NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

Wednesday, 19 January 2022

December 2021 Quarterly Report

This time last year the outlook had significantly improved after a daunting 2020. Not only did we have vaccine options for Covid but continued massive global monetary and fiscal stimulus largely protected economies and putting them in a strong position for further recovery in 2021.

As we moved through the first half of the year countries began opening as vaccination rates rose and economic growth accelerated further underpinning sharp rises in shares, property and commodities markets. Delta then struck mid-year triggering new lockdowns and interrupting global manufacturing and logistics at a time when consumer demand for goods was booming. This created significant supply problems starting in March when the 'Ever Given' container ship blocked the Suez Canal.

Economic activity was weaker in the second half of 2021 as lockdowns impacted supply and transport logistics fell into chaos leading to sharp price rises, inflation spikes and the prospects for higher interest rates which unnerved investment markets and particularly impacted bond markets.

In 2022 the pace of global growth will slow as governments wind back fiscal stimulus and central banks tighten monetary policy. Assuming Omicron does not put the world back into significant lock-down, then inflation will be the key focus for markets and whether it is persistent or abating and whether central banks are managing it appropriately. There are signs global supply problems are easing but tight labour conditions (including in NZ) and energy shortages remain a significant problem.

Central bank and government support will diverge significantly this year as they grapple with different local conditions and the impact of Covid and inflation on their economies. This divergence of policy will likely unsettle markets until the outlook for growth and inflation becomes more certain. Strong growth momentum will assist market returns this year though it will be a more challenging environment and require careful management.

Kind regards,

Wayne Ross
Director Investments

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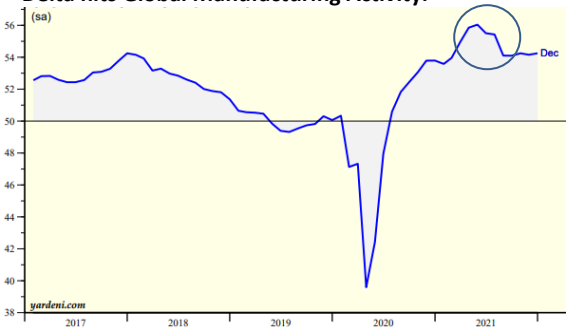
ECONOMIC AND MARKET SUMMARY

2021 was actually a pretty good year. Despite the emergence of Delta and further lockdowns, global economic activity was remarkably resilient supported by successful vaccination programs and ongoing government fiscal and central bank monetary stimulus. In some ways this support was too successful. Covid support packages meant US household incomes were higher in the pandemic than they were pre-Covid. Household savings leaped on higher wages, lower mortgage rates, low expenditure on leisure and other services while home values rose sharply. Confident consumers embarked on a spending spree as did governments and global manufacturing jumped to meet this strong demand only to stumble in August (see below) as Delta took hold and locked down factories as well as slowing critical port and transport operations.

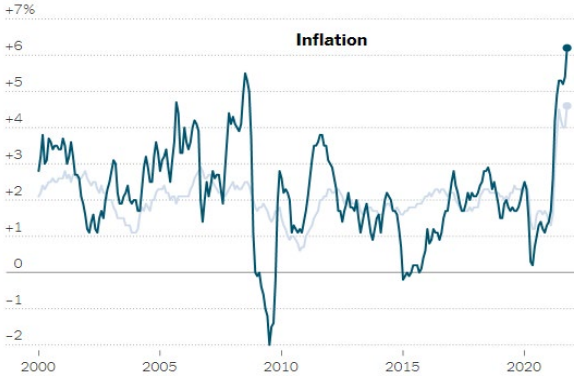
Delta hits Global Manufacturing Activity.



Source: J.P. Morgan and Markit in association with ISM and IFPSM.

The subsequent supply / demand imbalance as well as global energy shortages created sharp spikes in headline inflation. Central banks and initially markets thought this would ease as manufacturing caught up and global supply chains untangled themselves. While there are signs transport logistics and supplies are improving (especially in the US) it has not yet unwound to the extent expected and the US Federal Reserve in particular, is under increasing political pressure to act.

US Inflation 6.8% Annualised in November – Highest since 1982.



Central banks were prepared to let inflation run hot being focused on supporting sustainable economic growth but are now reassessing the need to reduce stimulus and raise cash rates. The outlook for rate rises is being brought forward daily. Goldman Sachs recently predicted the US would raise rates 4 times this year while most market commentators are expecting as least 3 hikes and the same for NZ. There is keen debate whether higher interest rates will address the inflation spike which is primarily being driven by supply shortages rather than excessive demand. Reducing demand through higher interest rates may tip economies back into recession and this is a delicate issue given Omicron is now forcing additional global lockdowns that will curb economic activity at least in the short term. Interestingly, President Biden said inflation could be addressed by fixing supply issues including bringing critical component manufacturing back to the US and improving infrastructure and lifting wages.

Markets remain conflicted on the prospects for inflation but seem to expect central banks to at least reduce their ultra-easy, pandemic-based policies. This has is has led to higher global bond yields in 2021 and falling bond values. The NZ 10-year government bond yield more than doubled rising from around 1% in January to 2.3% by the end of the year. Australia was similar. Despite strong company earnings performances over 2021 higher interest rate prospects started to impact share markets in the recent quarter particularly for interest rate sensitive companies such as utilities operators but also growth stocks including technology providers whose valuations are also dependent on long term expected cash rates. The NZ sharemarket has a significant proportion of higher yielding companies which means our market is also more interest rate sensitive. The NZ sharemarket had one of its worst performing years being slightly negative for 2021. Conversely, the global sharemarket index was up +22.4% for the year with the US +28%, Europe +25%, Australia +14% and other markets generally 10%+. China was the worst performing -27% due to government intervention into high profile listed technology and education providers. Commodities also performed strongly +27% supported by rocketing energy prices +55%. Providing we can get past the Omicron wave and that supply side problems improve; the world has good momentum for 2022 (+4.9% IMF growth forecast). This will be positive though valuation extremes in some markets and sectors (US tech stocks) means returns will be more selective. Policy makers and markets will continue to obsess over inflation creating more volatility as we thread our way through a multi-year rising interest rate cycle.

