likely interest rate increases. We expect the global economic cycle will likely extend further through 2018 and 2019 but volatility will be greater.

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

Market Returns	Mar Qtr.	1 Year p.a.	3 Yrs p.a.	5 Yrs p.a.
$NZ v TWI	**0.0**	-2.3	-1.9	-0.7
$NZ v $US	**1.5**	3.2	-1.2	-3.0
$NZ v $AUD	**3.7**	3.0	-1.3	3.2
NZ Cash	**0.4**	1.8	2.2	2.5
NZ Fixed Interest	**0.5**	4.6	4.0	3.9
Intl Fixed Interest 100% hedged to $NZ	**0.7**	3.5	3.6	5.3
Australasian Equities 50/50 Indexes	**-3.3**	7.4	8.9	9.0
NZ Listed Property	**-3.9**	7.0	6.8	8.1
Intl Equities 50% hedged to $NZ	**-2.1**	11.5	8.7	11.7
Commodities $NZ	**-1.8**	0.5	-2.0	-5.5

SECURITIES RETURNS FOR THE QUARTER

The following tables show the returns from the securities recommended by NEWTON ROSS. 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	-3.6%
F&P Healthcare	Healthcare	-8.0%
Freightways	Transportation	1.3%
Harbour Focus Fund	PIE Fund	-1.9%
Mercury	Energy	n/a
Meridian Energy	Energy	-1.6%
Stride Property	Property	-2.3%
Trade Me	Consumer	-5.9%
Vista Group	Software Services	0.1%
Australian Equities		
Aurizon	Transportation	-15.0%
Brambles	Professional Services	-2.9%
CSL	Pharma & Bio	6.7%
National Australia Bank	Financials	-7.1%
Scentre	Property	-9.4%

- The Harbour Focus fund outperformed the market benchmark but ended down for the quarter. Losses from holdings of building & construction insurer CBL, Syrah Resources and GTN offset the positive attribution from holding Summerset and an overweight position in A2 Milk whose stock price completely dominated the NZ market return (eg. excluding A2 the NZ market was down -4.8% vs -0.9% including the company). CBL was a significant disappointment, entering voluntary administration and likely to be broken into parts for sale following an actuarial review which found $100m in additional capital was required and writing off $44m of their recent investment in a French insurance and broking business. The NZ reporting season for companies was generally positive although there was significant divergence between companies. Those with a global rather than domestic focus tended to be more optimistic and this has been reflected in subdued local business confidence measures.
- Australian financial stocks were lower on concerns the Royal Commission into banking practices will led to regulation which constrains bank profitability. The enquiry is looking into allegations of misconduct, fraud and customer exploitation over many years. Along with banking the enquiry will look at superannuation, insurance and wealth management industries. Much of this is covering old ground but public hearings will ensure renewed attention is focused on any dirty laundry.
- Trade Me reported a solid result with record revenue. The company is working hard to mitigate the ever present risk of technological disruption and new competition by focusing on 3 key areas. Firstly by enhancing core products with better functionality and customer experience across devices to improve trust in their brand and build scale. Secondly by looking at opportunities to expand into complementary businesses such as courier services and data, and thirdly by investing in new businesses which can leverage their existing audience such as money lender Harmoney.

Seek	Services	-4.0%
Sonic Healthcare	Healthcare	-2.1%
Westfield Corp	Property	-11.8%
Westpac	Financials	-12.0%
Woodside Petroleum	Energy	-12.1%
Woolworths	Consumer Staples	-5.0%

- Woodside Petroleum undertook a 1 for 9 rights issue which offered investors new shares at a 10% discount and raised A$2.5b. The company earmarked $500m for taking its stake in the Scarborough LNG project to 50% and the rest of the capital is earmarked for potential growth projects to meet the expected global LNG supply gap in 2-3 years. WPL are positioning themselves (especially if they are able to progress the Browse LNG project) to meet expected increase demand from Asia and we participated in the rights issue which was at a 10% discount to the share price.
- Stride Property owns 59 property assets including the NorthWest Shopping centre in Auckland and has tenants such as Countdown, Pak N Save, New World, ASB, the Warehouse, Meridian, Lion and NZ Govt departments. Internet retailing remains a long term structural risk to retail operators and with 67% of their direct property portfolio in retail the company is constantly focused on maintaining a high quality book through lease renewals and value-add redevelopment/refurbishment. As part of a strategy to diversify revenue streams the company has also built an impressive external property management arm (which requires limited capital) who manage $1.2b of properties for other owners.
- APA Group also sought to raise A$500m of new capital however it was less clear about how the funds would be invested to generate growth and the discount was a more modest 3.5%. We did not participate for clients and have subsequently sold the stock.

