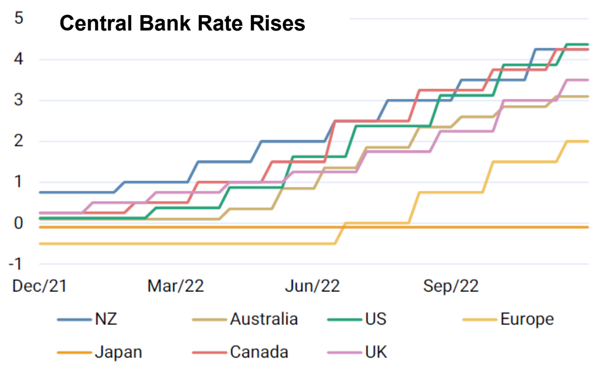
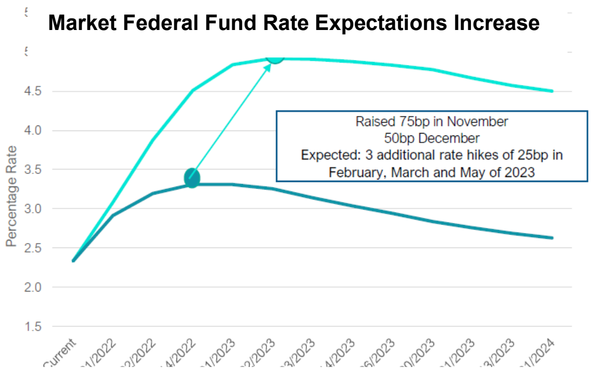
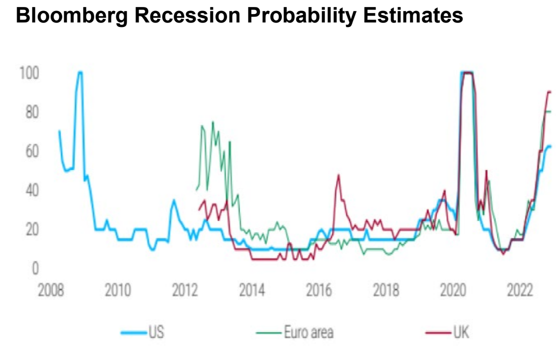
Investor Update

It remains deeply ironic that extreme government fiscal and central bank monetary stimulus deployed to combat Covid lockdowns in 2021 then exacerbated the sharp inflationary impulse generated by the re-starting global economy. After actions to save economies, central banks are now in the process of using record interest rate rises and reducing money supply to try and contract economic activity to quell that inflation. The central bank 2021 thesis was inflation was transitory and being driven by resurgent demand overtaking broken global supply chains. This 'transitory' expectation was thrown out the window as the Ukraine war sparked an energy crisis. Central bank patience turned to near panic policy tightening from that accelerated through the year. The impact on markets has been epic with all major asset classes except cash falling. The recent annual American Economic Association meeting (some 6,000 attendees) was most divided for the outlook and appropriate policy settings. They acknowledged a poor record last year with forecasters failing to see the inflation outcome. Consensus now appears only for greater uncertainties ahead! The way forward is murky. Higher interest rates are decelerating growth and some form of recession likely. On the flip side, inflation has peaked and markets have already born much of the damage providing opportunity for near term bounces. The key issues for the year ahead:



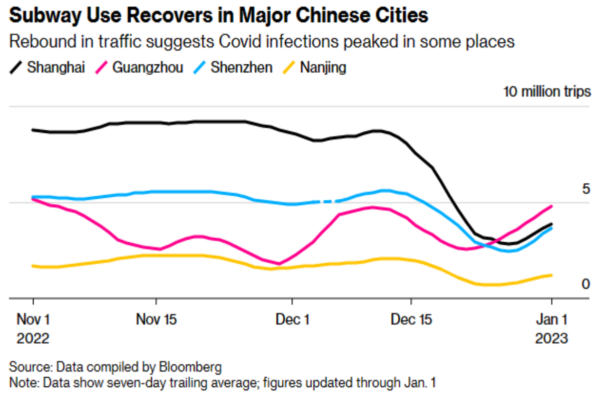
Inflation Peak. We have likely reached peak inflation though central banks have now narrowed their interest to wage inflation which is sticky. They no longer care about creating recessions and happy to contract growth as required. Given so much of the inflation remains a supply side problem and will take time to address, crushing demand to meet those supply constraints is a brutal way of addressing inflation and politically unpalatable. On the positive side, global labour mobility and participation rates post lockdowns are now improving though services industries (80% of US GDP) are still re-opening and needing staff. Central banks will keep tightening for now but at a slower rate and with far more caution. Cash rates will reach a terminal level early this year (5% in the US? – see opposite) and bank actions diverge significantly as their respective economies respond. These rate rises have already been priced into markets which are watching wage inflation closely and will move sharply as new data arrives. A drop in core and specifically wage inflation would sustain a significant market bounce.





