NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

16 July 2018

June 2018 Quarterly Report

Investment markets were mostly stronger over the quarter helping portfolios generate solid returns and assisting recovery from the sharp dip in global sharemarkets in early February this year. Developed country sharemarkets, bonds and commodities were positive for the period while a weaker NZ dollar helped by lifting the values of offshore investments in portfolios.

These returns were achieved against a backdrop of easing economic growth which while still robust is decelerating from the very strong outlook in early 2018.

Despite better commodity prices, emerging markets did not perform so well as investors became increasingly concerned about rising trade war issues and with higher US interest rates increasing many developing countries' borrowing costs.

We expect global growth may ease further and become uneven over the second half of the year. Despite moderating growth, inflation continues to rise on tighter employment conditions and higher commodity costs. This means the cost of money will rise further (particularly in the US) leading to higher global interest rates. Despite this dampening force, there is significant economic growth momentum and no recessionary signals on the horizon.

Businesses are presently performing well though business confidence is being impacted in NZ from erratic government policy development and globally from trade war threats.

We continue to keep portfolios tightly aligned with their risk settings as we expect the second half of 2018 to contain periods of greater market volatility.

Kind regards,

Wayne Ross
Director Investments

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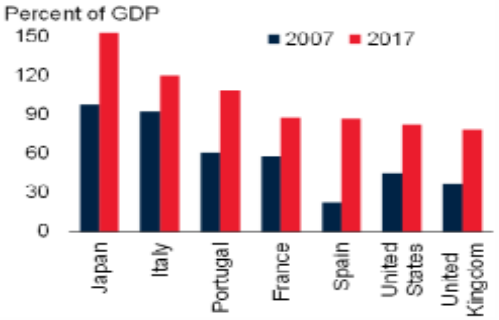
ECONOMIC AND MARKET SUMMARY

At the start of the year we identified a range of issues that may impact this year. These included, rising interest rates, Brexit disruption, trade friction, rising populism, technology disruption, cyber security risks, deteriorating Sino/US relations and greater Russian interference. All these issues flared up over the first half of the year. While the global growth outlook remains robust 3 key three issues may slow prospects.

1) Global monetary conditions continued to tighten but particularly in the US on rising inflation. As the US Federal Reserve lifts interests rates the global cost of money is rising. This is impacting borrowers, particularly in developing economies that are borrowing in US dollars but also in the advanced economies, where total public debt levels are at much higher levels than 2007 (but whose economies are much larger since then). Rising interest rates pose the greatest likely threat to global economic activity.

Public Debt

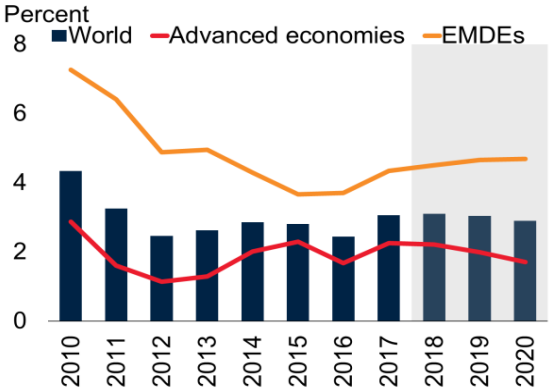


We expect the rate of tightening will be carefully managed by central banks but there are risks the US Fed and or European Central Bank moves too quickly against a backdrop of rising trade war risks.

2) Trade war tensions eased early in the quarter only to sharply rise again as Trump completed his Chinese brokered meetings with Kim Jong Un and then initiated tariffs on US$34bn of Chinese imports sparking retaliation by the Chinese who then imposed a 30% tariff on US agricultural imports. While these initial tariff impacts are relatively minor, the escalation risk is significant and disruptive to global activity. At the time of writing Trump announced tariffs on a further $200bn of Chinese imports and indicated he might tariff a total $500bn if China does not address US IP theft and cyber security claims. Morgan Stanley estimates a tariff on $250bn Chinese goods would hit US growth around 0.3 to 0.4% and China 0.3%. The US also blocked China tech companies ZTE and China Mobile on national security grounds. Trump is determined to roll back China's fast-growing influence on the US.

3)Brexit continues to have good days followed by bad. After achieving a timeframe extension for Brexit and calming immediate anxiety, Prime Minister May and her cabinet delivered a "soft" Brexit package to Parliament triggering resignations and putting her position at significant risk. Meanwhile a weakening UK economy needs certainty of process and likely outcomes. Financial services organisations remain nervous about potentially moving to the continent and hollowing out London's financial hub.

Despite these macro risks, global economic growth continues to be relatively robust though slowing. The chart below from the World Bank in June shows consensus expectations for moderating activity into 2019 and 2020.



In NZ, business confidence has been low since the election and on erratic Government policy development. Rising wages may impact earnings though help consumer confidence. Lower net migration, foreign investor restrictions and rising construction costs are putting a handbrake on house price rises.

Investment markets looked through most of the geopolitical pressures in the quarter and generally delivered solid returns. Developed country sharemarkets continued to recover from the sharp dips of February though the US market is still below levels reached in February. Emerging country sharemarkets were down over the quarter on capital outflows, while a weaker NZ dollar assisted returns from offshore assets. Bond markets finished the quarter well as investors moved more into safe-haven bonds in trade war concerns. Share markets may face headwinds in the second half should earnings prospects soften and as bond markets digest rising interest rates.