Change in Portfolio Holdings – Introducing Mercury NZ

Following a review of the companies held in the Australasian portfolio Devon advises on, they have recommended the inclusion of Mercury NZ (MCY). Mercury engages in the generation and distribution of electricity from hydro, geothermal and gas. Their core business is the production and trading of energy and related services and products. They are also involved in metering and upstream gas and geothermal development.

We limit the number of securities in the portfolio to 20 to ensure they are the fund manager's best picks and to minimise trade costs. In order to fund this acquisition Devon therefore recommended selling down APA Group. Funds from this sale we used to purchase shares in Mercury in early April.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	-2.8%	The fund was up +0.7% in A$ terms for the quarter and +21% for the year. Key to this strong performance in a volatile market has been an increased exposure to Asia-Pacific (building from 30% to 50% of the portfolio in the last 3 years) and under exposure to the US (from 20% to 0%). The manager reduced exposure to the high flying tech sector last year and added to cash and short positions (which make money if the share price falls) in stocks they felt were overvalued. Despite the expectation that tighter monetary policy will eventually have an impact, the manager can find plenty of great company's trading at prices which are cheaper than long term average valuations. China remains a firm favourite and expectations are for the country to continue to develop its global presence through increased demand from emerging Asian countries, dominating global manufacturing (they already own 30%), building intellectual capacity (there are 300,000 Chinese students in the US) and further domestic growth as the population moves to mid-tier cities and the focus shifts towards cleaning up their environment. Portfolio manager Kerr Neilson announced his decision to step down from the day to day management of the portfolio, handing over the rein's fully to Andrew Clifford. Andrew co-founded Platinum in 1994 and has jointly managed the fund alongside Kerr so we do not expect any material changes in portfolio strategy.
Monks Investment Trust	1.8%	The fund was down -1.2% in GBP terms for the quarter. Over the last 6-12 months the manager has been taking profits from strongly performing sectors such as US domestic cyclicals (eg cruise companies like Royal Caribbean), and reinvesting into emerging market related companies (eg 58.com a Chinese internet co and Brazilian banks). Importantly they have done this not because they have been worried about the companies or the US economy rather they have found better relative value elsewhere. Looking forward in 2018 the key positive themes for investing identified by the manager include: pro-business reforms in India, Brazil and South Korea; China's One-Belt – One Road initiative to connect Eurasian countries; the broader impact of a data-driven world including semi-conductor demand, tech connectivity, security and privacy concerns; dominant platform businesses and increased regulation alongside global tax reforms; and capital allocation to R&D growth initiatives rather than capital extraction via dividends or share buy-backs.
Magellan High Conviction Fund	-4.0%	The fund was down -0.4% in A$ terms for the quarter. The manager has been wary of overvalued markets and the likelihood of rapidly rising interest rates for some time and has positioned the portfolio for this by holding a higher (currently 14%) cash weighting. In their view there is a significant risk that tight labour markets, US tax cuts and the proposed fiscal stimulus will increase growth and inflation to quickly and force the Fed to raise rates by over 1%. If this were to occur they could see a short term global share market correction of as much as 20-30%. Despite being under the regulatory spotlight and subject to short term volatility the manager believes the tech leaders such as Facebook, Apple and Alphabet are not overvalued and their longer term growth prospects remain positive. Each dominates an expanding and profitable slice of the digital world and is leveraging their core business to build leading positions in complementary and potentially massively profitable new markets.

Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	-2.1%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The NZ dollar rose against all but the GBP over the quarter so the hedge contributed approx. +0.5% to the return. The quarter started strongly before worries about rising inflation and the removal of monetary stimulus increased volatility. This was exacerbated by the US continuing to increase interest rates and the rhetoric about trade and measures to impose restrictions. Markets have retreated from record levels but remain supported by continued global economic activity and strong corporate earnings.
iShares Russell 2000 Index Fund	-1.2%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. Companies outside of the US fared better over the quarter as investors preferred the relatively lower valuations to be found, particularly in emerging markets which also benefit from the lower US dollar.
Vanguard FTSE All-World ex US Small Cap Index Fund	0.3%	
Vanguard Emerging Market Index Fund	1.5%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets outperformed developed markets although this was largely due to very strong performance in January. Key positive influences were generally stable and strong economic growth, a bounce in Brazil due to a more positive political environment and Russia benefiting from an upgrade in their debt to investment grade. Late in the quarter escalating trade skirmishes increased volatility in emerging markets which have been relatively stable. Emerging markets are currently at a 25% discount to developed markets albeit with the current risk and uncertainty surrounding the extent and impact of global protectionism. Global investors are also conscious that typically emerging markets tend to lag in terms of economic activity so they fare better than developed markets in the late stages of a bull market rally.
iShares S&P Global Infrastructure Index Fund	-5.3%	The fund provides passive index exposure to listed infrastructure assets and is valued in USD. Global infrastructure stocks are sought by investors because they offer a yield premium over fixed interest. When interest rates go up, as they did over the quarter, demand for assets such as infrastructure and listed property stocks tends to fall as investors switch back to bonds. During the quarter there was also some uncertainty created by changes to US tax rules which may adversely impact the profitability of utility companies.

NEW ZEALAND FIXED INTEREST

Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	0.5%	Despite dropping back late in March, US interest rates rose over the quarter as expectations of growth and inflation built. Globally yield curves are generally flattening with short term rates rising more quickly than long term rates. In the US the Federal Reserve is now more than half way to their 3% target for short term rates (they have indicated there will be 2 more 0.25% rate increases in 2018 and a further 3 in 2019). This is contingent on continued strong economic growth and rising inflation as the new Fed Chairman will be conscious of not wanting to make a policy error leading to a sharp market sell-off. Typically rising interest rates only become a major problem for financial markets if companies are no longer growing and rates rise quicker than expected. By comparison, the NZ Reserve Bank is on hold and likely to be for some time yet while inflation remains subdued. Future rate decisions will now be made by committee and new Governor Adrian Orr has signed the revised Policy Targets agreement to include the dual mandate of both targeting inflation and supporting maximum sustainable employment. The fact that NZ is in a different part of the interest rate cycle led to the unusual situation where NZ 10 year bond yields fell below the US 10 year yield for the first time since 1994 (notable as the year of the 'Great Bond Massacre'). We are also starting to see the impact of greater financial regulation across financial markets with increased government supply (the US funding its deficit) and changes to money market rules making it harder and more expensive for corporates to issue commercial paper (i.e. it is costing more to borrow). This has flowed through to NZ/AU banks and companies who also use the US market for short term funding requirements and we saw 1 or 2 new bonds being issued at higher margins than we have seen for a while. This has yet to result in a significant move higher in existing corporate debt yields but this is likely to follow and the negative impact on corporates from tougher global lending conditions remains a real risk to both bond and equity investors, especially given the historically low absolute level of interest rates.
NZ Corporate Fixed Interest Investment Grade Rating	0.8%	

ECONOMIC COMMENTARY

Global

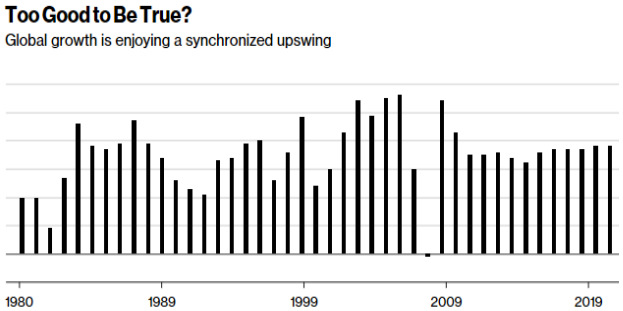
First quarter global data remains relatively robust and continues to support the forecast for 3.7% to 3.9% synchronised growth this year. During the quarter there was some softening of the strong activity in Europe, the US and UK in part attributable to terrible weather conditions but overall economic data was positive with continuing benign inflation ensuring monetary policy remains relatively accommodative.

Last quarter we raised some key themes and risks to global growth forecasts and some of these flared up in the quarter. We will keep track of these and their impact as the year progresses.