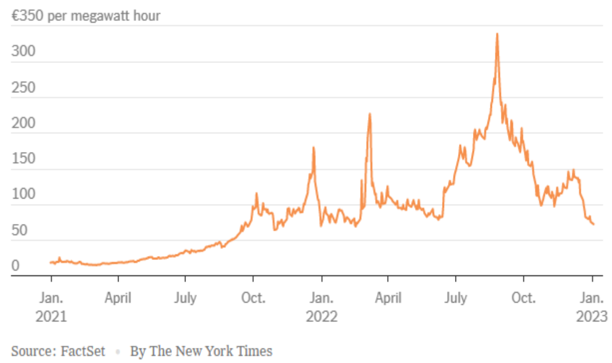
Recession. The full effects of raising interest rates takes time to work its way through economies. Increasing the cost of money (from near 0%) means borrowers and lenders will quickly become more cautious and likely to slow activity. This lag effect makes it near impossible for central banks to determine how far they need to tighten conditions. Bear in mind many central banks also have a full employment goal as well as managing price stability. Given the record rise in interest rates last year, there remains consensus for recession at some time in 2023 but no one knows how deep or shallow it will be. Recessions are an important part of the economic cycle assisting re-set the allocation of assets and labour. A recession would not necessarily be unwelcomed by markets which have already priced in the possibility of a shallow one. A deeper recession presently seems unlikely given near full employment numbers while household and corporate balance sheets remain strong even if spending intentions are declining (and disinflationary). We would need to see significant layoffs and much weaker house prices. The later more likely as mortgage costs continue to rise though we do not have the glut in global housing supply as in the GFC. A slowing economy, higher borrowing costs and possibly higher taxes will impact company earnings. Markets have priced in a decline in earnings (US market currently -4.4% for 2023) which would be the largest since 2015. Price to earnings ratios for markets are at or below long-term averages suggesting a larger negative earnings surprise would be required to move markets substantially lower.

China growth to stimulate global demand. Their Covid policy put China's economy into a slump in 2022 with business and consumer spending plummeting amid surging infections. Xi Jinping has radically changed tack for 2023 ending their punishing lockdown approach while Covid cases are also starting to peak around the country including in Guangzhou, Beijing, Tianjin and Chongqing. Authorities are working hard to address their property development woes and announced reduced regulatory overburden on public markets particularly the tech sector which has been subject to direct intervention. This will increase investor confidence and supported a recent market rally. Manufacturing activity and consumer consumption has recently started to re-gather steam and importantly more people are a moving around. Subway data shows a sharp rise in movements and China State Railway Group Co. aims to transport 2.7 billion passengers in 2023 which would be a 68% jump from 2022. Borders are also opening after 3 years, passports issued and international travel intentions rising. China has previously been as much as 55% of global growth so a return to +5% growth rate in 2023 from an estimated 3% in 2022 would provide an incredibly significant boost to global demand and could be the biggest positive surprise of the year.