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

Market Returns	Jun Qtr.	1 Year p.a.	3 Yrs p.a.	5 Yrs p.a.
$NZ v TWI	**-2.5**	-7.6	0.5	-0.3
$NZ v $US	**-6.2**	-7.6	-0.4	-2.8
$NZ v $AUD	**-3.0**	-4.1	0.8	1.6
NZ Cash	**0.5**	2.0	2.3	2.7
NZ Fixed Interest	**1.1**	4.2	4.1	4.6
Intl Fixed Interest 100% hedged to $NZ	**0.2**	2.7	4.4	5.6
Australasian Equities 50/50 Indexes	**9.7**	17.8	12.2	11.8
NZ Listed Property	**6.0**	8.9	8.7	10.6
Intl Equities 50% hedged to $NZ	**5.1**	15.8	8.8	12.0
Commodities $NZ	**7.0**	16.1	-4.6	-3.9

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	10.8%
F&P Healthcare	Healthcare	14.1%
Fletcher Building	Building	20.4%
Freightways	Transportation	3.3%
Meridian Energy	Energy	9.6%
Port of Tauranga	Ports	6.5%
Stride Property	Property	9.4%
Trade Me	Consumer	5.2%
Vector	Energy	7.6%
Vista Group Intl	Software	33.9%
Australian Equities		
BHP Billiton	Resources & Energy	23.9%
Brambles	Professional Services	-8.3%
CSL	Healthcare	5.0%
IAG	Financials	16.3%
National Australia Bank	Financials	2.9%
Scentre	Property	18.2%

- Fletcher Building had a better quarter after raising $750m in new capital from institutional and retail investors. One new share for every 4.46 shares held was offered to existing retail shareholders at a discounted price of $4.80 and we participated in this attractive offer on behalf of clients. The new capital has allowed the company to resolve potential short-term funding issues and puts them in a much stronger position, particularly if/when they complete the planned sale of non-core assets offshore assets such as Formica.
- Brambles fell during the quarter as investors became concerned about cost pressures in the US market (higher input costs such transport, handling and lumber). There was also news of the potential legal claim against the company for poor profit guidance in 2017. Brambles is a global provider of re-useable pallets, crates and containers. They operate a high quality, defensive business which dominants the market largely due to their unique supply chain pooling program which allows multiple customers to share and benefit from lower costs. Brambles is expected to address profit margin issues through a mix of transportation surcharges, cost efficiencies and price rises.
- Vista Group had a very strong quarter following a solid profit result and subsequent presentations to Australian institutional investors and their analysts who had previously not focused on the company. Improved disclosure by the company has also allowed investors to gain a clearer idea of how and where they make their money. Vista Cinema is the key driver with 8 out of the 10 largest cinema exhibitors using Vista Cinema. 2017 saw 793 new sites (+14%) with the software now installed in 93 countries (+11) and a +10% increase in the average site licence fees.
- The BHP share price recovered alongside higher resource prices and the company moved closer to a deal to sell US shale oil assets for an estimated US$9b. BHP's core iron ore business will benefit from demand created by new integrated steel mills being built in India and South East Asia along the Silk Road economic belt. To meet this demand the company approved a $2.9b

Sonic Healthcare	Healthcare	10.5%
Westpac	Financials	9.1%
Woodside Petroleum	Energy	25.0%
Woolworths	Consumer Staples	19.7%

- Woolworths share price recovered to hit a 3 year high as lower fruit and vegetable prices drove strong consumer demand and improved investor sentiment following corporate changes. The company has also agreed terms with Caltex on a new 15 year wholesale fuel arrangement, extending the fuel redemption rewards offer to more sites and will supply food to 700 Caltex sites including 250 convenience stores under the 'Metro' brand. While the company has made a number of positive changes, including moves to reduce distribution costs, it remains unknown what the long-term impact of on-line competitors will be especially in non-food categories such as health, beauty and cleaning.

development of its iron ore mine in Western Australia which will also allow it to produce higher grade ore.

- Australian financial stocks lagged again during the quarter as the Royal Commission enquiry continued into allegations of misconduct, fraud and customer exploitation over many years. While these stories have provided some incredible media soundbites the impact on the bank profitability is less obvious. What is has done however is focus investor attention and highlight potential concerns in areas such as the quality of the lending process for banks and therefore the potential risk of defaulting loans if interest rates rise too quickly or the regulators demand higher standards of responsible lending.
- Woodside Petroleum share price was boosted by the large jump in oil prices as OPEC sought to manage supply and US stock piles fell. WPL is also reaping the benefits of a tough 2017/18 period when they were forced to focus on cost reduction to improve operational performance and improve their capital structure by raising $2.5b in new equity. Rating agency Fitch confirmed their investment grade rating for the company citing its strong financial position and relatively low production costs which allow it plenty of headroom to continue making profits should energy prices fall back again.

