NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

15 October 2018

September 2018 Quarterly Report

It was a very positive quarter for portfolios but at the time of writing much of these gains had been given up post the quarter end. This increased volatility had been expected at some point but of course, no one knows when and how much markets will move.

Key reasons for the recent drop in share markets include increased concerns around a prolonged US / China trade war, rising interest rates in the US and the fact that increasingly a significant amount of market pricing can be attributed to programme (algorithm) trading which exacerbates market movements. With still robust global economic growth and a very strong US economy we expect markets will improve as valuations become more attractive and investors focus again on fundamentals.

Successfully managing portfolios during periods of market volatility depends largely on having a proven investment process in place well beforehand. The investment assets in your portfolio have been selected because they are high quality and offer a diversified exposure to companies, sectors, countries, currencies, regions and investment approach. Diversification can help smooth portfolio returns for example by active fund managers not having exposure to a region or by holding higher levels of cash in their funds. Managing portfolio risk also means keeping asset allocations closely aligned to target and we have been actively taking profits by selling down outperforming securities. This regular rebalancing process ensures portfolios continue to perform as expected and according to their risk limits when markets become more volatile.

Kind regards,

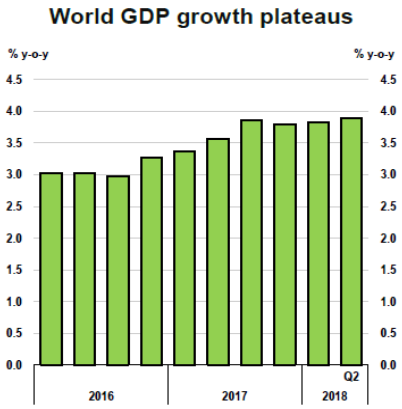
Wayne Ross
Director Investments

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

ECONOMIC AND MARKET SUMMARY

Both global economic growth and investment markets became more divergent over the quarter. Some emerging economies have slowed markedly while advanced economies continue to generally perform well but also moderating. The escalating trade disputes, higher energy and commodities prices and a stronger US dollar have impacted. Emerging economies with substantial external imbalances have been affected the most by the tighter financial conditions. Correspondingly, emerging share markets were much weaker over the quarter with some now back to their 2016 valuation levels. The Chinese share market was -8% over the quarter and down more than -20% over 1 yr. The US was the opposite with strong returns of +8% and +18% respectively.

The chart below from the recent OECD shows global growth flattening but not markedly decelerating. They are becoming increasingly concerned US trade disputes are starting to impact global manufacturing activity (falling orders and now exports). During the quarter, the US resolved trade pacts with Mexico and Canada but remains at loggerheads with Europe and especially China.



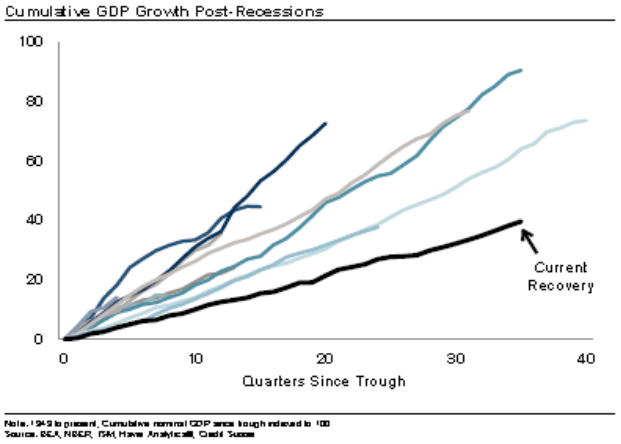
The retaliation against Chinese imports is now taking on the appearance of something greater. US rhetoric is increasingly focusing on Chinese intellectual property theft, cyber hacking and Chinese power projection both regionally and globally. The messaging serves Trump well for the mid-term elections and there are recent indications his administration is preparing a more constructive stance. To date the Chinese economy appears to be more impacted by the dispute than the US and they are taking steps to replace their weakening exports with stronger domestic activity as well as depreciate their currency to help offset tariffs.

The trade dispute is also starting to hurt Europe with manufacturing output slowing to a 2yr low (though still positive) on lower export demand. Business confidence has certainly been weaker. Brexit has bogged down with political infighting in the UK and with inflexible EU negotiation positions. The UK economy has been remarkably robust to date but both the UK and EU stand to lose significantly without a deal (estimates GBP120bn and GBP95bn in output respectively). Time is running out for a solution given the March 2019 exit deadline.

With a decelerating (though still positive) global growth outlook we expect most central banks to remain cautious on monetary policy settings despite tighter labor conditions and rising inflation. The US Federal Reserve however remains on track to continue their path of interest rates hikes on the better conditions in their economy. US unemployment has fallen to 3.7% (a 49yr low) and now stimulatory fiscal policies will only heat their economy further.

Higher interest rate settings in the US saw the yields on 10yr Government bonds rise suddenly to 3.24% (a 7yr high). Higher US bond yields are translating to higher global bond yields unsettling bond and share markets. Company earnings continue to be robust and should provide support for share markets though we expect the coming earnings reporting season to be more cautions. The greater market volatility we have been expecting has now arrived though we expect a recovery on better valuations and still robust fundamentals. There has been feverish press around the length of the present global economic recovery (11 years since the Great Financial Crises) arguing a recession is due but there are no signs of an impending lurch to global recession. The following graph shows the length of different global economic recovery periods since 1949 (Source: Credit Suisse).