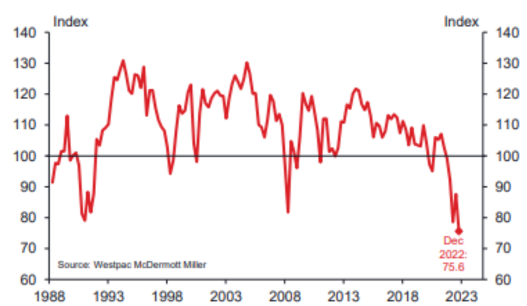
European growth may also surprise. A further ratcheting of the Ukraine war is likely as NATO support increases and a desperate Putin responds. Despite the dreadful war backdrop, a mild winter, efforts to reduce energy demand and an apparently successful pivot away from Russian energy reliance (50% of EU gas supply) has reduced much of the energy shock for Europe. Natural gas costs have plummeted back to pre-invasion levels. The energy squeeze impacted growth and put some states into recent recession but for now it appears any dramatic meltdown has been averted. Economic performance though weaker has been surprisingly resilient for manufacturing and exports. Consumer demand has also held up well. With inflation recently peaking and greater recessionary pressures, the ECB is now making moderating comments. Should Chinese demand improve and support exports, then Europe is well positioned to recover especially given the tail wind of a very low Euro. Europe' contribution to global growth could also surprise this year while Russia has now lost its biggest and profitable trading partner.

European Benchmark Natural Gas Prices (Dutch).



New Zealand

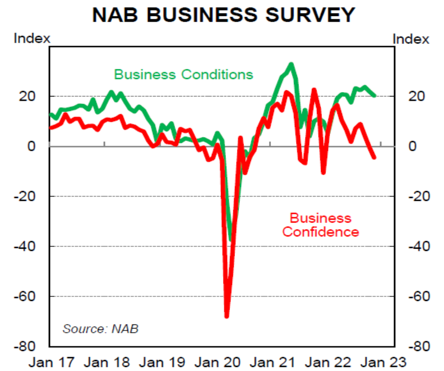
Westpac NZ Consumer Confidence



Our economy surprised everyone with a +2% jump in GDP growth in the September quarter and GDP is now above pre-covid levels. Construction activity including infrastructure spending was up +5% while our very important tourism sector continues re-accelerate as inbound visitor numbers and spending increase. As our biggest trading customer, NZ is well positioned to benefit from a stronger Chinese economy and as international travel restrictions on their citizen's ease. On the flip side, inflation has been persistent with wage inflation particularly worrying and underpinning the RBNZ's aggressive tightening program. The rise in the cost of living and the impact of rapidly rising mortgage costs will severely impact some household finances. About 65% of mortgages are expected to re-set over the next 6 months from very low fixed rates in the 2%-3% range to up to the 6-7% range. This will crush their discretionary spending. On the flip side, deposit holders will be receiving higher interest income than in recent years. Higher interest rates have hit median house prices falling nationally by -12.4% over the year and Auckland -18.1% (REINZ December report). The Westpac consumer confidence survey (index chart above) shows a drop to a record index low before Christmas and widespread across all age, income brackets and regions. The ANZ Business Confidence Index is also sharply negative and at record lows. Given household spending accounts for around 60% of NZ activity the economy is likely to stall and enter a shallow recession at some point this year. Unemployment is also expected to rise accordingly (RBNZ forecast 5.7% by 2024) and the Reserve Bank remains on track to continue to raise rates (terminal rate target 5.5%?) until wage inflation eases. Our chronic labour shortage (and our greatest growth impediment) means wage inflation will be tough to address especially as more of our workers look seriously at attractive options across the ditch. Meanwhile (and rowing in the opposite direction to the RBNZ) the government is likely to bring panic spending to bear as election timeframe pressures build. Some of which will could be stimulatory. NZ GDP growth is expected to finish the year slower but still in postive territory around +1.9%.

Australia

NAB Australian Business Survey

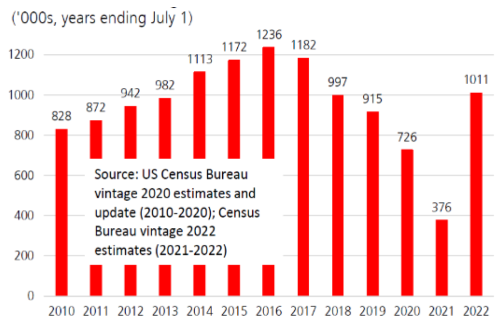


Mixed commodity prices are likely to impact Australian exports in 2023 though increased Chinese demand for iron ore and now also coal (lifting Chinese import restrictrions) will assist receipts. Australia's commodity exports will fair ok though domestically things are not as rosy. As for NZ, sharply higher interest rates are starting to impact activity with consumer and business confidence is falling there as well. Home prices, as in NZ have also dropped sharply -7% in 2022 and likely to fall further adding to household anxiety. Building approvals are also declining on higher funding costs. For now low unemployment (lowest since 1974) and record high household savings levels achieved through lockdown are providing a buffer for consumption though this is expected to fade in by the second quarter and the Australian economy will lose momentum. Westpac are forecasing 2023 GDP growth to drop back to +1.8% which is sharply down from the +3.6% growth rate forecast from 2022.