Change in Portfolio Holdings – Introducing CSL

Following a review of the companies held in the Australasian portfolio Devon have recommended the inclusion of CSL Limited (CSL). CSL is an Australian biopharmaceutical company. It researches, develops, manufactures and markets vaccines and plasma protein biotherapies to treat and prevent human medical conditions. The company is split into two main segments; CSL Behring which provides plasma collection centres and derived products, and bioCSL which manufactures and sells vaccines and anti-venoms. bioCSL also markets in-vitro diagnostic products which it manufactures in Germany, Switzerland and the US.

We have funded the purchase of CSL by selling down the holding in Westfield Group prior to the completion of their planned merger with Unibail-Rodamco. In Devon's view the combined assets of the new entities created by the merger did not offer such an attractive investment proposition and our intention was to sell. By selling our Westfield holding prior to the merger we have been able to minimise transaction costs.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	11.2%	The fund outperformed the market benchmark with strong returns from Vista Group, Fletcher Building (capital raising), Woodside (higher energy prices) and Meridian Energy. Vista has gained traction with Australian investors following a roadshow which clearly set-out the core parts of their business and the parts which have potential but are early stage and hence not relevant to current valuation. Meridian benefited from the release of a paper by Transpower (the state-owned enterprise which runs the national electricity grid) which indicated electricity demand rising more than 100% over the next 30 years. The major demand drivers are increased electric vehicle penetration, electrification of industry heating (Fonterra milk dryers) and continued population growth. Devon see risk in some areas of the NZ market where share prices have been driven higher by passive, price insensitive index buyers. Business confidence has dropped sharply and valuations could come under pressure if companies can't grow their earnings sufficiently due to factors such as higher fuel prices, higher wages, a slowing property market, fewer migrants and lower economic growth.
Harbour Australasian Equity Focus Fund	9.6%	The fund performed in line with the market benchmark over the quarter. Volatility in the A2 Milk share price impacted fund returns as the company responded to increased competition in the key Chinese market. The manager continues to view the outlook for A2 Milk very positively with the company successfully rolling out a new label product, record export volumes of infant formula, extending their supply agreement with Synlait Milk and hiring a new CEO with fresh skills and momentum. During the quarter the portfolio was rebalanced by taking profits in Oil Search, CSL and Xero and adding to positions in Challenger (recent price weakness seen as buying opportunity), Kathmandu (strong earnings growth under new mgmt.) and Sydney Airport (structural rise in global travel, retail hitting sweet spot and new management doing well to optimise business mix). Harbour are also cautious about the general economic outlook for NZ. Consumer confidence has remained high despite the fall in business confidence with households more positive due to low interest rates, strong job prospects and a build up of housing wealth. That should lead to GDP growth of at least 2% (down from 3.5-4%) in the year ahead but this would be at risk if credit conditions tighten or the housing market continues to slow further. The manager therefore prefers globally orientated companies rather than those which would be adversely impacted by slowing NZ economic activity, higher bond yields or regulatory uncertainty.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	2.4%	The fund was down -0.7% in A$ terms for the quarter. After extremely strong returns over the past 18 months, Trump's trade wars have seen Asian stocks punished over the quarter and the fund has trailed the broader market with 47% of the portfolio allocated to opportunities in the Asia-Pacific region. The manager sees China has a once in a lifetime investment opportunity and has been reallocating funds within the region, taking profits in tech/consumer stocks and positioning the portfolio to capture the Chinese governments developing environmental goals. Strong demand from Japan, Korea and India is expected to boost demand for resources.
Monks Investment Trust	10.1%	The fund was up 7.9% in GBP terms for the quarter. The manager prefers to focus on the quality of the company they are investing in rather than clever asset allocation or market timing. The strong contributors to performance over the past year came from many different industry's (insurance, cars, credit cards, semi-conductors) but all grew their earnings by at least a third. The fund has a large exposure to 'online platforms' where new players are disrupting by delivering traditional services more effectively. The manager has been repositioning the portfolio by actively taking profits, selling over valued cyclical growth and high dividend companies and buying shares in companies with better growth prospects. One such example is US company GrubHub which has invested in delivery technology and physical infrastructure (unusual for a tech disruptor) to establish itself as the dominate food delivery platform with access to over 80,000 restaurants including KFC and Taco Bell. Strong fund performance since the change in management team in 2015 has seen Monks shares trade at a premium to net asset value for the first time in 55 years. This has allowed the company to issue new shares to the benefit of existing investors and the increased fund size has allowed a further reduction in the annual fund management charge.
Magellan High Conviction Fund	10.0%	The fund was up 6.7% in A$ terms for the quarter. Stocks that performed best included Alphabet (gained after a 26% increase in revenue as Google boosted advertising revenue), Visa (30% earnings growth due to higher consumer spending) and Facebook which surged on a view that privacy issues surrounding user data wouldn't impede user and advertising growth (this was supported by strong earnings). Negating these positive stories was weaker returns from Yum! Brands (slower fast food sales due to discounting) and Starbucks which is reducing its US outlets due to weaker sales and faced a debt downgrade by Moodys due to an increase in borrowing. The manager has raised the level of cash in the portfolio to 18% due to the increased risk of a market correction should rising US wage growth force the Fed to raise interest rates quicker than the market is expecting. This is especially true if growth slips due to the current trade arguments with China, Europe and NAFTA. Currently markets are assuming short term deals will be done mainly for political reasons. There is however a larger risk that the US is seeking to address the larger strategic issue of long term dominance in global technology. If so then a trade 'war' could go on for some time.

Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	4.0%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The NZ dollar fell against all major currencies over the quarter, so the hedge reduced returns in NZ dollars. Global share markets had a volatile quarter as investors tried to second guess the near-term path for share prices in the face of competing influences such as rising trade tensions, emerging signs of inflation, high share market valuations, continued global economic growth and strong corporate earnings.
iShares Russell 2000 Index Fund	14.9%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. Reallocation of risk capital by global investors and the strong USD dollar meant outperformance from US smaller companies. Across other markets, smaller companies based in larger economies and able to sell their goods and services locally generally fared better relative to those who are reliant on trade with foreign markets.
Vanguard FTSE All-World ex US Small Cap Index Fund	3.8%	
Vanguard Emerging Market Index Fund	-3.7%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. After stellar returns in 2017, emerging markets have underperformed developed markets as a stronger US dollar saw investors prefer to redirect funds towards less risky USD assets. Countries with high debt levels (such as Turkey and Argentina) will struggle as global interest rates rise back to more normal levels and the increased trade/tariff war of words is a negative short-term influence, especially for those producer countries reliant on commoditised exports with less pricing power and fewer options to diversify.
iShares S&P Global Infrastructure Index Fund	8.5%	The fund provides passive index exposure to listed infrastructure assets and is valued in USD. The strong USD dollar helped returns to infrastructure companies which also offer some protection should weaker global growth eventuate. Many infrastructure companies operate essential services and in the US for example 80% have posted earnings growth this year above forecasts, the strongest result on record. Increased political risk in Italy did however raise questions about stability in the Euro region where many of the worlds dominate utility companies are listed.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	6.6%	The fund provides passive index exposure to commodities and is valued in USD. Commodities other than Precious Metals have been supported by rising global industrial production as the world economy continues to grow. Oil prices bounced higher as the US moved to reimpose sanctions on Iran despite their own accessible oil stockpiles being limited at present and OPEC indicating they will increase supply. Gold fell -5.4% which suggests investors are not concerned about a sharp market fall anytime soon.

NEW ZEALAND FIXED INTEREST

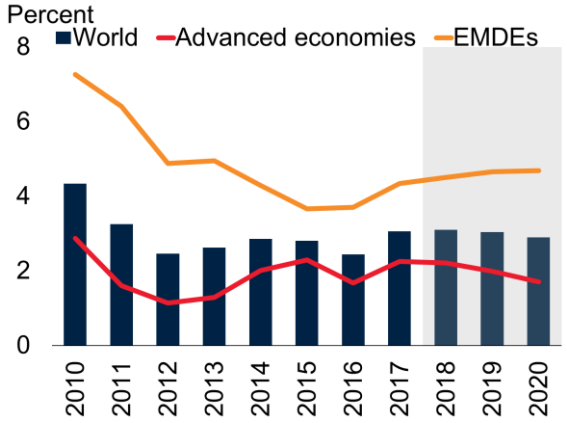
Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	1.1%	US 10 year bond yields rose above 3.1% for the first time in 7 years during the quarter as strong US retail sales data, record low unemployment and higher oil prices confirmed the Federal Reserve's upward trajectory for interest rates in 2018/19. The threat of a US-China trade war impacting global growth saw bonds rally and rates fall back again in June, ending the quarter only slightly higher at around 2.85%. Some of the volatility in yields reflects uncertainty for bond investors about the likely impact of higher tariffs given that in the short term higher import prices mean higher inflation (ie. higher interest rates required) but in the longer-term tariffs are likely to lead to slower economic growth (ie. lower interest rates required). Elsewhere the European Central Bank signalled their regional economy was strong enough to handle the withdrawal of quantitative easing measures brought in post the GFC. The ECB's program of buying bonds will end later this year although rates are expected to stay at their ultra low levels for some time yet.
NZ Corporate Fixed Interest Investment Grade Rating	1.1%	In NZ the RBNZ did not change the OCR so short-term rates were little changed. Longer term yields ended slightly lower over the quarter, outperforming offshore. Local market commentators are focused on the slowdown in domestic economic activity and have therefore shifted their expectations of the next hike in short term rates out to Nov 2019. Working against this view is the possibility of higher inflation taking hold earlier than currently expected due to rising oil prices, a weaker NZ dollar and domestic wage pressures due to industrial action and fewer migrants coming into the workforce. Longer term NZ bonds continue to trade at a similar yield to US rates rather than at the approx. +1.7% additional yield margin that we have historically offered. When combined with the stronger USD this means there is now no longer a profitable carry trade (when Us investors borrow at their lower interest rate to invest in the higher NZ bond yields). Despite the different monetary and fiscal policy settings providing some rationale for this anomaly it remains to be seen how long this situation can continue. NZ Govt Bond returns in USD terms are -3.3% for the year to date.

