NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

16 October 2019

September 2019 Quarterly Report

All asset classes performed steadily over the quarter generating solid returns for investment portfolios. Central banks either cut interest rates or maintained an easier rate outlook which supported bond, property and share market returns. The lower interest rate policy settings were in direct response to softening global economic growth driven by weaker manufacturing activity. This is largely attributed to the ongoing US/China trade war and Brexit debacle both of which are impacting business confidence, business investment and disrupting global supply chains and manufacturing orders.

The escalation of the trade war highlights the rapidly changing landscape of global and regional power politics including the Middle East where tensions have risen sharply. Against this noisy background, economic prospects remain steady but are below trend in some countries, including New Zealand and Australia. We expect the combination of lower global interest rates, full employment and new government spending initiatives will support economic activity though a recession in some countries, Germany in particular, is possible.

Investment markets will continue to be underpinned by historically low rates and by investors seeking alternative returns to falling deposit rates. Volatility will certainly rise as investors balance the need to take additional risk to get a reasonable return, against the possibility markets might weaken if we see either higher inflationary data (leading to higher interest rates) or markedly slower global growth.

In this tricky environment we continue to advise clients to be disciplined with their investment strategy and not take on additional risks to try and improve returns. Protection of capital and the management of risk to target levels is paramount.

Kind regards,

Wayne Ross
Director Investments

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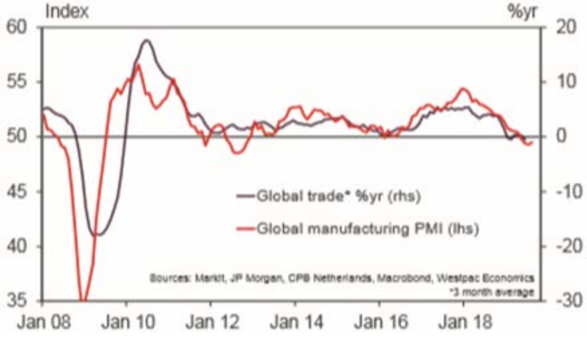
ECONOMIC AND MARKET SUMMARY

Central banks continue to cut interest rates to record low levels to stimulate economic activity and head off recession.

Global Activity Continues to Slow

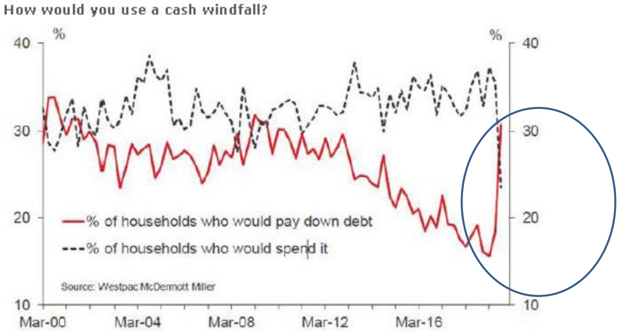


Interest rates are lower today than they were during the 2009 Great Financial Crises which is remarkable given the positive (though below trend) economic growth rates around the globe. Central banks can lower rates because inflation is persistently low despite relatively full employment. In part the rate cuts are also aimed at keeping currencies in check and preserving trade competitiveness. This seems to be the case for NZ.

But is this monetary policy stimulus working? To some extent it is. It certainly assists borrowers. Businesses are racing to lock in lower borrowing costs and extend their borrowing terms (globally corporates borrowed a record $300bn last month). This directly assists corporate profits and potentially investment providing business confidence is robust. Lower interest rate policies may also assist indebted developing markets with younger demographics and who are reliant on $US debt funding.

However, in advanced economies which tend to have older populations, households are more reliant on fixed incomes and lower rates mean lower investment income. This is leading to lower consumption, forced household savings and faster debt reduction. Lower interest cost savings are being used to pay down debt rather than consume. (see next chart). Households do not seem to be using lower interest costs to consume which is one outcome central banks would hope for. While some might see this as a good outcome the point is that lower interest rates are not necessarily spurring consumption as central bankers would hope.

Are Interest Rate Cuts Working?