US

The US economy is actually holding up well but with some very mixed signals for the Federal Reserve to absorb. Consumer spending in Q4 was robust while the critically watched (for wage inflation) labour market remains very tight with unemployment levels at 3.5%. Business fixed investment is also steady and the US Conference Board confidence index acutally rose to an 8 month high in December. Contrast this against a weak housing US market with sales down on higher mortgage rates, slowing residential investment and manufacturing is also contracting. The ISM manufacturing index has shown contraction in activity for the last 2 months. The re-opening of so many services sectors (including hospitality & tourism) has exacerbated the demand for staff and the resiliance of the labour market has certainly surprised the Federal Reserve. More recent data suggests wage inflation may be abating as the participation rate ticks up though more data will be needed. Interestingly US immigration is up very strongly and well above pre-covid levels. This should add capacity to the labour market. The Census Bureau (opposite) shows net migration at 1m for the July year and the highest levels since 2017. The Federal Reserve has raised rates to a 15 year high of 4.25-4.50% and indicated a terminal cash rate of over 5% may be required. US GDP is forecast to slow from 2% to around 0.2%.

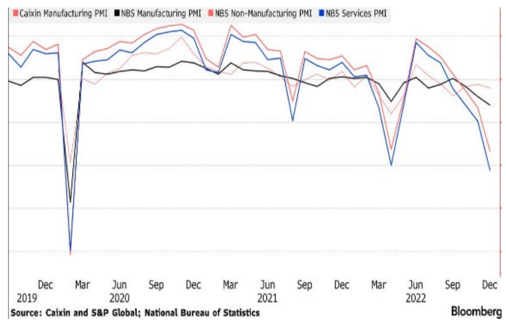
Net International Migration - US



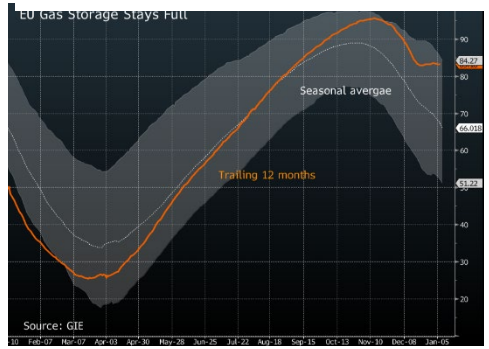
China

After China's economy ended the year in a major slump, Xi Jinping has suddenly swung towards growth. Economic management settings are increasingly reflecting his personal change in thinking and appearing to be more erratic. After locking down aggressively to protect his people from Covid, rising public resentment and an Omicron variant that was clearly "out of the bag" have forced a sharp pivot. So also, has the financial impact of Covid restrictions on China's economic activity. At a 3% growth rate this year (likely) China has arguably already put itself into recession requiring a faster rate than developed economies to keep standards of living rising. China is now out of sync with a constraining western world and in full stimulation mode to get momentum back on track. They recently introduced policies to prop up their embattled property market so critical to their growth. This includes easing lending for developers, capital support and residential mortgage support. Xi has also adjusted his foreign relations tone seeking more stable relations and hoping to improve trading activity. We have recently seen a lift in coal import bans from Australia while he has replaced his aggressive 'wolf warrior' foreign minister with a more moderate candidate. China is feeling the pressure of US technology restrictions with access to semi-conductors a critical technological issue they are presently failing to resolve through their own development efforts. After radical public market intervention, regulators are showing a more constructive approach and once again working hard to attract foreign direct investment. Strong economic performance from China may well help the world to avoid a deeper recession in 2023 much like it did in 2008/9.