ECONOMIC COMMENTARY

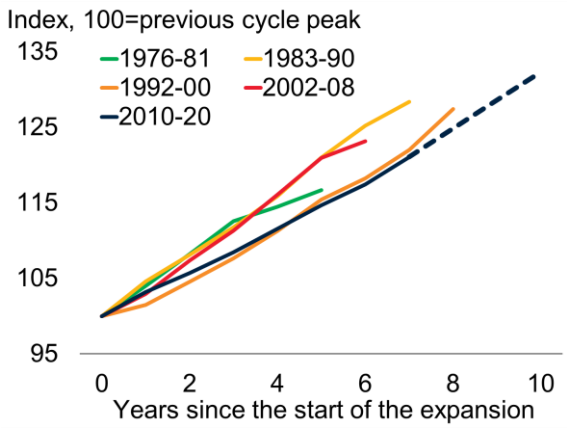
Global

Following a very strong start to the year global growth (while still robust) softened over the second quarter and may slow further into the second half of the year. It is also looking increasingly like global growth is de-synchronising with the US likely to accelerate as China slows. The World Bank June economic outlook suggests growth for 2018 year will come in closer to 3.1% (down from 3.7%). Moderating forces include; rising trade tensions, higher interest rate prospects and Brexit/EU uncertainty. Additionally, higher commodity costs (though recently lower), rising wages and now trade tariffs are likely to increase inflationary pressures. Central banks (including the US) are taking care to ensure that tighter policy settings can be digested. Europe and Japan look particularly vulnerable to monetary tightening despite improving employment conditions and lower public deficits while a robust US economy may need faster tightening to offset loose fiscal stimulus settings. US trade tariffs while currently symbolic risk escalation. China is arguably better positioned to absorb the impact of US tariffs than can Canada, Europe and Mexico. Different analysis of the Sino/US trade war suggests the direct GDP impact is not significant yet but could be as much as -0.5% p.a. on China and the US. The greater risk is damage to global business confidence. While there are no signs of recession on the horizon (and indeed the consensus outlook is positive) conditions are softening. The graph opposite shows the age and length of this cycle relative to prior periods. It is becoming one of the longest but also one of the slowest recoveries suggesting the cycle has further to go.

Global Activity Slowing



Years of Previous Growth Cycles. This cycle is long and aging <u>but slow</u>.



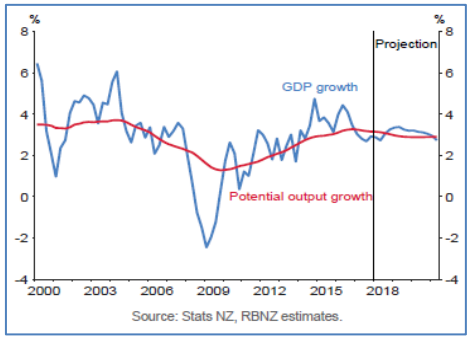
Key Themes and Risks

We introduced our global risk themes in December 2017 and we update some of the progression of these key issues below.

	This quarter	The issue
Surprise Inflation	US inflation is higher running at 2.3% yoy. Globally capacity is tightening but there is still significant slack yet.	Markets are potentially under-pricing US Fed rate actions.
Central Bank Misjudgement	US Fed lifted to 2% (targeting 2.5% this year). BOE, ECB, BOJ, RBA, RBNZ unchanged.	US Fed promoting more rises and possibly at a faster pace.
Cyber Attack/Security/ Fake News	Continued investigation into Russian influence on US and UK election outcomes. Trump blocked then fined Chinese IT company ZTE and China Mobile as a security risk. More on the way.	Accelerating global issue. Trump at risk on investigation. Trump addressing IP theft and cyber espionage. Some Chinese commentators questioning if China has miscalculated western tolerance.

Trade Wars	US implemented tariffs on USD34bn of Chinese goods. China responded with 30% tariffs on US agricultural imports.	Trump negotiating tactic or will he implement on the $550bn of Chinese imports he has targeted. Trump sees US win but fails to see global risks.
Brexit	"Clayton's" Brexit proposal from Cabinet sees two Eurosceptic ministers resign. Watered down Brexit will likely be popular solution and get cross-bench support.	Hard Brexit risk removed. Softer Brexit package will be business friendly, particularly for financial services.
Geo-political	Kim Jong UN / Trump meeting a circus. Both sides think they have won. NK has a poor history of compliance.	Tensions diffused. A win for Trump but likely being played by Kim Jong Un. China may let him of the leash again following US trade tariffs.

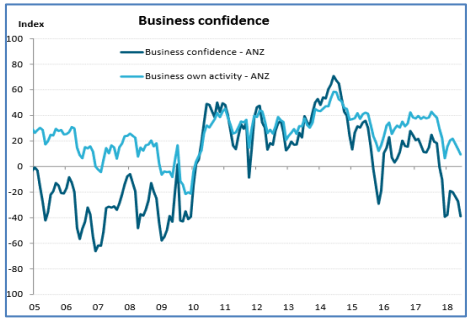
NZ GDP Outlook Ok



New Zealand

Our terms of trade have dropped down from record highs this year, but our trading partner growth remains robust enough and Chinese tariffs on US agricultural goods could directly benefit NZ, particularly for dairy. In recent months, increasing wages pressure, higher commodity prices (oil), a weaker NZD and greater Government spending and new fuel taxes mean inflationary pressures are building if not yet requiring Reserve Bank action as lower net migration, slowing construction and tighter credit conditions provide some demand offset. Also, bank lending rates may also be on the increase given rising offshore funding costs. Tighter credit, restrictions on foreign buyers and changes to tax rules have also seen house prices stall and fall in some areas. Following a post-election drop, business confidence has also not improved which is surprising. Business leaders remain concerned about 'erratic' policy development and signalling. Better business engagement is required to avoid this confidence shift which could lead to lower business investment particularly, if wage costs spike. Consumer confidence has been more robust but now showing some signs of easing and this probably remains the more concerning issue for the rest of the year. While starting the year with a GDP growth outlook of around 2.7%, the trajectory is looking lower and possibly as low as 2%. Against this backdrop company earnings growth may be harder to deliver.