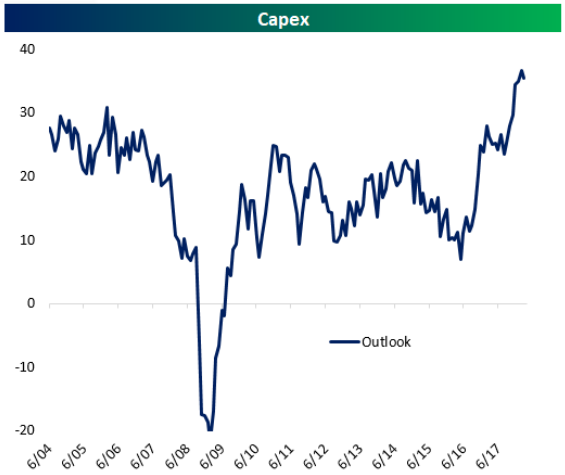
Key Themes and Risks

	This quarter	The issue
Surprise Inflation	Slightly stronger US wage inflation triggered early February market selling.	Markets are potentially under-pricing US Fed rate intentions. Further data in the quarter suggests inflation remains benign.
Central Bank Misjudgement	Predictably US Fed lifted from 1.5% to 1.75% in March. BOE, ECB, BOJ, RBA, RBNZ unchanged.	US Fed promoting more rises and possibly at a faster pace. Bond yields are not pricing this in.
Cyber Attack/Security /Fake News	Russian hackers outed, Russian poisoning scandal, Facebook data breaches, North Korean cyber-attacks on US and South Korea.	Accelerating global issue. Trump government at risk on investigation, Facebook data breach, $25bn value fall. More to come Q2.
Trade Wars	Trump has fired the first shot. Tariffs on potentially $150bn of Chinese imports and China responding with own tariffs on $53bn US imports.	Presently a skirmish and Trump negotiating ploy. Risk of escalation and wider global trade and supply chain impact. China and US presently cooling rhetoric.
Brexit	Breakthrough in March with EU and UK agreement for a transition extension to December 2020.	Hard Brexit risk removed. Uncertainty reduced for business and may also provide "improved equivalence" for financial services providers. Should improve business confidence.
Geo-political	North Korea has moved to open dialogue with the South and promoting a US meeting. Pressure from China to discuss denuclearisation.	Significant ratcheting down of tension. Sceptics highly wary. Major benefit to regional confidence and security.

Global Growth and Prospects – IMF

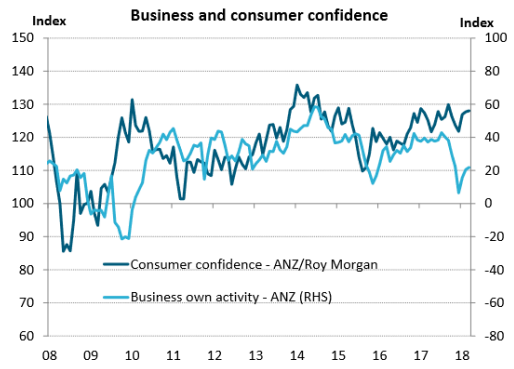


Global Capital Expenditure Rising



New Zealand

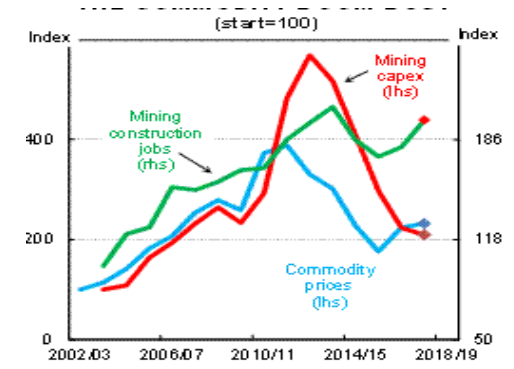
We continue to chug along pretty well though conditions have been softening a little. Business confidence remains key to lifting investment prospects (chart opposite) which is dependent on clearer Government policy particularly in relation to employment costs and labour capacity constraints. Lower net migration numbers may reduce housing demand and infrastructure strain but that is presently where our productivity and GDP growth has been coming from. The services sector continues to do well while agricultural and industrial production has been more modest over the period. NZ's unemployment rate fell to a nine-year low of 4.5% in the December quarter while wages growth is improving and should support stronger household consumption. Tourism continues to boom and our terms of trade remain high and improving. House prices were softer but showing some signs of life along with credit growth. We expect house prices to improve modestly from here. Though cooling slightly, the economy is performing reasonably well though probably weaker than last year. New fiscal initiatives should provide stimulatory support such as the regional development fund but budgetary constraints will be an increasing issue. The recent round of global trade tariff rhetoric has provided some nervous moments for our exporters but could produce new opportunities as well.