Chinese Economic Activity Indexes Contract



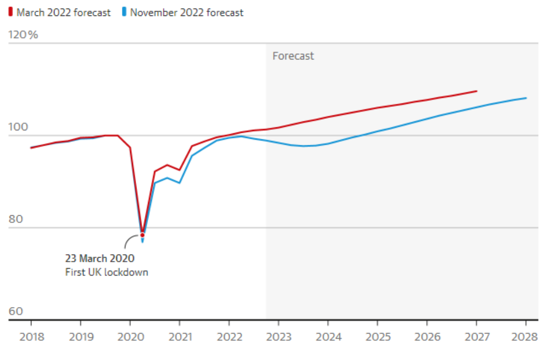
EU Gas Storage Stays Full



Europe & UK

What a dramatic year it has been for Europe with the Russian invasion of Ukraine risking wider conflict and sending millions of refugees fleeing to safety across the EU. The humanitarian impact has been appalling and continues to hamstring what was a vibrant and Covid recovering region. Reduced Russian energy supplies also sent prices soaring, spreading economic pain and a sharp inflation impulse to the rest of the world. It has been estimated that the invasion added around $1 trillion (GDP $17 trillion) of additional energy costs to Europe alone. Government energy subsidies for consumers and manufacturers have been around $700bn to date. Fortunately, Europe has had a mild winter. With careful energy use and now alternative gas supplies it has managed to avoid the dramatic recession that was expected. European gas prices are back below pre-invasion levels. Continued strong household spending, new business investment and a resistant manufacturing sector have also assisted. Growth in the Euro Area may come in around 3% for 2022 though some states are now in recession. After increasing cash rates by 2% last year the ECB can afford to slow its rate hiking as inflation has peaked and the outlook for GDP growth is presently less than 1% this year. A terminal cash rate of 2.75% is priced into markets and the ECB language has been recently moderative. Across the channel, the UK economy faces a gloomy 2023. It is currently in recession with down sharply in recent months as consumers tighten their belts in response to soaring living costs and business investment is falling. The Bank of England has the impossible task of reigning in rampant inflation (11.1% at peak, 40 year highs) and a soaring public deficit while not overly adding to the pain through excessively tight monetary conditions. The tightest cost of living squeeze in memory is driving increasing strike action in the public sector which is further hampering recovery. To add to Prime Minister Rishi Sunak's difficulties, Brexit is now most certainly costing the UK economy badly and increasingly resentment shown in polling.

Britain GDP Struggling to Reach Pre-Covid Levels



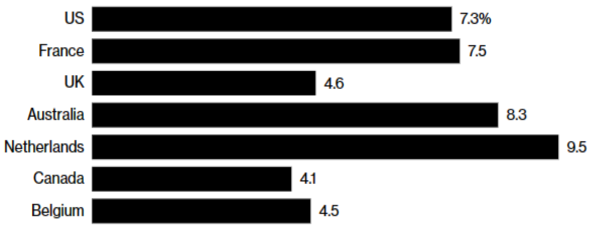
Guardian graphic. Source: OBR analysis of ONS and OBR data. OBR, Economic and fiscal outlook November 2022

Japan

As the rest of the world raised interest rates at a record pace the Yen depreciated sharply, supporting Japanese exports in a weaker global environment but also substantially raising the cost of critical energy and food imports. To reduce this inflation impulse the government introduced a large fiscal package (0.6% of GDP) to cap oil and wheat prices and directly support low income households. This has been effective in moderating price surges and protecting their domestic economy. Japanese growth will be steady in 2023 (+1.8% forecast). The large interest rate differentials Japan holds with the rest of the world may allow new BOJ Governor, Haruhiko Kuroda, to take rates higher after decades of ultra-loose policy settings. Japanese investors are one of the biggest lenders to the world (over $3 trillion) so higher home rates may affect global capital flows and liquidity. Japan's core inflation for November came in at 3.6% and higher than the BOJ's target of 2%. For now, Kuroda waits (sensibly!) to see whether "cost-push" inflation is sustaining or transitory.