The current recovery may be long, but not the longest but it is however the slowest. Because it has been so slow, central banks remain cautious and generally accommodative on any softer economic data. This approach is likely to support the cycle for some time yet.



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

Market Returns	Sep. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-0.5**	-5.6	1.2	-1.3
$NZ v $US	**-2.4**	-8.3	1.1	-4.4
$NZ v $AUD	**-0.1**	-0.7	0.1	0.5
NZ Cash	**0.4**	1.8	2.0	2.5
NZ Fixed Interest	**1.6**	4.9	3.9	5.2
Intl Fixed Interest 100% hedged to $NZ	**-0.6**	1.3	3.3	5.2
Australasian Equities 50/50 Indexes	**3.1**	16.4	15.5	11.2
NZ Listed Property	**5.7**	14.7	10.9	12.1
Intl Equities 50% hedged to $NZ	**5.4**	15.3	12.9	12.2
Commodities $NZ	**0.1**	11.9	-1.3	-2.8

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	7.7%
F&P Healthcare	Healthcare	1.1%
Fletcher Building	Building	-5.9%
Freightways	Transportation	2.7%
Meridian Energy	Energy	9.1%
Port of Tauranga	Ports	5.8%
Stride Property	Property	8.2%
Trade Me	Consumer	21.7%
Vector	Energy	5.1%
Vista Group Intl	Software	1.6%
Australian Equities		
BHP Billiton	Resources & Energy	4.8%
Brambles	Professional Services	24.7%
CSL	Healthcare	5.1%
IAG	Financials	-11.8%
National Australia Bank	Financials	0.2%
Scentre	Property	-7.0%

- Brambles produced a yearly profit of US$997m which was above expectations. Some analysts had been concerned about their ability to increase prices in the face of higher input costs such as energy and lumber prices. The company proved their model does allow some pricing power. They also announced an intention to demerge IFCO, a plastic crates business, which will reduce capital requirements and free management resources to focus on improving core business margins.
- The Trade Me share price surged following a strong profit result and announcement of a $0.22 per share special dividend. While disruptive new competitors remain a constant threat, the company is making good progress on improving its products and services, widening its share of wallet via aligned services (such as "book a courier") and exploring new business lines which leverage its client base such as Harmoney. TME is an extremely capital efficient business with high positive cash flows and very low debt levels.
- Woodside Petroleum benefited from share broker upgrades as analysts took a positive view of progress on the company's Scarborough gas resource in Western Australia.
- IAG profit was slightly below expectations despite strong insurance profits in Australia. A large loss on their Asian operations and lower investment income on shareholder funds were the key reasons for the miss. The company has also looked to rein in investor expectations for next year by providing a conservative outlook for profit margins. At the same time management are comfortable with business activity and new reinsurance arrangements which will see it reduce business risk and free up capital by sharing 12.5% of its revenue and costs with 3 global reinsurers.
- Vista, through its subsidiary Movio, has struck an exciting new deal with Walt Disney Pictures to supply research and analytical products and services. This is recognised as a big step for the company who already supply services to other big Hollywood studios such as Warner Brothers, Universal and Sony.

Sonic Healthcare	Healthcare	3.9%
Westpac	Financials	-5.5%
Woodside Petroleum	Energy	10.9%
Woolworths	Consumer Staples	-5.1%

- CSL's profit result was above expectations due to strong growth in both core and specialist product lines. The company continues to invest in its plasma collection facilities and this is allowing them to gain market share. While the company faces challenges from competitors who gain regulatory approval for substitute products in certain business lines, the star product remains immunoglobulins and at this point demand far outstrips the combined industry supply.

Studios are using the software platform to build profiles of moviegoers to better understand who, what, when and how consumers are watching movies to develop targeted campaigns and perhaps decide what the future blockbuster will be.

- Fletcher Building has made an opportunistic offer to buy Steel & Tube. Both construction-related companies have recently raised additional capital and reset their respective business strategies as they look to focus on core competencies. The $1.70 per share offer was 35% above the recent STU share price but was rejected by the board as under-valuing the company. For FBU the purchase of the steel distribution and processing company is consistent with its strategy although it would face a lengthy period before getting the sign off for the transaction by the Commerce Commission.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	4.2%	The fund outperformed the market benchmark with strong returns from Brambles, Trade Me, CSL, EBOS and GTN. The GTN share price bounced back after a recent selloff when a private equity investor who closed their fund was required to sell to meet investor cashflow requirements. GTN provides a differentiated radio advertising platform and is growing strongly in Brazil, Canada and Australia. During the quarter the fund manager visited a range of US healthcare companies to better understand pathology, hospitals, cochlear implants and healthcare distribution. Meeting with CSL confirmed that demand for immunoglobulins remains very strong with the large manufacturers not keeping up with demand, leading to better margins, however other areas remain challenging such as the over-supply of Albumin and rising donor costs. On balance, the manager remains positive and retains an overweight position in CSL. They also visited the new Fisher & Paykel manufacturing facility in Mexico and while FPH remains a very well run with an excellent strategy the current share price means it is fully valued.