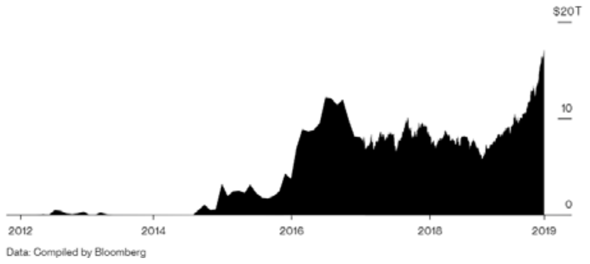


Source: Westpac McDermott Miller

Additionally, borrowers will only take on debt if they feel confident to do so. NZ currently has low levels of business confidence while household confidence is also fragile. Lower interest rates are becoming less effective. From here additional stimulus needs to come in the form of fiscal relief. This might include tax breaks, targeted spending programs and likely increased budget deficits. While some governments are heavily indebted and have less capacity to spend, we are seeing signs that even conservative economies like Germany are preparing for it.

Central banks need to provide price stability but avoid the monetary policy race to the bottom. Low rates are hurting retirees and their consumption. With rates near 0% will their next move be to quantitative easing again? Unless economies are in deep recession the question would be why. The next chart shows the increasing amount of negative yielding bonds (you get less back than you put in) on market. Investors are buying these bonds thinking yields will go more negative! A 10 year NZ Government Bond today will provide an investor with a 1.2% p.a. return before tax and inflation. We are clearly in interesting (pun intended) times. For portfolio management, bonds remain an important risk reduction tool, but they are very expensive. We are therefore keeping bond exposures in portfolios to only those high-quality issuers and to shorter terms or duration. This helps avoid potential capital losses from bonds when interest rates do inevitably rise while retaining some portfolio protection against potential recessionary conditions.

Global Negative Yielding Bonds tops $16trillion



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

Market Returns	Sep. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-4.1**	-2.6	-3.0	-1.6
$NZ v $US	**-6.9**	-5.2	-4.8	-4.2
$NZ v $AUD	**-3.0**	1.6	-0.7	0.8
NZ Cash	**0.4**	1.6	1.7	2.4
NZ Fixed Interest	**2.8**	9.6	4.9	6.0
Intl Fixed Interest 100% hedged to $NZ	**3.0**	11.1	3.9	5.7
Australasian Equities 50/50 Indexes	**4.8**	13.8	13.5	12.3
NZ Listed Property	**8.6**	34.7	15.2	16.2
Intl Equities 50% hedged to $NZ	**4.1**	3.9	12.6	9.8
Commodities $NZ	**5.2**	-1.2	3.5	-3.0

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	-7.1%
Contact Energy	Energy	10.4%
F&P Healthcare	Healthcare	11.8%
Fletcher Building	Building	9.3%
Freightways	Transportation	-1.2%
Meridian Energy	Energy	13.0%
Port of Tauranga	Ports	4.6%
Stride Property	Property	6.9%
Vector	Energy	-1.7%
Vista Group Intl	Software	-36.3%
Australian Equities		
BHP Billiton	Resources & Energy	-5.2%
Brambles	Professional Services	-7.5%
CSL	Healthcare	12.7%
IAG	Financials	1.8%
National Australia Bank	Financials	12.7%
Scentre	Property	8.5%

- Vista Group was marked down sharply after disappointing investors with lower revenue growth (+12% yoy) and weaker earnings. The market reaction appears overdone with the lower profits largely explained by increased corporate costs due to facilitating business growth and weaker outcomes in early stage businesses. The core business of Vista Cinema and Movio has actually strengthened and these divisions make up 84% of revenue and 100% of earnings. VGL has software in approx. 50% of large format cinemas globally and continues to expand.
- Woolworths is achieving above market sales revenue and an improved competitive position as it continues to refocus its strategy on core food activities and invest in store renewal and digital platforms. However, the investment and disruption from changing its business model is impacting margins and increasing costs in the short term so profits are expected to remain at current levels for at least another year.
- National Australia Bank announced an additional A$1.18bn of funds put aside to pay for wealth and insurance customer remediation following the Hayne inquiry. This was more than expected and is likely to ensure there are no further surprises when new CEO Ross McEwan takes the helm in November. NAB is not alone in being held to account with CBA setting aside $2.1b, ANZ $0.9b and Westpac $1.5bn. The big four banks can easily account for these costs given their record profitability (and some capital raising activity) however they will no doubt be keen to put the past behind them as they exit wealth management and focus on core banking operations with the Australian property market showing signs of life again.
- Woodside Petroleum was lower due to a weaker LNG price, disrupted profits due to cyclones and some scepticism of progress being made on key growth projects. While there have been some frustrating JV negotiation setbacks, the fundamental business remains sound. The current share price effectively assumes LNG stays at these low prices forever and that the company will reap