Australia

The long awaited lift in non-mining capital expenditure is increasing the prospects for broader economic activity this year. Higher commodity prices are assisting export growth with a strong trade balance surplus realised in March. On the negative side, indebted households and weak wages growth continue to dampen consumption though employment levels should improve on rising business investment. Residential property construction and more recently residential property price growth has been weaker but infrastructure activity remains strong. While a sustained fall in residential construction would be economically damaging, Australia's strong net migration will remain supportive over the longer term. Asian tourism and education visas are creating somewhat of a boom and Australia continues to look north for greater participation in the Asian growth story. So overall a broader recovery now the mining sector is positively contributing again despite the current US/China trade joust weighing on the Australian dollar. The Reserve Bank remains upbeat about domestic and international conditions but is keeping rates on hold.

Australian Mining Activity Improving (source: CBA)



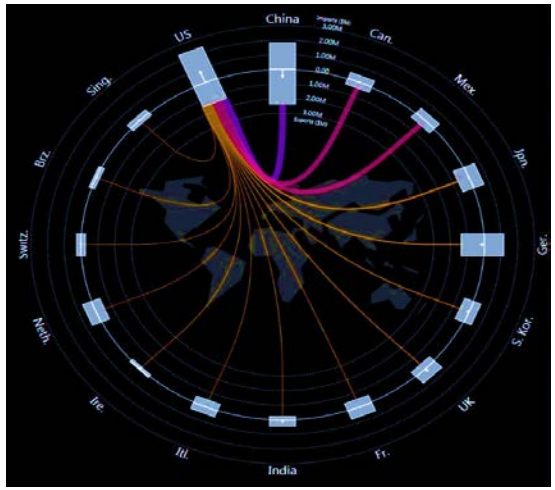
US

Lots going on in the US over the quarter. Trump pushed through a budget that will see a $1trn deficit (record) this year to finance his infrastructure and tax cut programme. There is no doubt this will be stimulatory but did the economy really need it and will it just create inflation? The market is highly sensitive to this risk and when slightly higher wage growth numbers appeared in early February markets took fright on tighter Fed expectations but high frequency share traders exacerbated the volatility. Record

US Wages Increasing

high household confidence is being underpinned by jobs growth, rising house prices and now rising wages (though these pulled back a little in March). During the quarter manufacturing data reached a 7 year high while services and consumption were slightly weaker and partially hampered by adverse weather conditions. The Federal Reserve remains upbeat about the US economy, lifting their target interest rate from 1.5% to 1.75% and raising their long term rate projections. Despite this, the new Fed chair Jerome Powell said there are no signs that inflation was about to accelerate. In March Trump announced tariffs on a range of imports and suppliers particularly China. This recently accelerated in early April into a tit for tat tariff response by China. It was an election promise by Trump to address the $375bn trade imbalance with China and he is looking to limit Chinese investment into US sensitive industries. How this develops is a concern for global trade. For now it looks like a negotiating gambit from Trump and is not unpopular in the US apart from those agricultural exporters (Soy and Pork) that have been directly impacted. China's response to date has been constrained but they have several tools at their disposal to retaliate (such as ensuring a weaker Yuan). The chart opposite shows the extent of the value of trade imbalances between the US and the world. Key imbalances arise with China, Canada, Mexico and Japan and Germany and South Korea. At the time of writing both Xi and Trump moved to ratchet down the rhetoric.