NZ Business Confidence Stays Low



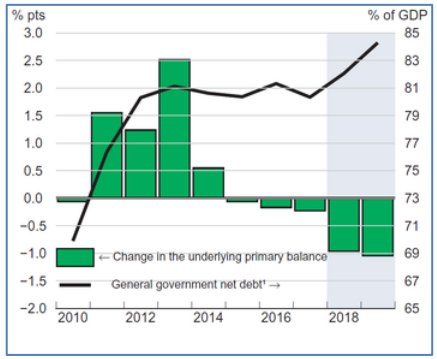
Australia

Things have improved across the ditch with their economy growing at a robust rate (3.1% annualised Q1). Higher commodity prices, larger mining volumes, improved terms of trade, stronger business investment and continued Government spending has assisted. House prices have however, been weaker but consumer confidence is holding up on better wages (+5.1% yoy) and higher employment participation. A 3.5% rise in the minimum wage and new income tax cuts (coming in to affect 2021) are also underpinning consumer confidence (up strongly and highest since 2013). Business conditions remain buoyant albeit off recent peaks and remains favourable. Commercial construction has improved, and manufacturing jumped sharply

Australian Manufacturing Rising

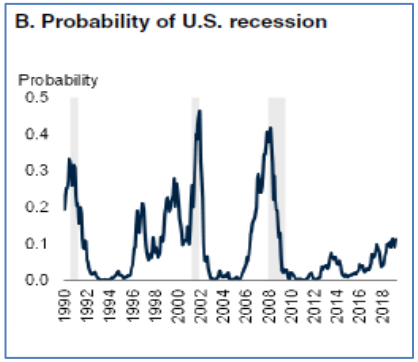
in the quarter while services were softer. Given weaker home prices, the Reserve Bank for now, can remain on hold. They also remain alert to a slowing China which would have a direct impact on export commodity prices while Australian productivity levels also remain weak.

US Fiscal Policy Loosening. Debt Rises.

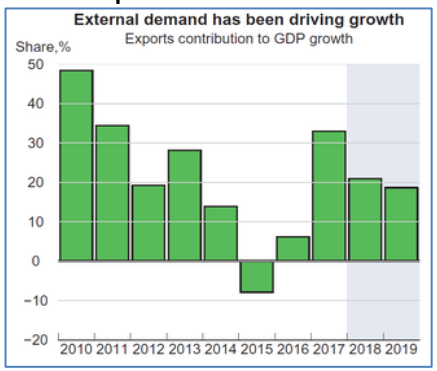


US

The US economy is accelerating. Trump tax reforms and further fiscal easing plans are boosting US activity. Business confidence is now the second highest on record and consumer confidence improving as unemployment falls to an 18-year low of 3.8%, (down from 3.9%). Wages are lifting, employment participation improving, house prices rising and household balance sheets in good and improving health. Consumer spending will continue to accelerate as the effects of tax cuts bolster household confidence and incomes. The US Federal Reserve raised interest rates in the quarter to 2% and continues to signal another 2 x 0.5% rises this year and targeting 3.25% by the end of 2019. In June, core inflation measures rose +2.3% over 12 months though recent producer prices rose to 3.4% yoy, the largest increase in 6.5 yrs. The world is now closely watching how the US Federal Reserve manages such strong economic data, loose fiscal policy and rising inflation against a backdrop of record post war public debt and in some pockets, heavily geared corporate balance sheets. While the US is far from overheating, a mis-step or mis-signal, could see borrowing costs jump too far before structural growth changes have fully taken hold. The outlook for the US remains good with the probability of recession unlikely (see OECD chart opposite) though some commentators are forecasting one for 2020. President Trump will be taking credit on the domestic front encouraging him to be more aggressive on global issues. He sees the resurgence of US economy as an opportunity to recover trade imbalances and restore security settings which will continue to make interesting geo-political news. The Trump administration recently ordered State Department officials in China to take a tougher approach to visa applications by Chinese citizens.