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

Market Returns	Dec. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-0.7**	-2.5	-0.1	-1.2
$NZ v $US	**-1.4**	-5.3	0.7	-0.4
$NZ v $AUD	**-1.6**	0.4	-0.4	-0.4
NZ Cash	**0.2**	0.3	0.7	1.1
NZ Fixed Interest	**-1.8**	-6.2	1.2	2.8
Intl Fixed Interest 100% hedged to $NZ	**0.3**	-2.1	3.6	3.3
Australasian Equities 50/50 Indexes	**0.9**	8.0	14.2	12.1
NZ Listed Property	**1.8**	2.9	12.1	11.8
Intl Equities 50% hedged to $NZ	**7.1**	22.8	19.9	14.3
Commodities $NZ	**-0.8**	33.7	9.1	4.0

SECURITIES RETURNS FOR THE QUARTER

The following tables show the returns from the securities recommended by NZ DIMS. Depending on your investment strategy you may hold all or only a portion of these securities and the returns for the securities held may also differ slightly depending upon cash flows and transactions in your portfolio over the quarter.

AUSTRALASIAN EQUITIES

Company	Sector	Quarterly Performance In NZ$ terms
New Zealand Equities		
Auckland Airport	Ports	-1.5%
Contact Energy	Energy	-4.2%
F&P Healthcare	Healthcare	3.1%
Fletcher Building	Building	2.1%
Freightways	Transportation	0.7%
Meridian Energy	Energy	-1.6%
Port of Tauranga	Ports	-6.0%
Spark NZ	Telecommunications	-5.3%
Stride Property	Property	-12.4%
Australian Equities		
BHP Group	Resources & Energy	12.1%
CSL	Healthcare	0.6%
IAG	Financials	-12.0%
James Hardie	Building	12.9%
Macquarie Group	Financials	16.5%

- Meridian Energy has agreed to sell its Australian business for $753m to a consortium of Shell and investment manager, Infrastructure Capital Group. Shell will own Powershop which is the retail business and ICG will own the wind farms, hydro power stations and development assets. Analysis by Jarden has highlighted that share prices across the NZ electricity sector including Meridian and Contact Energy have been more severely impacted by investor concern over rising interest rates than is justified historically or by the off-again, on-again supply deal with the Tiwai aluminium smelter. MEL and CEN have a reasonable ability to pass on the costs of inflation through higher prices and since it is difficult for consumers to reduce outright demand. These stocks are defensive in the event of an economic shock and while regulation remains a key risk a recent report by the Electricity Authority was reasonably well received by the Government.
- CSL announced its intention to purchase Swiss drugmaker Vifor Pharma for A$16.4bn. Vifor makes prescription medications and is focused on the treatment of kidney disease and iron deficiency. Vifor expects the renal market (dialysis and diagnosis) to almost double to US $25bn within 5 years. If the deal goes through it would mean a departure for CSL from its therapeutic area but would provide diversification - the Group already has an interest in kidney transplants and the Vifor R&D pipeline of late-stage drugs that are due to launch offers significant growth opportunities.
- Westpac has come to an agreement with the regulators to settle 6 of 7 outstanding claims against the company for a range of compliance and administration/system breaches which are largely related to poor processes identified as part of the Haynes Royal Commission. Westpac will pay a fine of A$113m which while somewhat damaging to their brand, is insignificant relative to annual cash profits of A$5.3bn. The company also announced a sizeable A$3.5bn share buyback program in December .

Goodman Group	Property	24.9%
Ramsay Healthcare	Healthcare	3.6%
Sonic Healthcare	Healthcare	16.5%
Westpac	Financials	-14.0%
Wesfarmers	Diversified Industrial	10.9%
Woolworths	Consumer Staples	-2.4%

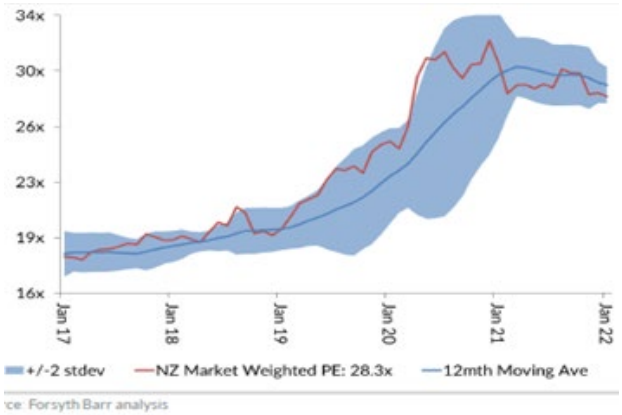
- James Hardie has benefited from the strong housing market and continues to profit from new product launches, improved manufacturing processes and further integration with distributors. The company is building market share in the profitable US repair and remodel market which will help mitigate expected volatility in the construction market as interest rates rise. Despite the positive long term environment, the company will now have to work through the short term implications of the recent surprise dismissal of CEO Jack Truong due to Board, senior management and staff concerns over his intimidating and disrespectful management style, a claim that Mr Truong disputes.
- Macquarie's Green Investment Group is undertaking preliminary works to identify a specific site for an offshore wind farm off the Bass Coast in Gippsland, Victoria Australia. The company has considerable international experience in developing offshore wind projects in the UK, Taiwan, South Korea and Japan. Gippsland has been selected as a preferred site due to wind speeds above 9 m/s, favourable marine conditions and existing traditional infrastructure and a community of skilled professionals with transferable skills relevant to developing and operating wind farms. The farm is expected to generate 1000MW per annum which would meet the electricity needs of more than 500,000 households while reducing carbon emissions equivalent to taking 885,909 petrol cars off the road.
- Sonic Healthcare has joined forces with a French competitor to bid for Swiss diagnostics company Unilabs who operate more than 120 labs and 44 radiology units across Europe. There are a number of suitors for Unilabs which could be worth as much as US$5b. SHL continues to benefit from COVID related activity including the phenomenal growth in PCR testing which has remained high due to the latest Omicron variant.
- Stride Property has underperformed following an unsuccessful attempt to list their office portfolio (a subsidiary called Fabric). This left the company with a stretched balance sheet although they successfully alleviated this through an oversubscribed $120m capital raising which reduced gearing to under 30%. Fabric has a conditional agreement (subject to an IPO by 31 March 2022) to acquire a property in Newmarket, Auckland which has new lease arrangements with Vector, Metlifecare and Aurecon. The management team remains focused on securing a sale of the combined office assets and completing the transition of the business strategy from a building owner to a fund management business.
- While property companies with mainly retail and office exposure like Stride have been negatively impacted by factors such as rising interest rates, changing company work practices and difficult retail trading conditions, those with primarily industrial exposure have fared much better. Goodman Group for example has been a standout performer with the industrial property developer benefiting from global shortages in the sector and low vacancy rates which have seen significant rent increases possible.