Harbour Australasian Equity Focus Fund	2.8%	Despite positive absolute returns the fund underperformed the market benchmark over the quarter as high growth companies Challenger, A2 Milk and Sydney Airport retracted some of their year to date gains. A2 Milk produced a positive earnings result and continues to ship more product but was sold down when investors took issue with new CEO Jayne Hrdlicka selling down all her shares (given to her as a sign-on bonus) and the Chinese government announced a review of e-commerce laws which could impact on the supply chain. The company share price was volatile over the quarter and the fund manager actively managed this by taking profits after the share price gained due to index buying, and then buying more shares during the recent weakness. Despite reasonable economic growth the Australian share market was volatile due to yet more political change and the bank and insurance sector being negatively impacted by rising global interest rates, brand damage and remediation costs from the ongoing Royal Commission enquiry. In NZ the company reporting season was solid but mixed and looking forward the expectation is that domestically orientated companies will have higher costs (wages, energy prices, more regulation) and potentially weaker consumer demand, while globally orientated companies will benefit from better global growth and a weak NZ dollar.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	-0.1%	The fund was down -0.5% in A$ terms for the quarter. Relative to the global market, fund returns were the weakest in almost 20 years reflecting the current portfolio exposure which includes an overweight position in China and Japan, underweight the US and short positions (assumptions that the asset price will drop) in highly priced sectors such as technology. Gains in Healthcare, Technology and Energy shares were offset by losses in cyclical shares and the cost of short positions. The fund has no net exposure to the US market which was up 10% vs the rest of the world which rose 3%. Much of this differential was due to the impact of a rising US dollar and returns from highly priced technology stocks which the manager prefers not to hold. The manager is currently well and truly out of step with the market in what they consider is an attractive investment and this is one of the reasons we hold them as part of the wider portfolio. As an example, the fund holds Samsung Electronics which has increased earnings by 18% over the last year while its share price has fallen by -18% so it now trades at a price/earnings multiple of 6.5 times expected earnings. Compared to the market multiple of 22x, the Samsung price is cheap if the company achieves its expected earnings. Contrast this to Amazon which has seen stellar growth in both earnings and share price but now trades on a P/E of 71 times. A great company with the potential for more growth but relatively much more expensive and therefore not held. The net invested position of the fund is 69% which is the lowest level since 2009 and reflects the type of stocks held and the 16% allocation to cash.

Monks Investment Trust	1.3%	The fund was up 3.2% in GBP terms for the quarter. The manager identified earlier this year that the very strong performance the fund had achieved was largely due to significant contributions from a relatively narrow range of technology and internet companies. They have been actively taking profits in large stocks such as Alphabet and Amazon and reinvesting in younger companies with potentially greater growth potential. One of the key themes impacting new investment decisions is the wave of technological advances driven by the use of data in areas such as health, media, transport and trade. Also the massive pickup in the use of mobile devices across emerging markets, supported by young populations and governments keen to reduce the wealth gap, is seen key to rapidly improving living standards which should provide exciting opportunities for a long term growth investor.
Magellan High Conviction Fund	6.3%	The fund was up 6.6% in A$ terms for the quarter. The manager has been cautious of key market risks for some time with asset prices at or near record levels, central banks removing liquidity from bond markets and the potential for inflation to rise quicker than previously expected due to late-cycle US fiscal stimulus of tax cuts and spending. Given the uncertain outlook for interest rates and the potential for a spike in inflation, there is a reasonable chance of a sharp (-20%) share market downturn and as a result they have held almost 20% cash in the fund for some time. Despite this potential drag, portfolio performance has been well supported by exposure to large technology, financial and healthcare companies which have posted strong profit results. While many of these companies are listed in the US they are true multinational players whose earnings are generated around the world. The manager estimates the effective geographic exposure of the fund at 49% US, 14% Emerging Markets, 12% Western Europe, 7% the rest of the world and 18% cash.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	5.5%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The NZ dollar fell against most major currencies including the US dollar which is now 8% higher over the last 6 months. The US market led by large tech companies rose strongly (up +7.7%) and Japan (up +8.9%) rebounded following the re-election of Prime Minister Abe and a weaker Yen. European markets on the other hand were flat or slightly lower due to a strong Euro and Italian budget concerns, while the UK continues to be negatively impacted by ongoing Brexit negotiations.
iShares Russell 2000 Index Fund	5.8%	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 market are faring well as the economy benefits from Government initiatives to boost domestic growth, whereas companies in other regions are struggling being negatively affected by the strong US dollar and the potential impact on demand as a result of trade wars between the US and everyone else.
Vanguard FTSE All-World ex US Small Cap Index Fund	-0.4%	
iShares S&P Global Infrastructure Index Fund	1.3%	Following a review of our international equity allocations we have sold all client holdings in this fund and reallocated the cash across the remaining securities in the sector. Many of the core international equity funds have an exposure to global infrastructure and analysis suggests this is a more effective way to manage the sector.