Sonic Healthcare	Healthcare	8.6%
Westpac	Financials	7.7%
Woodside Petroleum	Energy	-6.7%
Woolworths	Consumer Staples	18.2%

- Stride Property is shifting 12 industrial properties from its current portfolio into a new special purpose vehicle in a joint venture with a group of international institutional investors. Stride will initially own 70% of the new venture, to be called Industre Property, but this stake will be diluted over time as the institutions contribute additional capital and more properties are acquired and developed. Eventually Stride will be left with 25% of a $1bn fund and earning increased fees as manager of the much larger entity.
- Meridian Energy is considering plans to build a 140MW wind project in Napier and notes that the industry requires a more positive consenting framework if older gas and coal-fired electricity generation is to be replaced with renewables quick enough to meet an expected 50% increase in electricity demand. The major generators are looking to add 430MW of renewable supply over the next 4 years but in the next 20 years almost a 1/3rd of NZ's existing generation will need to be replaced or repowered. Coal fired generation is currently used primarily for back up supply during periods of dry weather but that is expected to become redundant within the next decade.
- CSL reported a strong profit result and has indicated mid-teen profit growth in the year ahead due to continued strength of their core immune globulin franchise. The company's strategy of expanding its plasma collection centres has allowed the company to exploit tight global supply when demand is increasing for product lines derived from plasma. Seqirus is their vaccine division and a tough flu season like the one we are having will further boost profits.

no benefit from its growth opportunities. These scenarios are unlikely in the medium term and Woodside is well placed to benefit (relative to competitors), given its existing asset mix and strong balance sheet.

- Fletcher Building continued its volatile relationship with institutional investors. The share price rebounded over the quarter but not before analysts widely panned their result noting the continued poor performance in Australia and the company's apparent inability to leverage the strong NZ building sector. Managing Director Ross Taylor points to the progress made in reducing debt, reinstating dividends and stabilising the construction business but many investors would prefer to exit the troubled Australian operations rather than spend another $100m trying to turn things around in weaker property market.
- IAG reported solid earnings of A$1.08bn and a positive outlook for insurance margins but the share price struggled to rise, reflecting the premium that is already built into the price. The company achieved an insurance margin of 16.9%, which is the highest it has ever delivered, and expects a similar result next year. Keys risks to earnings for insurance companies come from increased regulatory costs, natural peril claims, weaker investment income (lower bond yields) and weaker economic growth making it harder to cover increased costs by raising premiums.
- BHP announced a A$570m climate investment program over the next 5 years to fund the development of technologies aiming to reduce carbon emissions generated by BHP's own operations as well as those generated by customers. While some remain sceptical, the move was generally seen as a positive step and is part of a wider push by big companies to be good corporate citizens. Companies are fighting for investor capital that is increasingly channelled through fund managers who are driven by broader agendas including ensuring ESG factors are considered. Investors are looking for companies to not only demonstrate solid results and offer future growth opportunities but also to demonstrate how they are going to maintain their licence to operate.