AUSTRALASIAN EQUITIES

The Australian market benefited from a recovery in iron-ore prices and easing pandemic restrictions, ending up 2.1% for the quarter. Financials and Materials were the strongest sectors while Information Technology was the weakest. The 2022 outlook is positive with Westpac expecting +6.4% GDP growth. There is a political will to avoid further lockdowns due to Omicron, increased government spending is supporting the economy, taxation cuts are boosting consumer incomes and short-term interest rates are not expected to rise until 2023. Broadening the Australian economy away from resources remains a challenge however non-mining business investment activity is the best it has been in decades.

NZ Share Market Underperformed in 2021

NZ 1-yr Forward PE Ratio 28x



The NZ share market was down -1.7% over the quarter and -0.4% for the year, negatively impacted by higher interest rates (we are an interest rate sensitive market) and some profit taking. The local market has been trading at high valuations relative to other markets and historical levels. The weaker performance saw the weighted average 1-year price earnings ratio (PE) for our market reduce from 32x to 28x in 2021 although the more relevant median PE is closer to 22x which still represents a premium over the last 5-year average of 19x. Looking forward New Zealand 3-year forward earnings forecasts remain healthy at +7.1% p.a. on average though, this year's expectations are just +3.1% growth before rising to +10.0% in 2023.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	2.0%	The fund outperformed the market benchmark over the quarter. Positive contributions came from Ebos, Fletcher Building, NAB and Ramsay Healthcare who announced the acquisition of UK mental healthcare provider Elysium Healthcare, providing a complementary business line and exposure to a growth market. BHP is a key holding in the portfolio and their share price has rebounded in line with iron-ore prices, approval for a merger of their Oil & Gas business with Woodside Petroleum and a board decision to unify the corporate structure to a single Australian listing. Weaker performers included Mercury Energy (due to higher interest rates) and Vista Group which has been negatively impacted by additional lockdowns brought about by Omicron. The portfolio has a bias towards value companies over growth companies and this style has historically does well in an environment of rising interest rates and solid but not spectacular growth.
Harbour Australasian Equity Focus Fund	1.7%	The fund outperformed the market benchmark over the quarter. The largest contributors to performance were Macquarie Group, Ebos (raised capital to assist purchase of medical device and therapeutic distribution business LifeHealthcare), Charter Hall (profit upgrade due to property revaluation lifting FUA offsetting concerns about a foray into fund management after purchasing a 50% stake in Paradice), Goodman Group and Vulcan Steel (newly listed company which upgraded earnings forecast by 30%). Weaker results came from Ryman Healthcare as the aged care sector struggles with Covid related costs and several companies who were

		raising additional capital such as CSL. Afterpay shareholders approved a merger with global payments company Block however regulatory reviews of payments systems and increasing competition saw their share price end down -30.8% over the quarter.

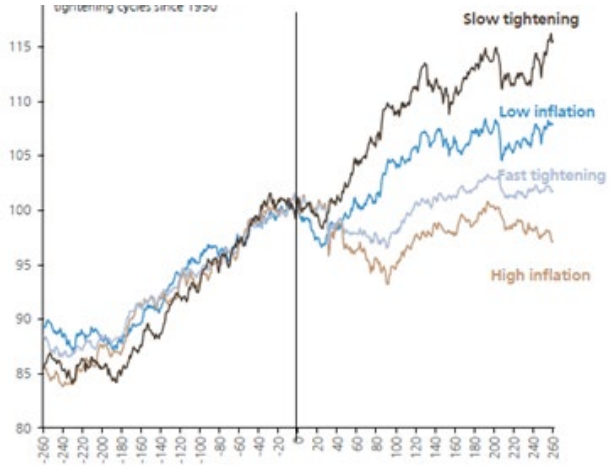
INTERNATIONAL EQUITIES

International equity markets surged to record highs during the quarter as concerns abated about the economic damage of Omicron and large companies in particular posted strong earnings. This occurred even though a number of central banks started the process of reducing very stimulatory monetary policies. Globally, Information Technology was again the strongest industry sector (up +13.2%) with Communication Services the only sector to post a negative return (-1.7%).

Despite Delta and now Omicron restricting global economic activity, underlying growth momentum is strong and business confidence sufficiently high to see a surge in investment intentions to address supply side problems and meet the unexpected demand. Some of this growth momentum is still Covid recovery activity so will level out in 2022/23. This means company earnings which have been very strong and supportive of valuations will come under pressure in the short term, although earnings through the year should still be positive there is uncertainty of timing. Potential earnings downgrades and the risk of overly tightened monetary policy is presently unsettling markets. The increased volatility will stay until there is more clarity on inflation and the impact of Omicron.

The global share market had a very strong year up +22.4% in local currency terms. Key to global performance was the US market and in particular the 6 large mega cap stocks which together combined contributed 35% to S&P500 returns. US investors were buoyed by better employment numbers and political approval to spend US$1.2 trillion on infrastructure. Companies in Europe posted strong earnings results and the eurozone economy is expanding, unlike in Japan which shrank by a larger than expected -0.9% in the September quarter and has closed the national border to foreigners over Omicron concerns. The newly re-elected government has promised a US$350 billion stimulus package to provide some assistance.

Historical S&P500 Performance - Different rate tightening cycles



The S&P500 1-year forward PE is 22.5x (but is dominated by 6 high PE technology stocks) and the index has pulled back from its bubble like 32x levels in June on retreating tech stock prices. Other markets are relatively better priced though differently weighted by sector with Australia at 18x, UK at 12x, Japan at 13x, while the regulatorily impacted Chinese market is seemingly well undervalued at 12x. Depending on interest rate rises and earnings revisions, valuation levels are high but not markedly so. Neither are valuations consistent within or across markets providing an opportunity for additional gains this year – particularly for active managers.
The historical performance of the S&P 500 around the start of any Fed hiking cycles depends on how aggressive the approach is. In slow rate tightening cycles, it has rallied 15% on average in the year after the Fed begins to tighten but has fallen -7.5% on average in the short term when rates are raised to address inflation running over 3%.