Vanguard Emerging Market Index Fund	-0.4%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets were weak during the quarter as investors tried to assess the potentially adverse impact of rising US interest rates on emerging economies with large amounts of US dollar-denominated debt. Turkey was the weakest market where we witnessed a sharp sell-off of the Lira on the back of geopolitical tensions with the US. Mexico by contrast ended the quarter higher after reaching an agreement with the US on NAFTA and a general election.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	0.0%	The fund provides passive index exposure to commodities and is valued in USD. Overall commodity prices fell in US$ terms over the quarter despite a 5% increase in oil prices and Natural Gas being up +3%. Trade uncertainty led industrial metals lower with copper and nickel falling sharply and even gold and silver losing ground despite their reputation as a safer asset during times of volatility. Closer to home dairy prices were much lower with Fonterra's average product price dropping 22%. The general commodity weakness saw commodity currencies such as NZ and Australia fall in value which helped boost returns to NZ investors by just over 2%.

NEW ZEALAND FIXED INTEREST

Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	1.6%	The US Federal Reserve raised short term interest rates by another 0.25% and long-term interest rates moved higher to end the quarter above 3%. Strong economic data including record low unemployment and strong corporate earnings is paving the way for the Fed to remove its accommodative policies. They have now lifted rates 8 times and are projecting another 4 increases before the end of 2019. Rising interest rates means falling bond prices and global bond investors saw a -0.6% loss over the quarter from high quality investment grade bonds. Lower quality, high yielding bonds fared better as investors continued to search for yield with less regard for risk. However, many of the exchange traded funds which invest in this part of the market have seen large outflows following the quarter end as US 10 year rates have pushed above 3.2%.
NZ Corporate Fixed Interest Investment Grade Rating	1.3%	In stark contrast the Reserve Bank of NZ remains concerned about poor business confidence adversely impacting growth in the local economy. Despite higher oil prices, a tight labour market and a weaker NZ dollar putting pressure on input costs for local businesses the RBNZ sees few signs of inflation and given their mandate now includes employment growth their clear preference is to avoid putting the brakes on the economy too quickly. They continue to keep rates at record low levels

		and have indicated a willingness to aggressively cut rates by up to 1% if they see annual GDP growth decline below 3% p.a. A stronger than forecast 1% rise in GDP for the June quarter gave everyone a surprise but it largely reflected a rebound from a weak March. The divergent central bank paths have seen the well-established relationship between US and NZ long term rates break down with the NZ 10 year rate ending the quarter 0.45% below US 10yr yields. The differences in growth and debt levels between NZ and the US provide some rationale for a reduction in the traditional risk premium that NZ has offered investors however it is hard to justify such a large move and unsurprisingly we have seen some selling by offshore investors (although this supply has been readily soaked up by local investors including the dominant KiwiSaver providers).

ECONOMIC COMMENTARY

Key Global Risk

The US reached agreement with Mexico and Canada on new trade rules this quarter while EU, Japanese and South Korean tensions are easing. However, the US/China relationship has markedly declined with a trade war now underway and both sides digging into their respective positions. The US accusation is that China has taken advantage of them. In May the US introduced a 25% tariff rate on selected Chinese imports to a final value of $50bn. In September a further 10% tariff was placed on $200bn of goods. This tariff rises to 25% from 1st January. Trump is now talking about additional tariffs on $276bn worth of Chinese imports (all Chinese imports). China has placed tariffs on $50bn of certain US imports and has now put a 10% tariff on an additional $60bn of US imports. 23% of China's total exports go to US and 8% of US total exports go to China.

Chinese Cyber Spying?

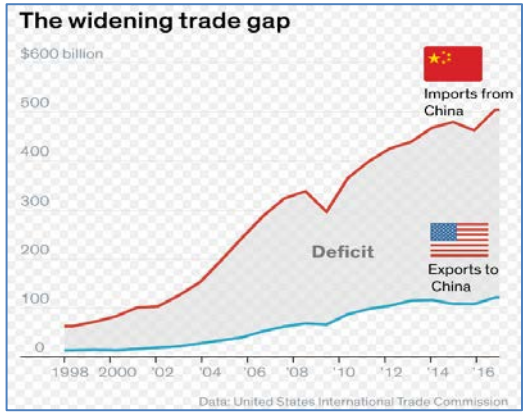
Trade War

What does a trade war mean for the US China and global economy?

The trade war in absolute financial terms is relatively small. If the total value of all tariffs threatened by both sides is implemented the value of those tariffs would be $100bn. This is about 0.13% of global GDP or about 0.5% of US GDP or 0.8% of China GDP. To date, the cost to China has largely been mitigated due to its currency devaluing 10% against the US dollar. This will likely lead the US to label China a currency manipulator.

The real impact of the trade war will be on global supply chains (which rely on just in time delivery for manufacturing) and the cost and time of replacing key supply sources. Manufacturers will also seek to re-route goods to change their place of origin status. The trade war is affecting business confidence while some markets have also been impacted on rising investor concerns. To date most of the market response in the US has been small dips and then recovery following tariff announcements. In China, their share market has been hit hard and now down more than -20% from 2017 highs and back to early 2016 levels. Weaker manufacturing data in China and Europe suggests the trade war is hurting. The OECD and now the IMF have both subsequently reduced their global growth outlook from 3.9% this year to 3.7%.

Trade Imbalance… only part of the story?