AUSTRALASIAN EQUITIES

The Australian market ended up +2.4%, placing it on track to record its best year since 2009. This was despite their reporting season delivering generally weaker results. The surprising exception to this was a more upbeat tone to those businesses exposed to domestic consumers such as JB Hi-Fi and Super Retail Group. In NZ, the market was one of the world's best, rallying +4% after the RBNZ cut interest rates to a new record low. This strong performance was achieved despite multiple company earnings disappointments and downgrades with generally lower business confidence. Inherent in the performance of the higher dividend paying stocks is the expectation of the OCR being cut to 0.5% and increased volatility can be expected if this does not eventuate.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	3.8%	The fund underperformed the market benchmark over the quarter. Stocks to contribute to performance were Kathmandu, James Hardie, NAB and Napier Port which gained 19% after listing in the NZX. The port company offers exposure to the Hawkes Bay agricultural sector (61% of NZ's pip fruit) and forestry. Key detractors included Z Energy and Atlas Arteria. Kathmandu jumped in September after increasing sales by 9.7% and profits by 13.6% (at the top of previous guidance). Their recent acquisition of outdoor retailing business Oboz was a standout feature (up 39%) as the company adds new wholesale customers and invests in brand awareness. Shares in CBA were sold due to valuation concerns and outperformance relative to peers in the last 12 months. Financial stocks have become unattractive investment options for many as they are trading at record low dividend yields with little growth and record high premiums to net asset value. While the NZ market will continue to be supported by very low interest rates, having already seen a return of 24% year to date, the manager is increasingly concerned about the level of NZ share prices and valuations.
Harbour Australasian Equity Focus Fund	3.2%	The fund underperformed the market benchmark over the quarter as strength in Kathmandu, Afterpay and Summerset were offset by downgrades in expectations in Vista Group, a2 Milk and Syrah Resources. Kathmandu upgraded profit guidance and acquired Rip Curl which is seen as complementary and diversifying addition with good prospects for growth. Retirement village operator Summerset announced their entry into the Australian market and has seen strong demand for units in their Ellerslie and Hobsonville villages despite the slower Auckland housing market. While the manager is wary of high share price valuation's they believe these are still relatively attractive against the backdrop of low interest rates, especially since lower rates imply a lower risk free rate (RFR) and many investors have yet to reset their view of fair value. For example, a 1% cut to the risk free rate used in analyst dividend discount models would imply a 30% to 40% increase in the share prices for portfolio holdings like a2 Milk, Goodman Group, Vero and CSL.

INTERNATIONAL EQUITIES

The performance of international equity markets was mixed over the quarter with the world index ending up 1% in local currency terms. Developed markets were strongest with Japan +3.1%, US +1.7%, UK +1% and Germany +0.2%. Emerging markets fell -4% with China down -2.2%. Shares slumped in August before recovering in September with major factors including concerns surrounding the direction of global trade policies and volatility in interest rates as central banks cut rates aggressively. The quarter finally offered some respite for fund managers who invest in value stocks rather than growth stocks. The valuation gap between expensive and cheap stocks reached its widest point in nine years in June and the rebound in September hinted at investors looking to exploit this opportunity and rotate into value stocks which will benefit more from easier monetary conditions.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	6.4%	The fund was up 3.2% in A$ terms for the quarter which was slightly less than the market. The manager notes year to date fund returns are amongst the highest in the last 20 years - albeit they are lagging the broader market where secular growth stocks and defensive stocks continue to be purchases by investors for their perceived safety. This reflects a growing consensus view of slowing economic growth, rather than any specific benefit from ultra-low interest rates since all stock values increase with a lower discount rate. Despite some US and European data appearing unsupportive of continued share market strength these crowded trades could rapidly unwind and the manager believes there is a reasonable chance we could see one or more of the following occur: a resolution of the trade situation, fresh recognition that China is growing, increased fiscal spending by countries or an expectation of higher interest rates. Especially given there is a US election looming and the self-esteem of the main protagonist appears inextricably linked to the level of the share market. The manager is therefore comfortable remaining largely invested away from the crowd in cyclical companies and primarily across Asia (underweight US) as they have been for the last 5 years. Over this time Asia Pacific stocks have returned 78% for the fund with key contributors being technology leaders (Alibaba, Baidu, China Mobile), insurers (Ping An Insurance, China Life), regional banks (Bangkok Bank, IDFC) and sportwear brands.
Monks Investment Trust	2.3%	The fund was down -0.7% in GBP terms for the quarter which was below the market. While the manager takes a long-term approach to building their portfolio (turnover is typically low), there have been some changes following a period of strong outperformance relative to markets. An inability to leverage a vast and rich dataset saw online search and entertainment company Baidu sold after the manager lost confidence in management. Overvalued share prices saw several retail bank holdings sold. Funds were redeployed in several healthcare companies such as Sysmex (biopsy machines), Abiomed (cardiac pumps) and Illumina (gene sequencing). Microsoft was also added to in the belief that the company will grow even faster as it maximises the strength of its position in cloud computing and grows its subscription-based business model.