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Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	1.8%	The fund was up +0.2% in AU$ terms for the quarter and +10% for the year. The manager's active value orientated style means they remain concerned about the risk of inflation and the valuation chasm between speculative stocks and everything else. In their view key to watch is the booming US labour market with rising wages, skills shortages and strikes starting to point to a stickier period of inflation than currently priced into markets. They note the six largest US companies (Alphabet, Apple, Microsoft, Amazon, Meta Platforms and Tesla) dominated market index returns last year (up 41% on average) and are worth a combined US$11.5 trillion – more than any stock market outside the US – with the 3 largest companies each worth more than all listed Australian stocks combined. Over the year growth was driven by exposure to companies in the financial sector, energy, semi-conductors and industrials. Small negative impacts came from the fact that around 20% of the fund is invested in China where general market sentiment has been poor (increased regulation, property sector pressure) although the quality of the invested companies limited the loss to -1%. The manager has also continued to protect the portfolio from any significant downside losses by short selling and this risk management strategy cost a further -1% over the year.
Monks Investment Trust	0.7%	The fund was down -0.8% in GBP terms for the quarter and up +6.8% for the year. The manager invests across a range of both growth and value companies however there is an increasing number of technology-led or digitised companies in the portfolio reflecting the view that the impact of technology is broadening, driving change and tipping a range of industries out of previous equilibria. They consider the pandemic has been a catalyst for permanent change in many industries rather than a temporary aberration. Several new portfolio holdings reflect this view of permanently altered behaviour including companies such as Peleton (home fitness/spin bikes tech), Carvana (US online used car market), DENSO (Japanese electric car part supplier) and Certara (bio-simulation company to speed/supplement human drug trials). ESG concerns have led to the sale of holdings in EOG Resources (oil and gas) and Fairfax (insufficient Board independence). Exposure to unlisted private companies was increased slightly to 6% of the total fund through a further allocation to The Schiehallian Fund which is also managed by Baillie Gifford and includes a number of late-stage private companies with exciting growth prospects.
Magellan High Conviction Fund	5.8%	The fund was up +4.2% in AU$ terms for the quarter and up +20.8% for the year. The biggest contributors to performance included Microsoft (up 22% in revenue due to its cloud business benefiting from the global shift to remote workplaces) and Intercontinental Exchange (improved revenue as energy derivative volumes climbed on the back of rising energy price volatility). The biggest detractors were investments in Alibaba (disappointing sales figures despite a 27% rise in revenue for the quarter) and Meta Platforms (the renamed Facebook warned advertising revenue will be lower due to Apple's new privacy measures which will reduce the effectiveness of targeted ads). Looking ahead the manager is wary of China's no-covid lockdown policy further disrupting global supply chains even if Omicron proves fleeting and assigns a 30% chance of central banks having to aggressively raise rates later this year to stamp out inflation, a move that would put considerable pressure on companies and assets with non-existent earnings.

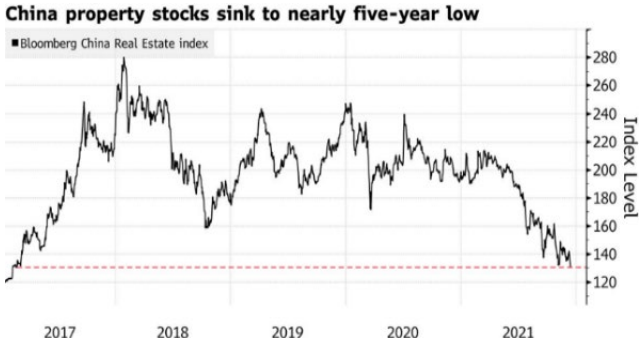
Passive/Index Funds		
Vanguard Ethically Conscious International Shares Index Fund Hedged to NZD	8.3%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZ dollar, so returns are not influenced by movements in the currency. Overall, the fund was up +24% for the year with the strongest regions being the US market (+11.0% for the quarter / +28.7% over the year), Europe (+6.5%qtr/+24.0%yoy) and the UK (+4.7%qtr/+18.4% yoy). Japan was down -2.1% qtr but up +6.7% yoy.
iShares Russell 2000 Index Fund	3.5%	These funds provide passive exposure to smaller companies in the USA and around the world and are valued in USD. The NZ dollar was lower against the US dollar over the quarter which assisted returns. Unlike the larger capitalisation stock index, where returns were dominated by a few mega cap companies, performance was much more broadly spread among smaller companies, especially those who stand to benefit from the economic recovery as lockdowns ease. High quality small companies with strong balance sheets are well placed to adapt quickly to sudden changes and for that reason they tend to outperform large cap stocks, bonds and cash during periods of high inflation.
Vanguard FTSE All-World ex US Small Cap Index Fund	1.6%	
Vanguard FTSE Emerging Market Index Fund	0.3%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets trailed developed markets over the quarter with Omicron concerns and regulatory pressure in China the major negative influences.

COMMODITIES

Broad commodity prices leapt over the year (Bloomberg Commodity Index +27%) driven by sharply higher energy prices as fossil fuel production and exploration slowed while demand has been increasing due to colder winters and manufacturing pressures. China cut electricity production on coal shortages (and re-importing Australian coal) and European gas reserves will reach historically low levels coming out this winter. The ANZ World Commodity Price Index rose +2.8% in November to a record high and the outlook for 2022 remains positive on strong global economic momentum. Despite rising inflation (which historically has helped demand for precious metals), gold was down -3.6%.