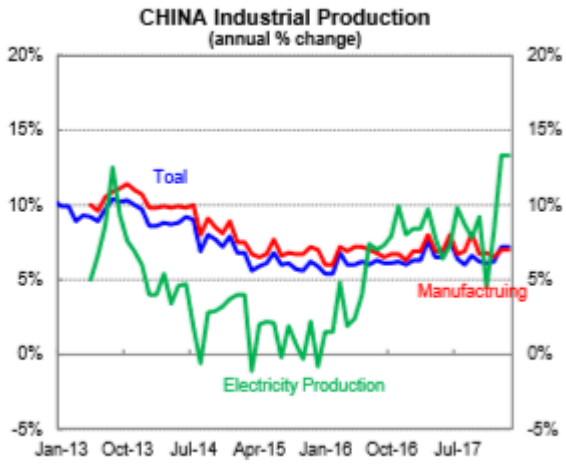
US Trade Imbalance by Country Source



China

Xi has cleared the constitutional way for his perpetual leadership. This cements his position as all powerful leader and with an aging standing politburo membership he is not grooming anyone soon to succeed himself. Xi's focus is on growth with stability. Quality over quantity and a fixed 6.5% growth level rather than striving for a faster rate. Despite the recent US trade spat it is important to remember that exports to the US account for only 4% of China's GDP with regional trade increasingly more important. In addition to the "One Belt, One Road" adaption of the ancient Silk Roads vision, China is accelerating spending on waterway improvement, closure of low value pollution generating activities, pushing hard on alternative energies and has a specific focus on faster technology adoption. China now has a faster take up of e-commerce than the US. Xi is also opening the doors for foreign investment into financial services activities, cutting corporate taxes and boosting household consumption. Retail consumption was robust in the quarter. In March (under pressure from the US) China also announced the removal of the requirement for foreign companies operating in China to provide Chinese access to their technology and IP. This is a significant step to opening the Chinese economy. Aside from the problem of negotiating a more sustainable trade position with the US, Xi's greatest challenge remains the stabilisation of China's financial system. Heavily leveraged, poor balance sheets, poor governance and still significant shadow (non-controlled) lending practices continue to pose a significant systemic risk. 2018 will determine if Xi can continue to successfully deliver China's model of state capitalism.

Chinese Industrial Production Robust

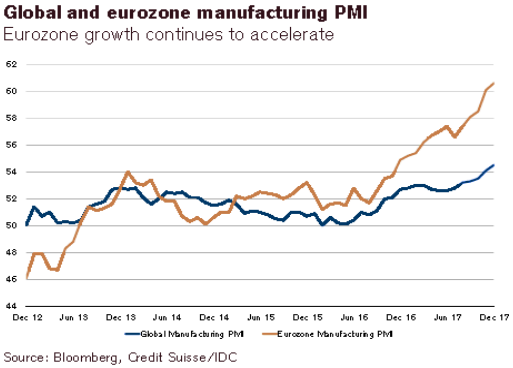


Source: China NBS

Europe

The Eurozone economy has posted 10 consecutive quarters of growth with the last quarter of +2.7% higher year on year. This quarter's data is showing some moderation of activity but this is off record levels while a recently stronger Euro will have some impact on export performance. The Purchasing Manager's Index remains near 12 year highs and business confidence strong. With improved employment numbers (down to 8.5% and lowest since 2008) and slightly better wages growth, stronger domestic demand is becoming a key driver for activity particularly, in France. With inflation running at 1.4% (March) and well below the ECB's 2% target, easy money conditions should continue for some time yet. Easier credit conditions particularly for small businesses, is also assisting private sector employment and capital expenditure. On the political front, Angela Merkel managed to win a 4th term with a major party coalition government. This will help stabilise a Union that has political turmoil in Spain, Italy and increasingly France. It remains to be seen if the new US protectionist focus will impact Eurozone export prospects. Meanwhile Greece's credit rating was upgraded by S&P 1 notch to B!

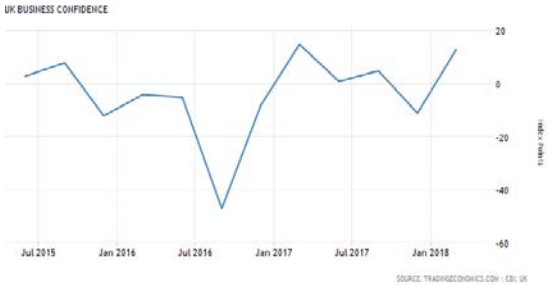
Robust European Growth



UK

In mid-March the UK government and EU agreed to an extension period for Brexit. This moves the exit date from March 2019 out to December 2020. The extension provides more room for a successful broader agreement to be reached while removing the immediate uncertainty for businesses particularly, financial services. The UK effectively stays in the EU single market and customs union but allows the UK to pursue third party trade agreements. It also appears the EU is considering an equivalency provision for the financial services sector which would be a significant breakthrough. The Irish border remains an outstanding roadblock that will require some form of specific trade agreement to cover the north. UK economic data was softer again in the quarter but business confidence may improve from here on the Brexit news. The BoE modestly raised their 2018 U.K. GDP growth forecast to 1.8% (previously 1.6%).