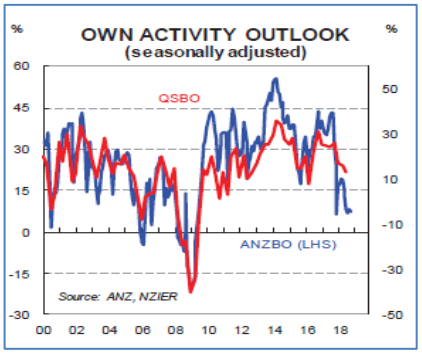


The US/Sino trade war is looking like a proxy for a bigger agenda. There are estimates that intellectual property theft by China is costing the US up to $600bn p.a. (putting the tariffs in perspective), and cyber security threats and accusations of political interference are rising. The size, speed and projection of Chinese power appears to be the real driver behind US actions. In the short term, the US looks better positioned to benefit while China says it is prepared for a long game (read waiting out the Trump administration) and prepared to pivot to domestic growth to offset weaker exports. The ramifications for a long-term trade war are yet unknown but it appears we are likely to find out. *At the time of publication, the White House said it is moving ahead with plans for President Trump to meet with Chinese leader Xi Jinping at a summit in November (WSJ).*

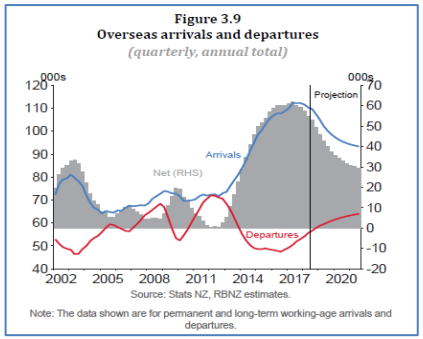
New Zealand

Business confidence did not recover in the quarter and is the lowest since 2009. The chart opposite measures business' own activity confidence which is normally higher than general confidence expectations. The weak trend for own business is consistent with a weak broader outlook. A net 28 percent of businesses expect economic conditions to worsen – the lowest level since March 2009.Government policy priorities and inconsistencies are cited as primary reasons for pessimism but the increasingly tight labour market, slow-down in the housing market, tighter credit, rising energy costs, lower milk prices and higher wages growth looks constraining. Added to this net migration numbers are also starting to come down and expected to drop by half by 2020, reducing demand but also reducing labour supply. Leading indicators suggest the current pace of growth is running at 2.5% to 2.7% which is well below the pace of recent years (3.5% to 4%). To the Government's relief, a Q2 1% GDP print surprised everybody while the fiscal accounts showed a strong operating surplus of 1.9% of GDP for FY18. This is 2.4b larger than projected in May. Government net debt also slips below the 20% of GDP target. Perhaps a sharp rise in Government spending may provide sufficient fiscal stimulus over the 2019 to moderate the presently softer outlook. The RBNZ, now with its multi- policy targets in place, left rates on hold citing a potentially weaker outlook and possibly cuts if required. It will be interesting to see company earnings results and indicators as we move into the final quarter.

Business Confidence Still Weak



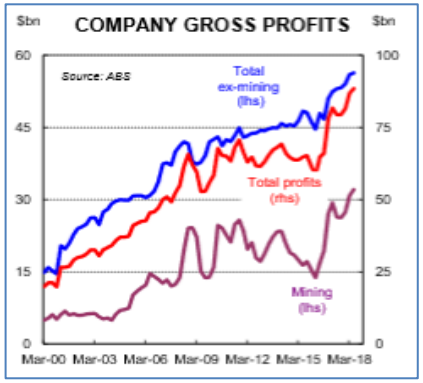
Net Migration Slowing



Australia

The Australian economy continues to improve as mining states start to respond to higher commodity prices and recommence investment. The economy has grown 3% over the last year and unemployment (5.1%) is back down to a 6yr low. Business investment continues to support manufacturing activity and expansion while services also remain strong lifting wages growth. While infrastructure and commercial construction is robust; tighter credit conditions, restrictions on overseas buyers and stronger supply is impacting house prices - particularly in Melbourne and Sydney. This may lead to lower household confidence. Mortgage repayments average 40% of NSW borrowers incomes. There has been a sharp drop in apartment consents and Chinese investment in Australia slumped -40% last year, twice the drop worldwide, as China cracked down on overseas deals and ties with Canberra were strained (AFR). The RBA remains accommodative (1.5%) and watchful for trading partner weakness, particularly Chinese demand for commodities. Company earnings continue to build with mining profits rising quickly (see opposite).

Australian Company Profits Rising

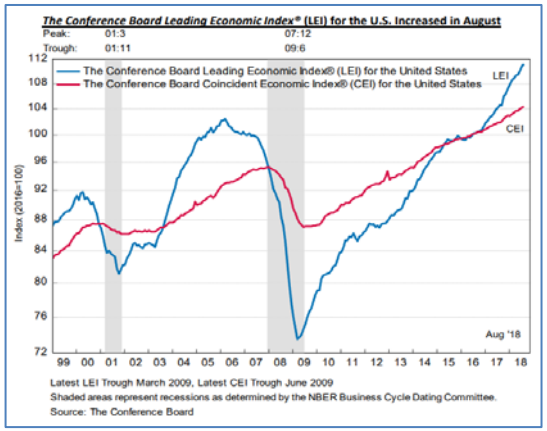


US

The US economy is currently growing at $US1 trillion p.a. (Bureau of Economic Analysis) and has now broken through the US20 trillion level with US household wealth now higher than US100 trillion. Economic activity is accelerating. GDP increased at an annual rate of 4.2 percent in the second quarter over the first quarter increase of 2.2%.
The Conference Board Leading Economic Index® (LEI) increased in August and is now above its previous peak and back to pre GFC (March 2006) levels. During the quarter the unemployment rate fell to 3.7% (a 49yr low) and the participation rate rose back to 2011 levels. Household savings are declining again as consumer confidence lifted to an 18yr high (consumer spending is 70% of US economy) and wage growth prospects improved though, higher mortgage