PROPERTY

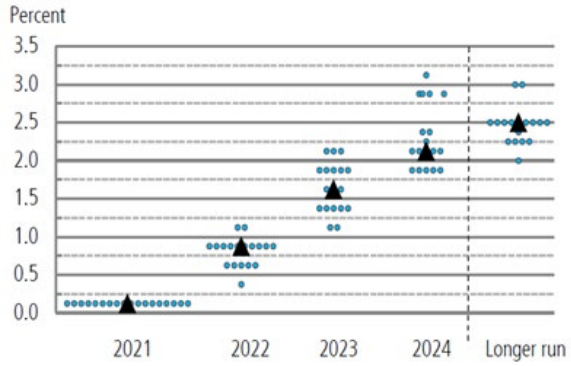
Globally, property prices have improved over the year as economies have opened up with city (office) property showing signs of early recovery as employees move back into offices post Delta lockdowns and "de-urbanize" while industrial (manufacturing and logistics in particular) continue to do well. Retail is showing early signs of recovery though high street strip properties remain under significant pressure. Residential prices have also risen in most major markets with China an exception as it deleverages its rampant market while Australian city prices pulled back in the last quarter. NZ residential prices rose +28% over 2021 hitting a record in December with QV median prices at $1.05m. Sales and auction clearance rates have been recently lower. With record building consents (to November 48,522 new homes - Akld 20,000 alone) improving supply, higher mortgage costs, tighter credit conditions and increasing tax impositions for property investors, bank forecasters expect prices to pull back this year in a range of -4% to -7%. Additionally, it will be interesting to see the impact on demand from open borders and net migration changes this year.



FIXED INTEREST

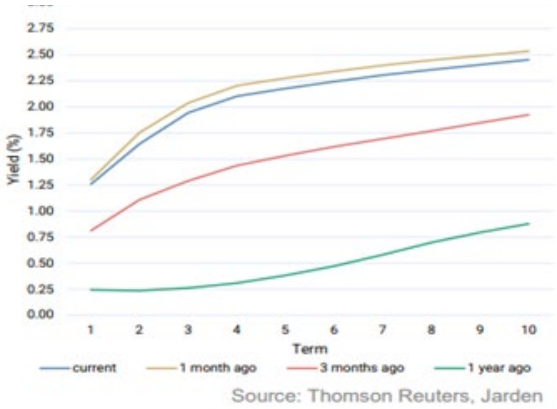
Though a lag indicator, inflation numbers have spiked sufficiently for markets to price in more hawkish central bank action in 2022. While much debate rages over the supply side nature of the inflation numbers, sufficient concern on structural components including labour (non-productive wage pressures) and possibly energy (alternative energy and fossil fuel divestment) are pressuring policy settings. The US Federal Reserve brought forward their timeline for quantitative easing, opening up the possibility of earlier than expected rate hikes. Investors now expecting the US Federal Reserve to implement at least 3 rate hikes in 2022 (see FOMC dot plot chart opposite) with the first of these likely now in March following the recent jump in US inflation to 7% annualized which is the highest since 1982.

FOMC Dot Plot for US Cash Rates



It is similar inflation story in other developed market economies. The Bank of England raised rates by 0.15% to 0.25% as record job vacancies indicated increased labour market tightness. The European Central Bank announced a cautious taper with their emergency pandemic purchase program ending in March, leading to long term bond yields moving close to zero after being negative for almost 3 years. The People's Bank of China on the other hand is lowering cash rates in an effort to support agricultural and small enterprises.

NZ Govt. Bond Yield Curve Moves



Long term interest rate also rose sharply in 2021 with NZ and Australian 10yr government bonds doubling and US and UK 10yr yields up +0.6% and +0.8% respectively leading to losses over the year. Over the year interest rates across all maturities rose but most yield curves ended flatter with short rates rising more than long term rates. These yield increases are from historically low levels and real yields (after inflation) are still negative given recent spikes with US inflation hitting a 39yr high.

With present inflation levels, bond yields may have further to rise in 2022 if central banks are forced to act more aggressively although recent volatility suggests markets are increasingly worried about economic growth prospects and the possibility of stagflation. Despite the inflation 'noise' and rising political pressures central banks will be very cautious. Presently, a range of market forecasters have the US Govt. 10yr bond yield at 2% by the end of this year, a smaller increase than last year and suggesting the downside for bond prices may be more limited.

Waning central bank support and persistent inflation will continue to be headwinds for fixed income markets but credit, particularly high yield, should be supported by strong corporate balance sheets and earnings.

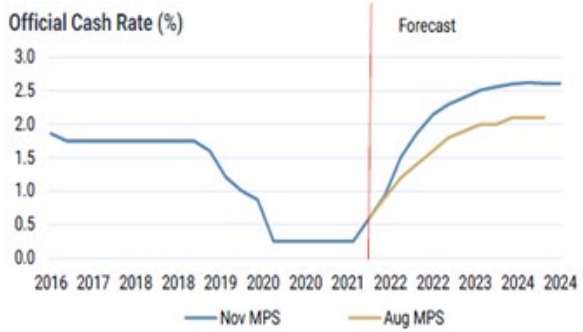
As we write Omicron is swamping world health systems and triggering additional lockdowns while some inflation indicators are also starting to roll-over. Central banks will need to tread a fine line between signaling the start of the new interest rate tightening cycle (normalizing) versus overstepping the mark and facing yield curve

inversion risk. A significant misstep (such as in late 2018) would likely trigger a selloff in wider investment markets and force a central bank policy reversal. This remains the single greatest risk for investment markets this year.

In New Zealand where the Reserve Bank has multiple mandates to consider (not just inflation) cash rates have already been lifted twice to 0.75% as the RBNZ was one of the first to start tightening. In 2022 we are likely to see a further three rate increases, with forecasts of a 2.50-2.75% OCR by the end of 2024. Given the assumed RBNZ nominal neutral cash rate of 2%, setting cash rates higher than this means the RBNZ would be actively trying to slow down the economy.

Long term NZ bond yields also rose in line with international moves and the NZ 10yr ended 0.3%. Higher yields mean lower prices and the market index finished down -1.8% for the quarter and -6.2% over the year. Corporate bonds were marginally better, but this was still the worst year for bond performance since the 2008/09 global financial crisis. NEWTON ROSS client portfolios were invested in shorter duration fixed interest investments, and this helped relative performance compared to the market.