China Exports. GDP Contribution

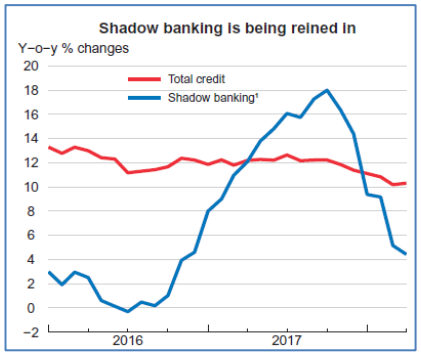


China

China's economy is slowing on lower exports, tighter credit conditions and slower investment. Forecasts for Chinese growth are still robust at 6.7% in 2018 but moving lower to 6.4% in 2019. This cooling is being driven by the need to address internal financial imbalances, increase investment effectiveness and to get a focus on better value add activities sand higher margins. Exports have been a key contributor to growth (see opposite) but reducing in recent years from a contribution rate of over 30% to less than 20%. The current trade spat with the US is likely to further dampen export activity to that market (up to -0.5% of GDP) but not unduly unsettle China's progress. In our last quarterly review, we talked about China's need to improve financial stability. The government has now created the Financial Stability and Development Committee which has sharply reigned in non-bank lending and other shadow banking activities, stabilised capital outflows, managed down the exchange rate and curtailed inefficient public spending. At the same

time house prices are stabilizing and tax cuts are on the way with additional fiscal stimulus going into a range of projects under the One Belt, One Road infrastructure initiative. Domestic consumption though improving, remains the missing key to balancing China's growth. As household savings rise and public healthcare improve, consumption is expected to accelerate and help balance China's reliance exports, investment and credit.

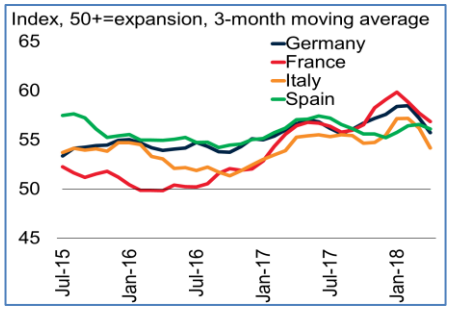
China. Shadow Banking (Source: OECD)



Europe

After a sizzling 2.6% growth rate in 2017, the pace of activity though still high, is moderating as the higher Euro starts to impact exports, orders and manufacturing activity. Despite recently soft data, the Eurozone economy is still going well with unemployment falling to a 9-year low, employment participation rising, business investment improving on easier credit conditions and domestic consumption higher. Inflation for now, remains at bay as there is still enough slack in the labour market and a stronger Euro is offsetting higher energy prices. The European Central Bank is slowly reducing monetary support but remains patient and waiting for inflation to sustainably breach its 2% target (about 1.5% at present) and indicating no rate rises until late 2019. Looking forward Eurozone growth may move lower to 2.2% (OECD forecast) in 2019.

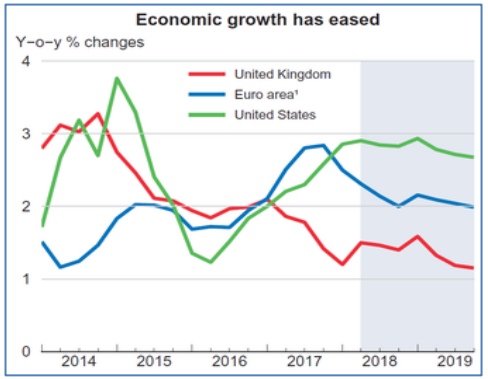
Europe Moderating. Composite PMIs **(Source: OECD)**



UK

While recent data has been quite strong, business investment is slowing in the UK as confidence continues to slide on Brexit uncertainty. Many businesses say they are at breaking point, with some such as BMW, Airbus and Landrover (Tata) indicating they may pull out of further UK investment. Prime Minister May and her Cabinet delivered a watered-down Brexit package that affectively agrees to maintain recognition of most EU rules while reserving control on immigration, trade policy and removes the European Court of Justice from UK affairs. The softer package will be a popular compromise though euro-sceptics will be unhappy. UK growth is forecast at 1.4% in 2018 though employment is robust and below 5%.

UK Underperforming (Source: OECD)



Japan

Like China, better domestic consumption remains the key to Japan's prospects. Though unemployment rates are low (2.5%) real wages have declined and labour shortages are beginning to impact business activity. An aging population, tired workforce and gender wage gaps are impacting productivity. Structural reform is desperately required to free up labour resources otherwise low wage growth will continue to hamper consumer spending. After reaching 1.7% growth in 2017, 2018 will be closer to 1%.

Emerging Markets

Commodity exporting countries are doing well on rising prices but remain vulnerable to a slowing China while indebted emerging countries are under pressure with some experiencing capital outflows and rising borrowing costs. EM growth forecasts remain stable and slightly improving in 2019.

MARKET COMMENTARY

Cash

After its meeting in June 2018, the Federal Reserve decided to hike the target range by a quarter point to 1.75%-2.00% which lifted the prime lending rate above 5% and 1-year deposit rates above 2.3%. Despite trade war concerns and slowing momentum elsewhere, US data remains sufficiently strong at present to keep the Fed on track for 2 x 0.5% rises this year. The Fed is now well ahead of other central banks and becoming desynchronized which is impacting capital flows. The RBNZ held rates steady in the period but reiterated the view that inflation pressures are modest at present and suggesting no change in rates until late 2019. The recently softer data may stay their hand further and there has even been some commentary about the possibility of a rate cut. Elsewhere central banks remain cautious but seeking normalisation which may now take longer.