UK Business Confidence Rises



Japan

The Japanese economy continued to perform well in the quarter following a very good 2017. Unemployment has fallen to a 20 year low and manufacturing output increased again for the 19th month in a row. During the quarter Japan has also signed up to the Comprehensive Progressive Agreement for Trans-Pacific Partnership which will further assist exports. Prime Minister Abe's personal credibility took a solid hit in the quarter on a real estate corruption scandal and he may not survive as leader. More recently the US/China trade story saw the Yen sharply rise (a safe haven currency) which may impact exports in the shorter term. Meanwhile, wages growth (see opposite) is starting to reflect the tightening labour market. This is good for consumption prospects but points to rising business costs as well.

MARKET COMMENTARY

Cash

The US Federal Reserve moved as expected to lift their official cash rate from 1.5% to 1.75% in the quarter supported by slightly stronger US Q4 inflation data (2.1% core inflation). The Fed is likely to tighten another 2 times this year with some commentators suggesting 3 more rises. Elsewhere, central banks kept rates on hold on flat inflation data. The RBNZ confirmed its cautious outlook for rates though a change of governor, mandate scope and decision making process may impact policy settings (more likely to be easier for longer). A cash rate rise is unlikely until late 2019 particularly with our overvalued currency, though higher offshore funding costs may mean we see higher bank term deposit rates.

Currency

The US dollar was weaker against most currencies in the quarter, including NZ. This is primarily due to weakening US financial position from increasingly higher current account deficits and now a record US budget deficit. The NZ dollar was also much stronger against the Australian dollar (+3.7%) as US/China trade war fears impacted energy energy/material currencies. The stronger NZD negatively impacted returns from offshore assets in client portfolios though our partial hedging assisted. The high NZD remains a significant management issue for the RBNZ.

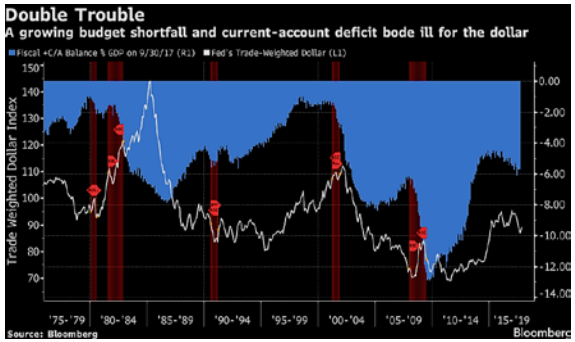
Fixed Interest

Midway through the quarter, the US 10 year bond rate rose to 2.95% and on track to break through 3% to continue the sell-off that started last year. Equity market volatility, the recent trade tariff issues and now US/Syrian engagement concerns have seen investor flight to safety with US 10 year bond yields moving back under 2.8%%. This significant move delivered good returns for bond investments in the quarter. Despite the recent rally, the firm economic outlook and gradually constraining labour market suggests bond yields will rise again once geo-political tensions ease though Fed Chair Powell has emphasised there is only gradual upward pressure on inflation despite lower unemployment.

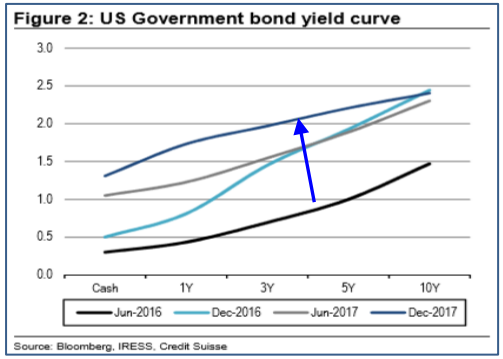
Equities

Volatility returned in February after record low volatility last year. After tracking steadily higher over the year markets became increasingly vulnerable to a pull back. An uptick in US wage growth data was the catalyst for the sell-off but volatility was exacerbated by high frequency trading activity which is an increasing part of short term market noise these days. The US market was down -10% in 10 days. After some recovery, markets were again softer on the recent US/China trade skirmish, potential US coalition action in Syria and further senior adviser changes in the White House. The chart opposite shows the bounce in the VIX index (volatility measure. The sell down means that global market valuations are back to