		The manager considers good stewardship to be important in the success of any business i.e. running the business for the long-term and with consideration given to the needs of its stakeholders and wider society. This approach is reflected in the type of companies they invest in and how they actively engage with owners, management and board members. Key principles they look for include; prioritisation of long-term value creation; a constructive and purposeful board; long term focused remuneration with stretching targets; fair treatment of stakeholders and sustainable business practices. Engagement can take many forms including agitating for change or providing positive advice and support.
Magellan High Conviction Fund	4.2%	The fund was up 1.1% in A$ terms for the quarter which was less than the market. Current market volatility is expected to continue due to trade tensions and the manager expects any short-term truce will largely be a domestic political question for Trump. It is in his interest to have an ongoing fight with China in the run-up to the election, so that he can show he is being tough on behalf of America, but only if the share market doesn't collapse in the meantime. Despite the slower outlook a US recession is not expected since the financial system is robust, unemployment and interest rates are low, and the economy is not overheating. The manager launched a new listed investment vehicle during the quarter, raising $250m to invest in the high conviction strategy. Current company holdings include Alphabet, Apple, Berkshire Hathaway, Facebook, HCA Healthcare, Microsoft, SAP, Starbucks, Visa and recent acquisition LMVH which is the leading luxury goods group in the world. The French company has a portfolio of prestigious luxury brands across fashion, watches, jewellery and cosmetics and has posted strong earnings despite slower global growth. A growth market is the affluent Chinese consumer, a segment which is growing at 30% p.a. and currently makes up 1/3 of all company sales across brands such as Louis Vuitton, Christian Dior, Moet Hennessy, Bulgari, Tag Heuer, NZ's Cloudy Bay and more recently the Orient Express.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	1.4%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD which means values were not impacted by a drop in the NZ dollar against the AUD (-3.0%), GBP (-%) and USD (-6.9%).
iShares Russell 2000 Index Fund	5.2%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD which provided a benefit over the quarter as the NZ dollar fell sharply.
Vanguard FTSE All-World ex US Small Cap Index Fund	4.6%	
Vanguard Emerging Market Index Fund	3.0%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets have lagged developed markets as investors appear to be losing confidence that globalization is sustainable. Global trade has been the engine of growth for emerging economies over several decades. Despite this uncertainty there were positive developments such as tax cuts in India including incentives to attract manufacturing from China, Indonesia's re-elected President has announced a 5yr infrastructure spending program and Brazil is closer to resolving pension reforms.

COMMODITIES

Global growth continued to slow with most manufacturing indices contracting and putting pressure on commodities. Weak demand saw price falls for Copper -4% and iron ore dropped -20% to US$93/tonne. Oil prices were down -8% despite a drone attack on Saudi oil facilities which temporarily knocked out 50% of their oil production. This reflects crude's inability to sustain higher prices due to unfavourable global demand vs supply. US energy independence, a dream since the Carter administration, is forecast to be achieved before the end of the year. In contrast precious metals such as Silver and Gold have benefited from a flight to safety and lower bond yields. Gold rallied 5% to near US$1500/oz and benefit from any increase in share market volatility or weakness in the US dollar.

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	5.3%	The fund provides passive index exposure to commodities and is valued in USD.

FIXED INTEREST

Global fixed interest yields hit record low levels in August in response to escalating trade tensions and weakness in the global manufacturing sector. The US cut rates by 0.5% over the quarter and another 50bp of cuts is expected by mid-2020. Even this would not be enough for President Trump who has been increasingly strident in his demands to slash rates in support of his trade war(s) and keep the share market buoyant in the run up to Presidential elections. In Europe, Brexit uncertainty continues, while Germany's economy is flirting with a technical recession as demand for automotives slows dramatically in key markets such as China. Germany's 10-year yield touched lows of -0.75% and the European central bank lowered its key deposit rate by 10bps to -0.5% while kick-starting quantitative easing.

Reserve Banks in Australia and New Zealand lowered short term interest rates to record low levels in an attempt to boost weak business and consumer sentiment amid lower growth and increased uncertainty. This was good news for borrowers (Australian house prices have bottomed in the 5 capital cities) but not so good for those that rely on fixed incomes and a return on their savings to fund consumption. The RBNZ surprised the market with a 0.5% cut to the OCR In August and expectations are for an additional 0.25% cut in November before moving to 0.5% by mid-2020. Inflation has remained stubbornly below the 2% midpoint of the RBNZ target band as imported inflation remains weak and a weaker domestic economy leads to spare capacity. There is considerable debate however as to whether cutting rates further will have the desired impact on growth and inflation targets and the RBNZ has already indicated they are looking for the NZ Govt to provide support with fiscal spending initiatives.

Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	2.5%	The manager is holding a longer than benchmark duration position across fixed interest portfolios as global trade tensions are unlikely to dissipate meaningfully in coming months. They expect the yield curve to flatten and for longer term rates to adjust downwards as investors pick up the slightly higher rates being offered. In the credit space, shorter dated and higher rated corporate and bank issues are favoured given the uncertain growth environment.
AMP Capital NZ Short Duration Fund	1.4%	
Harbour Wholesale NZ Core Fixed Interest Fund	2.1%	The manager is holding a long duration position in portfolios as they expect yields to fall further across the yield curve given the weak economic outlook. However, given current record low levels they do not expect any move to be sharply lower and it is unlikely NZ will see negative yields like Europe. Technically it is difficult for NZ banks to pass on the full extent of a lower OCR since they are forced to fund themselves significantly via retail term deposit rates and can't risk losing depositors to competitors or alternative investment options.
Harbour Enhanced Cash Fund	0.7%	

ECONOMIC COMMENTARY

Trade Tensions Taking a Toll

Global Outlook

The IMF now sees global growth reducing to about 3.2%. This is still above its 30-year average of 2.6% but the slowest growth since 2009. The damage is being done by the significant export-led weakening in manufacturing as orders and output take a hammering from the fallout of the US/China trade war. Trade issues extend between the US and anyone else with whom it has a negative trade imbalance. Recently, the US is focusing on Europe and been successful in taking a World Trade Organisation complaint against Europe (Airbus industries) for subsidies. European carmakers are particularly worried. While the US has completed trade deals with Mexico, Canada and more recently Japan, new culprits such as Vietnam (a Chinese export proxy, see graph) are popping up and drawing the ire of Mr Trump.

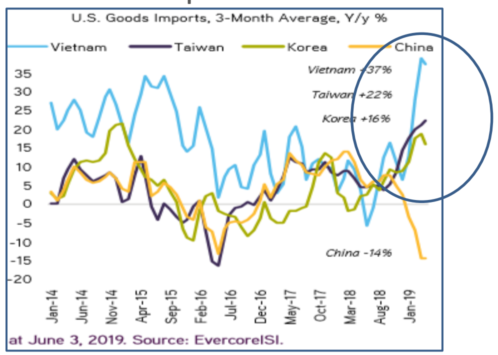
Despite several shallow overtures (next US/China talks in October), the US/Sino relationship continues to deteriorate following a failed agreement in April (China reneging). With bi-partisan political support in the US, a cold war has now broken out on broader US complaints. Trump said in his recent UN speech that patriotism and looking after one's own country must come first. "Not only has China declined to adopt promised reforms. It has embraced an economic model dependent on massive market barriers, heavy state subsidies, currency manipulation, product dumping, forced technology transfers, and the theft of intellectual property and also trade secrets on a grand scale". At the celebration of China's recent 70th Anniversary of the Communist Party, President Xi Jinping said "no force" would stand in the way of the country's economic development.

While the direct cost of trade tariffs and embargoes is economically significant, the real damage is being created by the uncertainty of doing business with any confidence. Businesses are losing orders, having to re-arrange supply chains and work into new markets while exiting others. The graph opposite from Bloomberg measures the impact on global GDP of actual tariffs (about -0.3%) with the orange bars. The white bars show the cost of the confidence impact (about -1%).

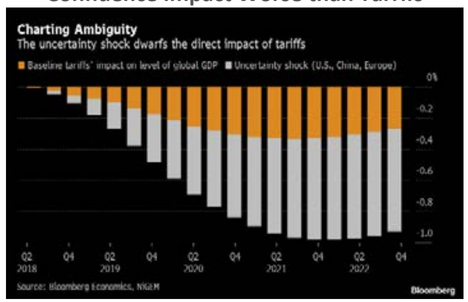
The trade disputes have now become enduring and likely signal the end of the globalisation trend that has enabled such global productivity gains over the last 30 years. We are returning to protectionism, regionalisation and isolationist policies that point to a structurally lower global growth outlook. This does not mean the world is going to "hell in a handcart" or that any global recession is imminent, just that it will be a different place to live and work in than the one we have had in recent times. Businesses, economies, capital markets and politics will have to adjust accordingly, and this includes how central banks set policies and governments allocate spending. We expect this developing environment will also be more inflationary than central banks are presently forecasting while any interim trade concessions will likely provide a sharp lift for markets.