interest rates will likely impact. Factory orders rose in the quarter, house prices moved higher (+6% over the year), manufacturing was robust (21yr high) and small business optimism is at record highs. Additionally, the Trump tax cuts have yet to feed down fully into economy suggesting better business investment could be on the cards and is certainly required to lift productivity levels. All this while core inflation came in at 2.2% and less than expected. Company earnings continue to improve and provide support for market valuations. The US Federal Reserve raised (well signalled) rates to 2.25% reiterating a present commitment for a hike in December and several more in 2019. Bond markets finally reacted to the strong economic news selling off sharply into the end of the quarter which is likely to also put pressure on share markets *(and which has now happened).* With the mid-term US elections coming in November, markets are bracing for greater Trump rhetoric particularly around Chinese negotiations. He presently appears well positioned for these elections as growth prospects look robust for at least the next 2 years.

US Leading Economic Indicators…Charging Ahead and back to pre GFC levels.

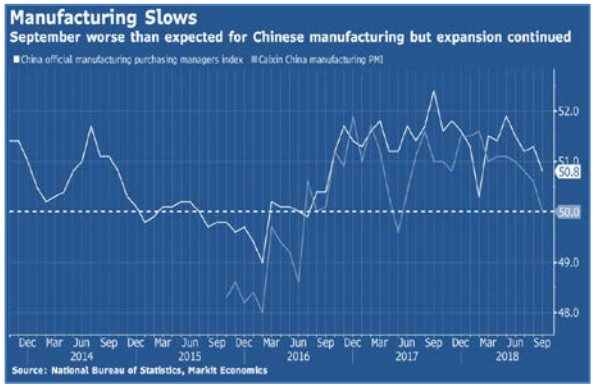


China

China may need to put its deleveraging plans on hold. This year it began to tackle its high levels of internal debt that are putting financial stability at risk. It has also been addressing inefficient capital allocation and low productivity activities. However, the US trade spat is impacting export orders (lowest since 2016) and manufacturing and investment activity. While there was an expectation economic growth would slow to 6.5% this year, unofficial estimates have growth running well below that (we have seen as low as 4.7% by some estimates) China's official manufacturing has hit a 7-month low and the Caixin manufacturing PMI declined to 16-month low in the quarter.

With the lack of progress in trade discussions with the US, China can expect further tariff increases and possibly more retaliation at a time China least needs it. The outlook for China's economy now increasingly hinges on renewed fiscal and monetary stimulus to ramp up domestic activity. The Peoples Bank of China recently cut rates and lowered their reserve requirements to stimulate borrowing and investment while the Government has held back on fiscal stimulus measures for now as domestic demand for services and construction still remains robust. The Chinese share-market has however dropped -18% this year and is down -20% from 2017 levels on the back of investor confidence concerns. The Renminbi has also fallen -10% against the USD since April (nearly a 10yr low) on negative funds flows; though the Trump administration appears to be close to declaring the fall as currency manipulation.

Chinese Manufacturing Slowing

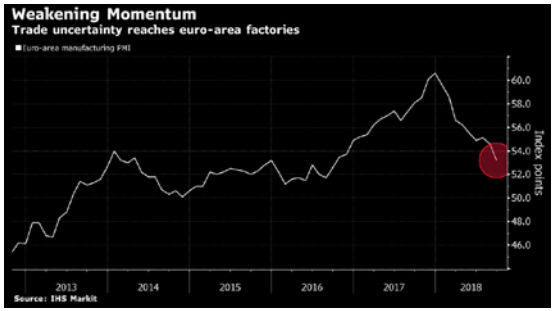


There is a growing feeling that the US China trade war is now moving into a cold war. *"There's a whiff of fear in the air in China as escalating trade frictions with the US begin to impact on an economy that had its own pre-existing issues…..Nevertheless, with the US rhetoric on China shifting from the simplistic view that China is stealing US jobs and manufacturing activity as well as its intellectual property to one that appears more strategic and designed to try to frustrate China's long-term ambitions of economic and technological supremacy, there is a real risk for the Chinese if the renminbi keeps falling."* (The Sydney Morning Herald via Reuters)

Europe

European activity continues to moderate from its stellar 2017 year with manufacturing slowing (though still positive with a PMI at 53.2) to 2yr lows across the whole EU. Orders are fizzling as the US tariff threats, ongoing Brexit saga and higher energy and commodity prices dampen confidence. Inflation has also lifted sharply (German CPI at 2.2%) on higher energy prices and the stronger US dollar. The new Italian Government' instance of running a larger then permitted budget deficit is also rattling the EU bureaucrats as well as bond markets. Business and consumer confidence are also generally lower though the euro-area economy. The IMF recently reduced their growth expectations down to 2% from 2.2% and European share markets are negative for the year to date.