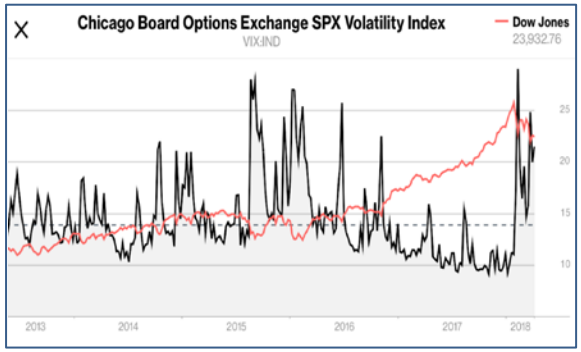
Double Deficits Weigh on US Dollar



10 Year US Bond Yields



Volatility is Back



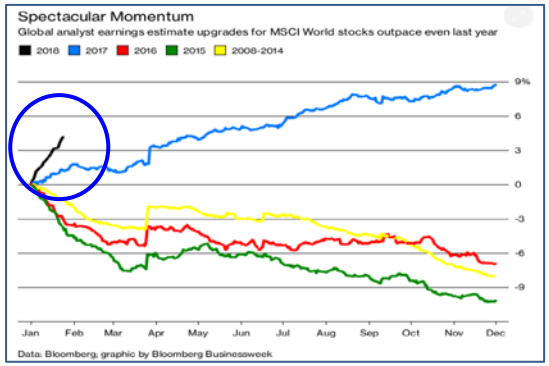
NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

reasonable levels again with the US S&P 500 trading at 16x rather than 19x earnings. This puts that market back to where PEs were in 2016. The Australian market is back to 15x earnings though the NZ market remains elevated at 23x earnings with A2 Milk's high PE and high market weighting skewing things. Interestingly, the NZ50 gross index for the March quarter was down -1% but excluding the returns from A2 Milk, the index would be down -5%.

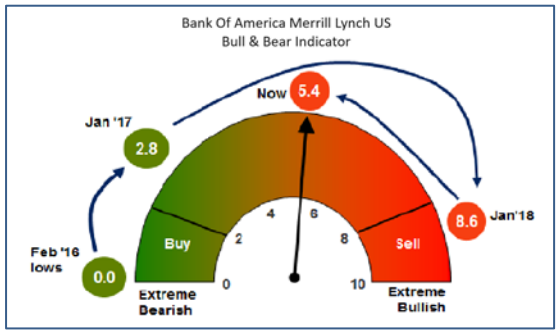
Despite the recent selling, the outlook for equities remains attractive as corporate earnings revisions are showing strong momentum this year supported by steady global economic growth prospects. Credit Suisse forecast earnings growth at 17% in the US, and 10% in Europe. With still subdued wages growth, excess market liquidity and the recent pull back in prices, global equities will continue to be attractive to investors particularly relative to the returns from bonds and cash. We can expect volatility to be a bigger feature with so much geo-political noise and as the Fed Reserve grapples with appropriate monetary settings.

S&P 500 PE's back to 2016

Strong Global Earnings Momentum



Sharemarket Investor Positioning Back to Neutral



Property

Residential property price momentum has recently slowed particularly, in Auckland. However, the REINZ House Price Index for NZ in February still shows an increase of +3.9% year in year to a record high. Excluding Auckland the index is up +6.9% year on year and Auckland only +1.1%. Proposed tougher investment restrictions on foreign buyers, a move to a 5 year brightline test for capital gains and tighter credit conditions have softened market conditions. Additionally, net migration numbers are also lower however, a new Reserve Bank discussion paper is putting Auckland's shortage of houses at far higher numbers than previously estimated. In Auckland, 10,867 new homes were consented, the highest level since 2004 and up 8.4 % from 2016. But consents are one thing construction is another and the Reserve Bank estimates Auckland needs another 9,000 construction workers. Auckland and Tauranga are amongst world's most unaffordable housing markets (14th Annual Demographia International Housing Affordability Survey). The structural supply/demand imbalance remains and with likely easier credit conditions ahead we expect property prices to improve. Australian house price growth is slowing, US prices are robust as is construction and Chinese residential construction is solid while their commercial market remains weak.

Commodities

The ANZ Commodity Price index was up 4.8% over the quarter on further improving dairy prices, forestry, meat and fibre prices. Offshore commodities were volatile over the period on trade tariff tensions though generally finished higher with oil prices surging on recent middle eastern tension. Steady global demand is likely to continue to underpin industrial materials prices. At the time of writing, the NZ government has announced a ban on offshore oil and gas exploration which will have a significant regional economic impact and raises energy security and funding issues for our economy.