Lower Global Growth – Weaker Manufacturing

Chinese Export Proxies to US



Confidence Impact Worse than Tarrifs



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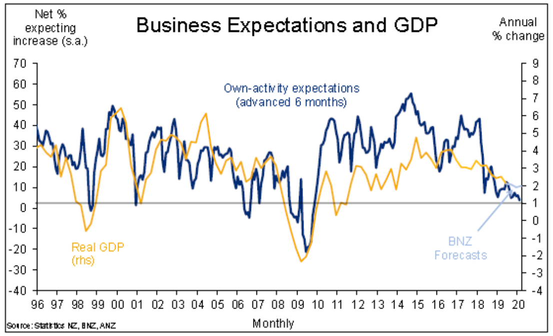
New Zealand

The New Zealand economy continued to lose momentum over the quarter with annual growth falling further and confirmed at 2.1% annualized for the second quarter. This is the slowest rate since 2013 and a significant drop since 2018 (3% outlook). Negative growth factors include; reducing net migration, the run-off of Christchurch earthquake work and the slowdown in the housing market (sales and prices). The latter impacts consumer confidence while business confidence is also weaker with all business surveys point to a continuing deterioration. The NZ Quarterly Survey of Business Opinion recently reported that a net 30% of firms were experiencing declining profitability. Rising wages, labour constraints, fuel and regulatory costs, softer offshore conditions and government policy confusion are all contributing to this lower confidence. Business expansion plans and investment intentions are weak while hiring intentions have also recently eased. The RBNZ OCR rate cut in August assisted exporters, but broader business confidence remains at the lowest levels since the Great Financial Crises. Given weak inflationary conditions, the RBNZ is likely to cut rates again in November and possibly February taking the cash rate to record low 0.5%. The RBNZ is also due to make a final decision in December on increased capital requirements for banks which may have a structural impact on borrowing costs and deposit rates. Despite the recent falls in borrowing rates, households are showing a reluctance to spend instead and are focused on paying down debt.

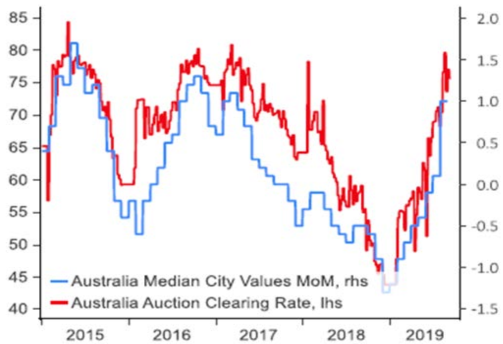
On the positive side, unemployment remains at intergenerational lows (3.9% June quarter) with wages growth supported by the large increase in the minimum wage. Our terms of trade are at 50-year highs providing much needed relief for exporters with export volumes holding up despite the tougher conditions offshore. Construction activity outside Christchurch also remains positive with recently very strong house consent levels in Auckland and home building is up around 5% from a year ago. Government expenditure has increased but not contributing to GDP growth to date (mainly benefits transfers and public servant pay while Kiwibuild was abandoned). Further spending programmes are likely to have more of an impact over the next year while record low borrowing costs will likely underpin house demand and prices through spring and summer. An interesting aside to our infrastructure pressure, MBIE advise almost 1 in 10 people now living in NZ are doing so on a migrant visa.

NZ Business Confidence at a 9 Year Low



NZ Consumer Confidence

Australian Dwelling Prices



Australia

The Australian economy was weaker in the June quarter (up 0.5%) and at a 10-year low (1.4% annual rate), as lower housing construction and poor business investment impacted activity. Net exports however improved with solid commodity price gains assisting Australia to a record trade surplus and also creating a current account surplus (first since 1975). After lowering the cash rate in June and July, the RBA again cut the rate in early October to 0.75% despite an improving domestic setting. Like other central banks, the RBA is keen to get in front of the slowing global picture by ensuring the Australian dollar remains competitive for exports. The lower cash rates and borrowing costs have led to a sharp resurgence in Australian house prices which have been significantly depressed over the last 18 months. This recovery is likely to lift household confidence and consumption while tax rebates and higher wages (up 4.7% over the year to June) will also assist the important consumer sector. Business confidence also recently strengthened to a 13-month high. An interesting aside, Australia supplied 74% of China's imported iron ore

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in June - almost double 10 years ago, as well as 46% of China's LNG. A Chinese academic Yu Lei has warned in The Global Times (reported by AFR) that Australia faces "100 years of solitude" if it isolates itself from its Asian neighbours by strengthening military ties with the United States.