RBNZ Cash Rate Forecast



Source: Reserve Bank of New Zealand

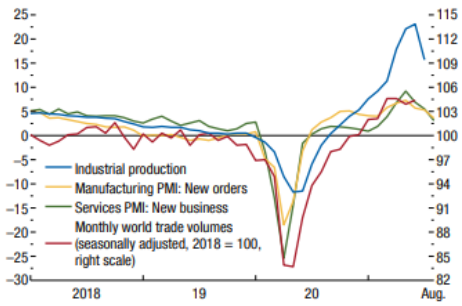
Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	-1.6%	The manager outperformed over the quarter due to positioning the portfolio in bonds with shorter duration which have not been as negatively impacted by the rise in interest rates. Now that OCR hikes are fully priced in this exposure has been reduced. An overweight position in credit was also reduced by the end of the year as that part of the market became very expensive. Looking forward the manager expects long term yields to grind higher in line with global moves amid heighted volatility. Shorter term rates will be range bound as the RBNZ moves in line with expectations until August when it is expected the central bank will pause to take stock of the impact on growth and the local housing market. If the housing market starts to show signs of a faster than expected slowdown the manager will actively look to buy more longer dated bonds. Relative to benchmark the portfolio holds more credit, less government and about the same in Local Authority bonds. Despite more corporate bonds being issued and rising term deposit rates offering an alternative for investors it is expected that continued RBNZ liquidity and KiwiSaver flows will support demand.
AMP Capital NZ Short Duration Fund	-0.6%	
Harbour Wholesale NZ Core Fixed Interest Fund	-1.3%	The manager outperformed over the quarter largely due to holding inflation indexed bonds. This also helped with outperformance over the year, along with being relatively short duration relative to the market as interest rates have increased. At present the market is pricing in a further 1.25% rise in the OCR by August 2022 and while this is expected to occur there is also a chance that the RBNZ may delay if consumer confidence is dented by the negative wealth effect of a slowing housing market, extended border controls or further lockdowns. For this reason, the manager continues to hold an overweight position in shorter dated bonds and are underweight longer-term bonds which are more likely to follow offshore markets.
Harbour Enhanced Cash Fund	0.2%	

OVERVIEW

At this time of the year, we like to consider the themes that will most likely dominate for the next 12 months and identify the key risks and also tailwinds. 2021 will likely record a global economic growth rate of +6% marking a near full recovery to pre-covid levels. With global activity recently dipping on supply side restrictions (see opposite) and new Omicron-induced lockdowns, 2022 activity is expected to be initially muted before recovering to meet current IMF forecasts of +4.9%. There will be much to navigate but the key theme is the return to pre-covid economic normality as the year progresses. This does not mean Covid goes away but that we learn to live with it and manage it as an endemic condition. Ironically, this may be made easier by Omicron potentially crowding out other, deadlier Covid variants. On the other hand, developing nations vaccination rates are worryingly poor relying on natural immunity development and they remain a significant source of mutation risk for everyone. Governments and central banks will transition from pandemic induced settings to more traditional policy areas.

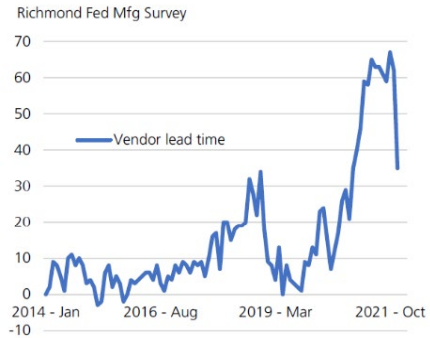
Global Activity Indicators –Dipping (IMF).

Higher-frequency indicators point to softening momentum.



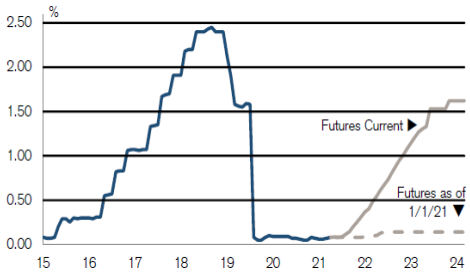
Inflation and inflation management remains the key risk for 2022. Headline inflation spikes were higher than expected over the recent quarter where they were expected to pull back (and hopefully will in this coming quarter). Central banks are under increasing pressure to tighten monetary conditions (see opposite: Rising Federal Reserve Policy Expectations) and dampen demand. If they move too prematurely and aggressively, they risk recession where patience may have been the right option. Consequently, markets will likely be nervous and volatile until a clearer picture emerges. In addition, each central bank is facing a different set of domestic conditions so policies will also likely diverge this year. Some like China will need to stimulate their slower economy after their austerity drive in 2021 (aimed at reducing debt and stabilising their financial system), while a hot US economy (and NZ) will warrant some rate rises.

US Supply Lead Times Reducing



Government fiscal policies will also diverge this year as many winddown their Covid justified budget deficits and others need to stimulate (China, Japan, UK, Europe) to ensure sustained recovery. Record high public debt levels will gain more attention this year as higher interest rates impact public borrowing costs. Removing fiscal support will be a key risk for economic momentum particularly should Omicron have lasting effects.

Rising Fed Policy Expectations



The world has been de-globalizing since the US/China trade wars commenced in 2018 and geo-political risks have continued to rise. Covid is accelerating this theme as countries seek to bring critical component supplies closer to home and move away from now considered high risk 'just in time' inventory control. The covid induced supply chain crises showed just how exposed some countries are with governments re-examining their overreliance on trade partners (NZ included) even if de-coupling increases import costs or reduces export earnings.

As Covid fades we expect climate policy responses to build momentum including through ESG sector divestment and through government policies (de-carbonization, carbon reporting and trading, alternative energy and subsidies). A side impact of fossil fuel divestment is the reduction in exploration and production - presently a key driver of higher energy

prices. Electric car manufacturing will jump this year with new and traditional auto manufacturers hitting the market with a wide range of new products.