Over Exposure

Japanese investors' equity, bond holdings in country as proportion of GDP



Emerging Markets

Weakening global growth and tighter financial conditions impacted developing country activity through 2022 though energy export countries fared better on sharply higher prices. As we move into 2023 there are significant tail winds. Faster Chinese growth should help accelerate Asian EM activity. Commodity prices should remain firm and supportive for exports and inflation will abate and ease financial conditions for indebted countries as will a weaker US dollar. Foreign investment should also improve after significant capital flight through 2022. Interestingly, a consequence of rising geo-political risks has been the trend towards 'friendly shoring' of manufacturing activity by large global companies to reduce supply risks. This will continue and particularly benefit emerging Asian countries such as Thailand, Vietnam, Cambodia and India. The Ukraine invasion will further hamper developing eastern European activity while Turkey and Argentina have elections this year amidst rising domestic tensions.

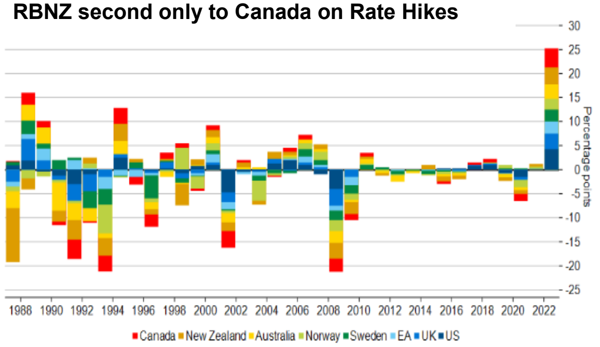
MARKETS

Inflation has likely peaked in most countries though wage inflation remains sticky on globally tight labour conditions and the sharp rise in living costs. Central banks are narrowing their focus on labour especially important for developed countries that have services reliant economies. The pace of interest rate hikes in 2022 was staggering and potentially near panic policy. With headline inflationary pressures abating, central banks after talking and acting very tough are likely to moderate their language from here particularly as recessionary risk rise. Engineering the 'goldilocks' soft landing is fraught with consensus views for some form of recession this year. It was an annus horribilis for all markets except cash which still however recorded negative real returns for investors. Traditional portfolios suffered badly in 2022 with little protection from diversification. A typical balanced 60% growth assets / 40% income assets strategy experienced losses similar to or even greater than those during the GFC. We have to look back to the early 1970s or 1931 to find a worst period.

Cash

A very tight 3.3% unemployment number in September saw the RBNZ lift rates a further 0.75% to 4.25% in November with a further rise expected in February. Markets are pricing in a terminal rate north of 5% with some estimates at 5.5%. This looks aggressive given the RBNZ's own expectations for a period of recession this year. The US Fed also lifted rates to 4.25% in November. We can expect global cash rates to rise further in the near term though there has recently been some softening in posturing with commentators suggesting central banks need to take a longer term approach to wage inflation management. Markets will continue to sharply gyrate around each inflation data release and this volatility is likely to continue until a clearer trend emerges.

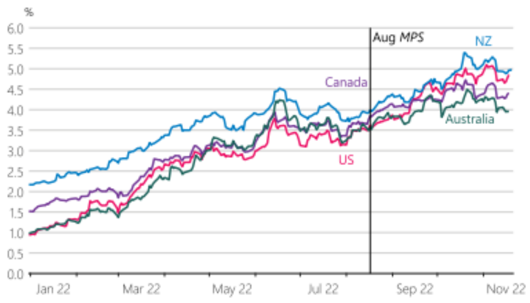
RBNZ second only to Canada on Rate Hikes



NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

Fixed Interest The expectation for rate moderation, given potential recessionary conditions, has seen longer term bond yields recently pull back after record rises in 2022 and provide some welcome relief from record price falls during the year. Bonds provided no protection benefits for diversified investment portfolios doubling up in the losses from share and property assets. 10 year US treasuries lost -14.8% and EU government bonds fell around -19% over the year. NZ 10 year government bond holders lost -14% in value over the year. US 10 year treasury yields have now retreated from their 2022 highs of 4.2% to 3.5% and NZ 10 year bonds from 4.6% to 4.1% (they started 2022 at 1.5% and2.5% respectively!). The critical 2 year rates have also pulled back from their peaks. The inverted nature of most yield curves (10 year minus 2 year yields) supports the near ubiquitous view for recession this year. Relative to other assets bonds at present levels represent good value for investors and should provide a good yield contribution to portfolios in 2023 as well as far better diversification benefits. We continue to be wary of holding long dated bonds and remain positioned less than market duration. Credit risks are also rising as the global economy slows. We expect weaker corporate issuers will come under significant pressure this year as funding becomes scarcer and more expensive. We continue to only hold high quality bonds for investors to provide better protection against this risk.