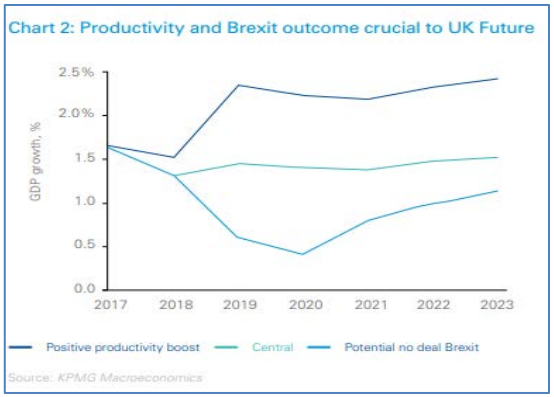
Europe Manufacturing Slowing



UK

Brexit negotiations have repeatedly broken down over the quarter with PM May snubbed by EU leaders in September with her soft "Chequers" plan. This plan also triggered a party backlash and Cabinet resignations for being too soft. Politics has firmly gotten in the way of economics. There is little more than 6 months until the UK formally leaves the EU and something has to give. In the last few days there has been increasing speculation that the EU may agree to a soft boarder plan for Ireland which is the key sticking point. May has been given until 18 October to propose a new plan to address these issues or else the possibility of a no-deal Brexit increases. Authorities are preparing for a hard Brexit with the Bank of England working hard to shore up contingency plans. If Brexit fails, there will be a sharp impact on the UK economy. In the meantime, the economy continues to perform relatively well on strong consumer and business activity (GDP +1.4% annualised). Employment is robust (best since 1975) though possibly more due to some EU workers leaving. *Latest news at publication. UK and Brussels close to agreeing Brexit deal (breaking FT headline).*

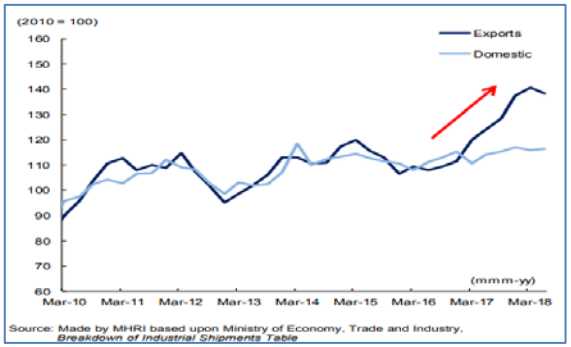
Brexit Deal vs No-Deal Impact on UK GDP



Japan

Increased trade tensions and moderating Chinese demand (and a weaker Renminbi) is slowing Japanese export orders which have been very strong over the last year. Despite this export slip; their current account surpluses continue to be positive with Japan marking its 50th straight month of surpluses. Employment remains robust, tourism strong and consumer spending is better after torrential rain caused flash floods in western Japan. Higher import energy costs will hurt though it is not showing up significantly in the inflation numbers yet. The key risk for Japan is whether or not they will be able to achieve a trade deal with the US. To date the overtures have been positive but nothing has been agreed. Japan will be increasingly nervous that they might get Trumped.

Japanese Exports Moderating on Trade Wars



Emerging Markets

Energy and metal commodities exporting countries are faring well while other emerging economies faced increased financial stress over the quarter. Weak offshore financial positions (predominately US dollar loans) were further impacted by a much stronger US dollar and higher energy costs. Inflation rates have soared for some and currencies are under attack. Interest rates have been raised sharply to slow capital flight. Turkey, Brazil and Argentina have been the most exposed, but rates have been lifted sharply in Russia.

MARKET COMMENTARY

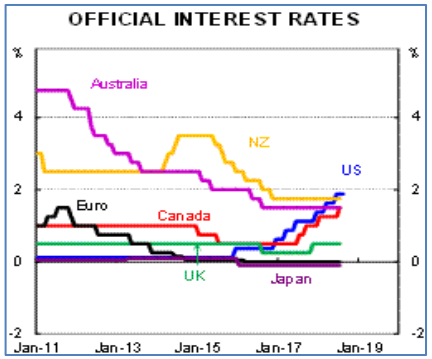
As we write, investment markets have sold off sharply with volatility levels (opposite) approaching those last seen in February this year. This has been expected for some time given the months of steady rises and the prospect of higher interest rates in the US lurking in the background. Added to this, the uncertainty being created by US trade tariffs has already significantly hampered prospects from many emerging markets; particularly China, which has seen its share market fall more than -20% over the last year. Western markets have generally disregarded the trade tariff war but when this issue is combined with higher US interest rates (on strong US economic performance) markets have finally been spooked; and significant algorithm (programme) trading has added considerably to the negative momentum in both bond and share-markets. Markets don't appear to be in panic mode. Global economic growth prospects, though slightly softer, remain robust and the better valuation fundamentals after this dip will be supportive of some market recovery.

Volatility Returns

Cash

Continually solid US data and rising inflation numbers saw the US Federal Reserve raise rates again this quarter by 0.25% to 2.25% in September; and they remain on track for another rise in December with 2 more next year to reach 3%. There is significant political pressure to let the US economy run, with Trump criticising Federal Reserve tightening; but with full employment, fast rising wages, significant fiscal stimulus, import tariffs and higher energy prices inflation pressures are building. In contrast to the hotter US economy, central banks elsewhere may acknowledge inflationary forces but are adopting a wait and see approach with concerns of a softer growth outlook for their economies. In NZ inflationary pressures are also building but moderating activity saw the RBNZ decision leave rates on hold and likely to continue to do so until early 2020. With a broader mandate the RBNZ has also left the door open for rate cuts which has assisted a weaker NZ dollar response.