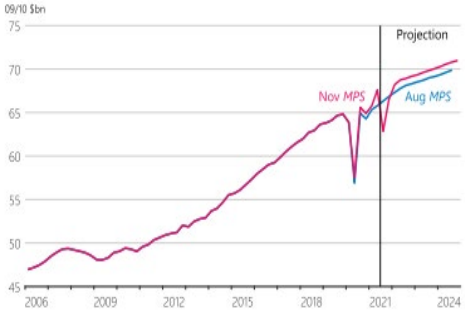
New Zealand

The Delta lockdown "Level 3" in Auckland, Northland and Waikato impacted NZ growth in the quarter - though less than expected with activity remaining surprisingly high and ahead of the 2020 lockdown period. Despite continued headwinds for tourism and hospitality, strong exports, record construction activity and resilient domestic consumption (fiscally supported) is underpinning growth. The RBNZ November numbers opposite show growth bouncing and on trend to surpass pre-Covid levels this year. Unemployment is expected to fall to just 3.1% (currently at a record 3.4% low) and our economy to grow at 4.6% this year although inflation is expected to rise to 5.1% on rising import costs and domestic constraints before subsiding. Given the underlying economic strength, inflation impulse and soaring house prices, the RBNZ moved cash rates higher in November to 0.75% and indicated they will raise rates to 2% by the end of this year and to 2.5% by the end of 2024. The NZ Half-Year Economic and Fiscal Update (HYEFU) from the Treasury forecasts a material improvement in the Government's books with a $2.1bn surplus by June 2024 and running a surplus 3 years earlier than expected. This is mainly due to a higher tax take ($10bn more). Our net public debt is now forecast at 40.1% of GDP in 2023 (vs 48% expected last May). The Government will spend the majority of the forecast surplus on health and climate response with no sign of any tax cuts even though wages are still falling on a real basis. The close Covid response alignment between the RBNZ and the Government may falter this year with competing priorities (fiscal stimulus vs tighter monetary settings) particularly should resource constraints (labour and materials) worsen. NZ company earnings forecasts remain positive (+3.1%), but again may be affected by resource issues and rising input costs. With slightly better supply, higher mortgage costs and tighter credit conditions, house prices are expected to moderate this year and potentially fall though most economic commentators predict price corrections to be limited. A significant fall in prices would be a key risk for our economy.

Australia

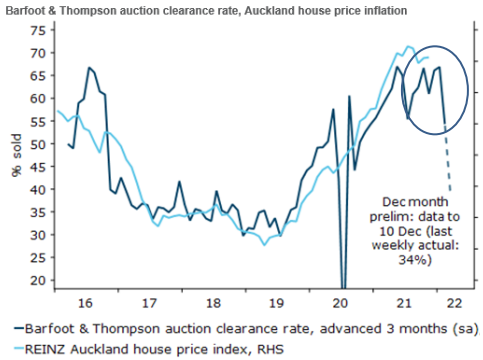
The Australian economy also contracted in September (-1.9%), but like NZ was also resilient in the face of Delta and remains determined to avoid further lockdowns under Omicron. Australian Treasurer Josh Frydenberg said "we can and must live with the virus and its variants. The lockdowns are behind us". (AFR). GDP momentum remains very strong with Westpac forecasting a bounce in the final quarter and targeting +6.4% for 2022. The Australian economy is well supported by government spending ($24bn during the last lockdown), taxation cuts boosting incomes and continued easy monetary policy settings. Australian exports have been robust with record current account surpluses each quarter driven by iron ore sales and with China re-importing coal after cutting Australia imports off on political tensions. Business investment is lifting and expected to grow +8.5% (Westpac) in 2022 as households unleash Covid savings. The outlook for non-mining business investment is also the best it has been in 20 years. Unlike NZ the RBA has more room to keep settings easy as preliminary data shows home auction clearance rates and prices fell in the last quarter after rising strongly over the previous 12 months while headline inflation will moderate to 3%. Staff shortages will be problem for business this year as vacancies have risen to 74% higher than before Covid. The RBA has signaled a tapering of quantitative easing settings but unlike NZ is forecast to keep cash rates where they are at 0.1% until 2023. Australia may face rising geo-political risks this

NZ Quarterly Production GDP

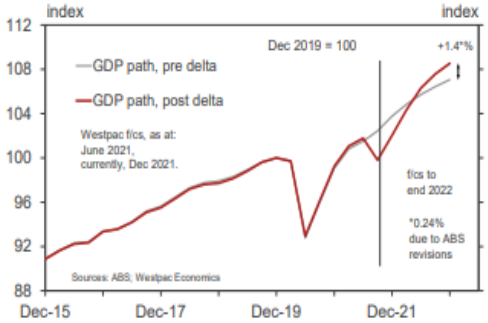


Source: Stats NZ, RBNZ estimates.

Auckland Auction Clearance Rates



Australian GDP Profile



year. "Scott Morrison says Australia cannot afford to show 'weakness' in the face of China's growing combativeness, backing Defense Minister Peter Dutton's dire assessment that the loss of Taiwan would be the first step in Beijing's domination of the region" (AFR). Australia recently registered 1.58 babies per woman which is the lowest rate on record.

US

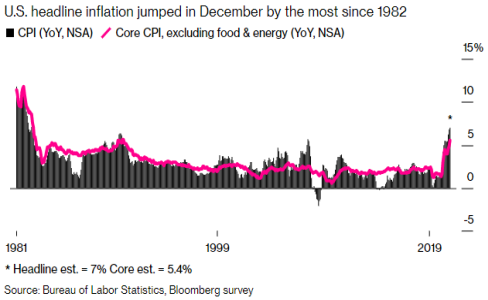
The US economy was on a tear in 2021 as they emerged from lockdown and consumers started spending their near record household savings. GDP growth should come in at 5.7% for the year, though current quarterly numbers suggest activity is moving back down closer to pre-Covid trend levels (2.4% p.a.), hampered by remerging Covid risks. Recent leading and co-incident economic indicators are strong with the manufacturing PMI index still above 60 (less than 50 means contracting) and services activity is accelerating. Supply side speed bumps, noticeably shipping and disruption at key ports are also starting to improve with imported goods statistics rising in November (see chart opposite). This should help ease inflation which reached a 39-year high in December (see opposite) of +7% (though core inflation, ex energy and food was closer to 5.5%). Looking ahead business confidence is robust although households are more wary given Omicron concerns. Unemployment dropped to 4.2% in the quarter though participation rates remain weak and record retirement rates and immigration shortfalls mean a structurally tighter labor market. Significant pressure is being brought on the US Federal Reserve to tighten their ultra-lose monetary policy settings which they have been reluctant to do so for fear of derailing the recovery. Investors have been pricing in an expected 'pivot' by the Fed with bond yields rising and interest rate sensitive stocks also impacted. In addition to bringing forward the winddown of their Quantitative Easing program (asset purchases), markets are expecting the Fed to hike rates at least 3 times this year starting in March. The management of any 'pivot' will have a profound effect on the US economy and global markets. Markets have been recently volatile while the Fed tries to buy time to see how transitory the inflation effects are and assess the impact of Omicron. Meanwhile, contrary to inflation concerns and post-war record budget deficits, President Biden continues to push an ambitious fiscal program to address the US's significant health and welfare problems and climate response.