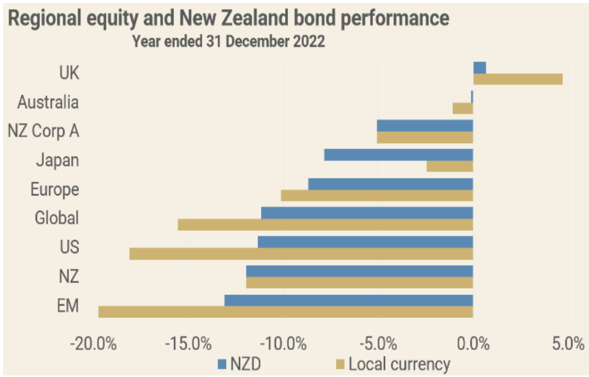
Global 2-year interest rate swaps



Source: Bloomberg.

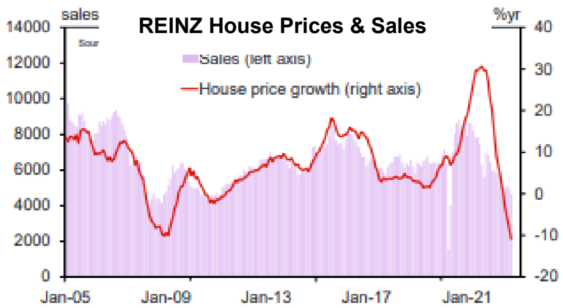
Equities In local currency terms, the annual calendar return from global equities has been one of the worst at -17.7%.

Growth oriented companies (primarily tech) stocks fell -29% while value type companies fared better at -5.8%. The Tech heavy Nasdaq index fell -32.5% and the S&P 500 -19.4%. Our market was down -12%. A weak NZ dollar provided some protection against offshore returns though in the last quarter swung sharply the other way rewarding those with currency hedges. The Australian market performed relatively well with its heavy make-up of mining, energy and financial companies. With the sharp fall in sharemarkets, valuations have subsequently improved over the year. Despite the higher interest rate environment global company earnings have been resilient through the year at +10% though corporate profit expectations and CEO confidence are now in decline. The Price to Earnings ratio for the S&P500 index is back to 16.5x and below its 10 year average of 17x. This includes analysts' expectations for a -6.5% decline in 4th quarter earnings and -4.4% drop in 2023 earnings - the largest expected decline since 2014. Sharemarkets are pricing in tough times ahead and well positioned for bounces on any better economic data while much of the bad news has already been factored in.



Property

NZ residential property is in the process of giving back several years of over valuation. The November monthly REINZ report shows median house prices in NZ are down -12.4% and Auckland prices -18.1% over 12 months. Though net migration has been surprisingly positive, new dwelling supply is accelerating while tough tax reforms and rapidly rising mortgages costs are impacting. More than 60% of mortgages will re-set in the next 6 months putting significant pressure on mortgaged households and taking many potential homebuyers out the market. This is recipe for further price falls though a another drop of -10% would only bring house prices back to pre- Covid levels! Commercial property including office, retail and industrial assets have also been under pressure as interest rates impact valuation criteria though rentals have been holding up well and industrial rents robust. Sales have slowed and construction increasingly challenging as costs remain high and funding tougher.



Commodities

Commodities had a mixed year with energy still up around +44% despite the recent pull back in prices. Industrial and precious metals prices have been flat to slightly down over the year with Agricultural commodities also mixed. The recent ANZ commodities index report shows most agricultural prices were also weaker over the year in world price terms (see their chart opposite) with meat and fibre down -25%, dairy -11.2%, forestry -3.8% and aluminium -11.4%. Horticulture was a relatively bright spot +5.6% over the year but producers have had to contend with rising operating costs.

A weak NZ dollar over the year assisted with terms of trade but has been much stronger over the quarter and now providing a headwind. Importantly transport has markedly improved with both shipping container availability improving and container costs falling back near pre-Covid levels. Chinese demand should improve this year as they open up from lockdowns and be supportive for our goods.

Figure 1. ANZ Commodity Price Index