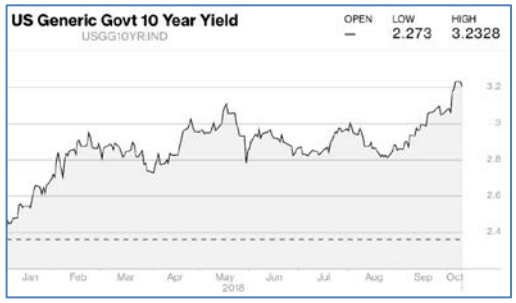
US Tightening Continues



Fixed Interest

Global bond markets followed the US bond market down as investors finally succumbed to the reality of accelerating US economic growth and rising US inflationary pressures. Though the Federal Reserve has stuck to its pre-warned rate rise schedule, more hawkish inferences have been enough to trigger a sharp rise in yields causing significant losses to long term bond holders. The 10 Year US bond moved from a yield of 2.83% to 3.24% over the quarter. Yields have recently moved lower back to 3.1% as investors seek a safe haven from the more volatile share market. Elsewhere, central banks remain more accommodative - though US bond pricing has also affected higher yields in those markets. NZ bonds yields also moved higher but the unusual yield discount that first appeared in May for investing in NZ and Australian bonds continues; suggesting that investors may value our lower Government debt ratios and the diversification benefits of investing in this region. In anticipation of higher yields, we remain conservatively positioned for both duration and credit risk in our client portfolios.

US 10 Year Bond Yield Sharply Higher

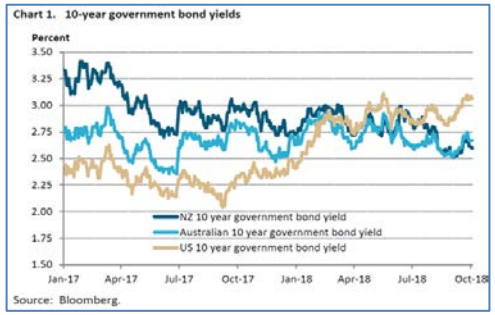


NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

Equities

Advanced economies' equity markets were positive over the quarter with the US leading the way (+7.7%) on very strong company earnings results. The chart opposite shows quarterly earnings growth is at its highest in 7rs with the red line showing earnings growth is robust even without the recent tax cuts. Although absolute values are high the US market remains attractive on a forward earnings basis. The NZ market delivered another strong return over the quarter (+4.5%) but unlike the US, our economic outlook is softening which will challenge earnings growth prospects while our market also remains historically overvalued. Emerging economy markets performed poorly over the quarter with trade war risks weighing heavily on the Chinese (-7.9%) and other Asian markets, though the Japanese market held up well (+9%) on positive US trade talks. Post quarter end, the sharp rise in market volatility will have negated these positive results but also returned valuations to more appropriate levels (NZ) and in some markets (Australia, US, Europe, Emerging Markets) to more attractive levels.

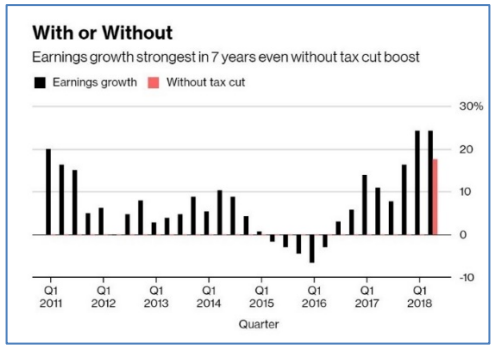
US 10 Year Bond Yields higher than NZ/AUS



Property

Auckland residential consents are at record levels + 35% year on year as the market scrambles to provide supply. Consents elsewhere in the country are slowing however with prices decelerating markedly. The graph opposite shows Auckland prices actually moving into a negative position over the year. The price deceleration has been driven by tighter credit conditions, tougher offshore investor restrictions, a move in the tax bright line test to 5 years and slower net migration rates. Additionally, new Auckland consents are comprising higher density dwellings which may push average prices lower. Listed property securities performed well over the period up +5.7% but this sector is expensive and near all-time highs with a price earnings ratio of 19.8 times. With an average gross dividend yield of 6.6% the sector is also close to all-time low yields (2007 being the lowest) but even at this level yields are attractive for income seeking investors. In the background, the Tax Code Working Group is angling for the introduction of a specific tax on asset gains which may change the fundamental nature of returns from this asset class.

US Company Earning hit 7yr highs



Commodities

The ANZ world commodity index fell again in September (4th month in a row) on broad based price declines. Dairy prices are now down -11.5% since May on stronger global production; while meat, fibre, horticultural and timber prices were all weaker over the period. Despite a recent reduction in the forecast milk solid prices, farmers should still fair well on strong production volumes. Despite trade tariff concerns; global demand is robust but does risk moderating should tariff wars widen. NZ may be well positioned given our trading relationship with China while the UK also offers opportunities post Brexit. Elsewhere energy prices were higher on US Iranian export sanctions and a reluctance by OPEC to lift production. This is certainly being felt at home with prices at the pump rising quickly and likely to reach $3 a litre by Christmas.

NZ House Prices Decelerating