US Federal Reserve Funds Rate- Move to 2%

Currency

The NZD was unsurprisingly weaker over the quarter on rising US interest rates and better economic data out of Australia. The NZD fell -6.2% against the USD and -3.0% against the AUD increasing returns from offshore assets held in client portfolios. The NZD was also generally weak against most currencies with the TWI down -2.5%. We expect the NZD may weaken further on softer NZ economic data in the second half.

NZD/USD – Sharp Drop

Fixed Interest

During the quarter 10yr US bond yields rose as high as 3.1% in May on better economic data and modestly increased inflation. As trade concerns started to dominate the news, investors moved back into bonds and the US 10 yr. yields fell back to 2.84% generating good late quarter returns for investors. NZ bonds followed these moves but also rallied after a constrained government budget. With softer global data non-US bond prices may rise further as central banks adopt more accommodative language. Credit spreads are continuing to widen as leveraged corporate balance sheets come under pressure from higher borrowing costs. Junk bonds have been very popular over the last 10 years both as a cheap funding source for corporates and for yield chasing retail investors and financial institutions packaging income / yield products.

Given the inflationary momentum long dated bond yields will likely grind higher in the second half of the year while short term rates remain more anchored. It is also difficult to see how the NZ and Australian 10 yr. bond yields can remain like US bonds (and even lower) without some near-term adjustment to the risk premium. The diversification argument is becoming stretched.

US 10-year Bond Yields – Jan to June 2018

Equities

International equities returns were mixed and quite volatile over the quarter on a variety of geo-political pressures and uneven economic news. Global share markets were up +5.1% for the period (4.2% in USD), with the US +3.4%, UK +9.6%, Europe +3.6%, Japan +4.1%, Australia +8.5% and NZ +7.5%. However, some emerging markets dropped, particularly China -10.1% and Asia ex Pacific -3.5%. The Sino/US trade war hit Chinese stocks hard especially as Trump is targeting specific Chinese companies for IP theft or destabilising cyber activity. Australia finally had a very good period on rising commodity prices (Resources +16.4%) and strong economic news while financial stocks have been weaker after negative findings by the Royal Commission enquiry into financial services practices. Europe and the UK had a good quarter on reduced political risks, strong earnings results and better Brexit news. The NZ market performed well on a recovering Fletcher Building share price and the lower NZD providing a boost to Fisher & Paykel Healthcare. Our market is expensive trading at over 23x earnings. While earnings results have been supportive to date, a softer economic outlook would be headwind for these price levels though Kiwisaver cash flows help. With rising wage pressures and lower business confidence earnings growth may be more elusive in the second half of the year. US corporate profits were strong in the first quarter (+6.1%) and their May earnings results show 80% of companies are beating targets. On a trailing PE basis, the US market looks over-priced at 24x earnings but on a forward earnings basis (16.5x) still relatively good historical value. Interestingly the S&P500 index is still below the highs reached in early February.

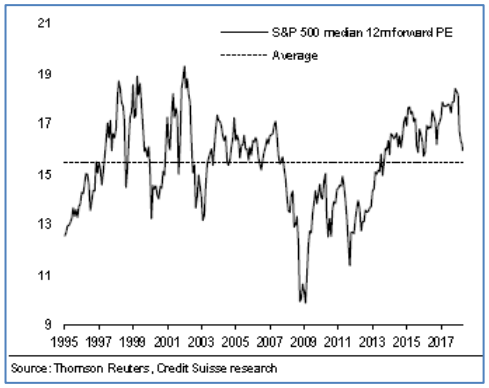
Property

New Zealand recently achieved a new median house price level of $562,000 (REINZ) a 5% annual increase. Northland, Tasman, Manawatu, West Coast, Otago and Hawke's Bay all had strong increases however the tide has finally turned in Auckland which is down -1.3% over the year. Lending and foreign investor restrictions are impacting prices. Auckland workers are also just running out of the income capacity required to gear any higher purchases. Net migration numbers have dropped back a little and building consents are rising quickly but construction is struggling with massive capacity constraints. The government Kiwibuild programme looks like missing its target beneficiary needs before it even gets going and just threatens to overwhelm and already strained industry. REINZ data also shows the Dairy Farm Index was lower over the year -8.2% while the all farm index +5.8%. Non-residential construction activity remains robust.

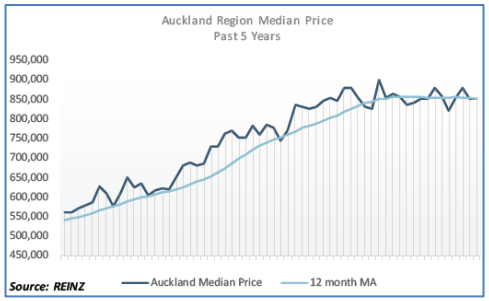
Commodities

After 5 months of rises the ANZ Commodity Index fell back in June -1%. Our terms of trade while lower are still historically high. At the time of writing, commodities have taken a sharp dip, primarily on trade tariff threats. The Bloomberg Commodity Index has declined 8.9% from this year's peak in late May.

US S&P500 12month forward PE Ratio



Auckland Region Median Price last 5yr. (REINZ)



Trade War Impacting Commodity Prices