China

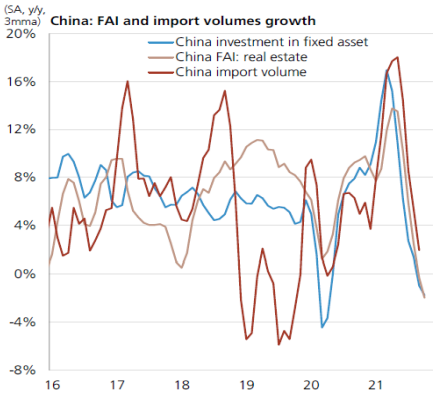
As the first country to bounce out strict Covid lockdowns in 2020, China then embarked on an austerity program in 2021 to address its financial system risks primarily driven by excessive property leverage and speculation. Tighter credit, weaker property prices and severe Covid lockdowns (elimination strategy) have negatively impacted domestic activity showing up in sharply lower import volume growth over 2021 (see opposite). Premier Li Kequiang said the growth is worrying and not far from 2% year on year in the last quarter calling on more stimulatory settings including encouraging higher household spending. China remains committed to achieving a more balanced economy reliant on domestic development and rising standards of living while depending less on export activity – although the 2021 surge in offshore demand sees Chinese manufactures now scaling up capacity. China's momentum remains intact but fiscal and monetary support is required to assist their domestic economy. Personal income tax cuts have now been extended with additional direct support for Covid impacted areas, while the People's Bank of China cut the reserve requirement ratio for banks by 50bps. These stimuluses will inject some USD188bn of liquidity (ANZ) into their economy which should help offset some of the negative impact from their embattled property sector. Despite slower domestic activity burgeoning exports mean China is still on track to

US Imports Surged in November

US December Inflation at 39 Year High



Chinese Domestic Demand Lower



deliver around 8% GDP for 2021 though slowing to 5.5% this year. World growth remains highly dependent on a strong Chinese economy.

Europe

Europe achieved a solid recovery in 2021 bouncing out of a second lockdown driven recession (see opposite) and posting strong growth in the second and third quarters as manufacturing geared up to meet offshore orders and domestic demand surged. Supply bottlenecks restricted production from September with auto industries especially impacted by semi-conductor shortages. Europe should still post a near 5% growth rate for 2021 but supply constraints and Omicron will impact output in 2022 (forecast 4.5%) and they may require additional monetary support in 2022 particularly as fiscal programs are expected to wind back this year as many states hit their budget deficit limits. Meanwhile, inflation rose to 5% in the quarter on rampant energy prices (see gas price rises opposite) and on global supply constraints. Despite lower unemployment (7.4%) Europe retains sufficient labour capacity for the ECB to let inflation run above the 2% target rate while they assess how much of the present spike is temporary. Energy prices are a key risk for Europe as they try to transition from fossil fuel fired electricity plants to increasing their reliance on renewables. Europe's natural gas production has been falling for years and they will reach record low gas reserves coming out of winter leaving them even more dependent on Russian imports.

UK

Like Europe the UK economy rose strongly in the first half of 2021 before slowing in September on supply and labour shortages - the latter is being acutely felt since leaving the EU and restricting migrant workers. Critical skills shortages include transport (truck drivers) and logistic services which has added to the general global bottleneck. GDP growth should come in around +7% for 2021 before moderating to around 4.5% in 2022 . Inflation is running around 5% (core inflation is 4%) and well above the BOE 2% target as additional Brexit border costs increase and higher energy prices also impact. The government's plan to phase out fiscal support and increase taxes will now need to be reassessed if inflation pressures force the BOE to tighten and Omicron forces lockdowns.

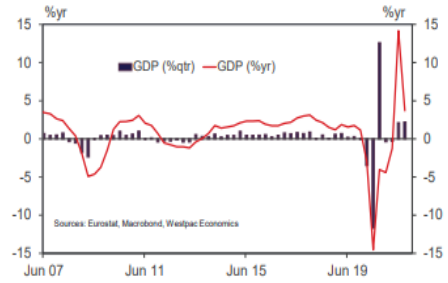
Japan

Japan's recovery has been too slow and well behind pre-Covid growth trends. Additionally, domestic activity has been unexpectedly weak with government fiscal support translating into higher household savings (+22%) rather than consumption. A massive new $490bn fiscal program (10% of their GDP) was recently announced and will hopefully boost household incomes sufficiently to assist a better recovery this year.

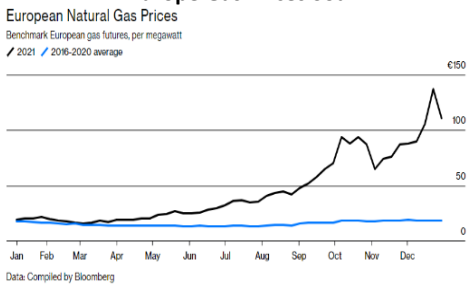
Emerging Economies

With less capacity to provide fiscal stimulus, emerging economies have generally been hit harder. Commodity producers benefited from surging prices over the year although a strong US dollar has been a significant headwind. Those countries that have better managed Covid (typically Asia) with less lockdowns and disruption (South America) and provided government fiscal support are well positioned for the year as are the producing economies such as Russia and Middle Eastern states.

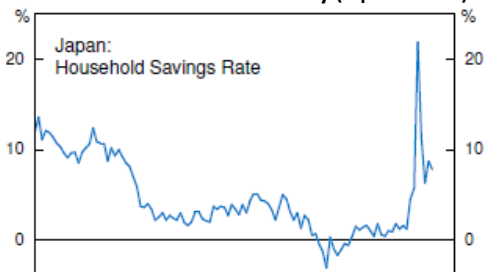
Europe GDP Bounced in 2021



Europe Gas Prices Soar



Lack of Demand Stalls Recovery (Alpine Macro)



Russian Unemployment Rate near 4%