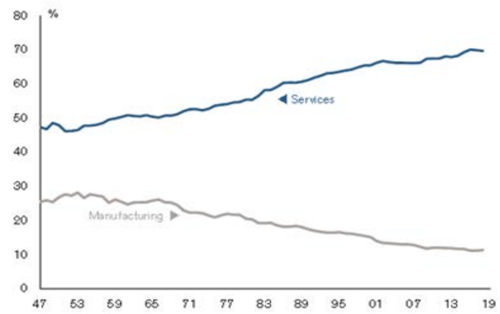
US

Although the US economy has continued to perform well it is also starting to feel the effect of the global manufacturing slowdown. Though only representing 10% of the US economy, manufacturing has been much weaker than expected and continues to deteriorate and contract. The graph opposite shows factory activity falling to a 10-year low. Offsetting this manufacturing weakness, the services sector of the economy has held up well but also starting to see signs of stress seeping over from the manufacturing side. Rising home sales/prices, rising incomes and intergenerationally low unemployment claims are still boosting household confidence and leading to the strongest consumer spending in 4.5 years. This better consumption eases the fear of any near-term recession and housing growth (on lower interest rates) should provide an effective offset to weaker business investment. US housing starts and permits have both surged to their highest level since 2007. Despite a reasonable domestic picture, the Federal Reserve cut interest rates by 0.25% to 2% in September citing global growth concerns and increasing trade policy tensions. The decision to cut rates was a split decision noting that the labor market remains strong while they also upgraded the US GSD outlook for 2019 and 2020. Trump continues to lambast the Fed - wanting greater cuts to support growth ahead of 2020 US elections. The market is pricing in a 66% chance of a further rate cut in December, but recently strong wage inflation data may change this.
Impeachment proceedings have commenced against President Trump which will be distracting but ultimately likely to fail unless an indisputable smoking gun can be found. This may embolden the Chinese who have become increasingly worried about a Trump second term tenure. During the quarter the US doubled down again on China trade issues implementing a further $110 billion of tariffs on mainly imported consumer goods. The final $190 billion of tariffs (total $300billion) will come into effect in December. China retaliated with $75billion on US imports. Additionally, the US has moved against strategically significant Chinese companies with recent rumors of broader investment restrictions on investment in Chinese companies. Finding a solution to the trade war is becoming increasingly unlikely, although talks are expected in mid-October. Any resolution would significantly lift global sentiment - but a resolution is not a political necessity for Trump.

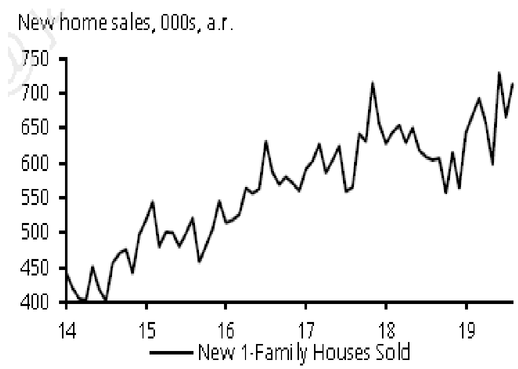
China

Chinese economic growth also continues to moderate despite significant stimulus is being applied to try and shore up their economy. This is being done through increased government spending, easing bank lending restrictions, infrastructure investment and tax cuts. Industrial output is at its lowest levels since 2002 and retail sales also slower although services industries have held up well. ANZ noted that China, unlike the US, is not yet able to rely on domestic consumption as its growth engine. More recent monthly data suggests some stabilization for growth is

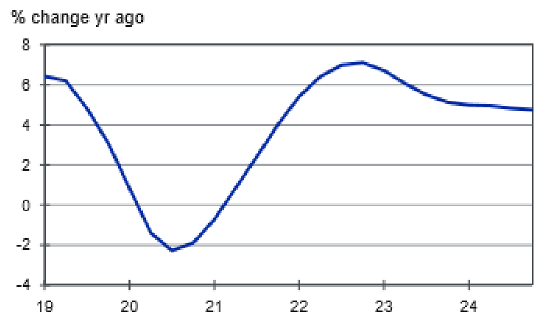
US Manufacturing Down, Services Steady



US Home Sales and Prices Rising



Chinese GDP Growth still Moderating



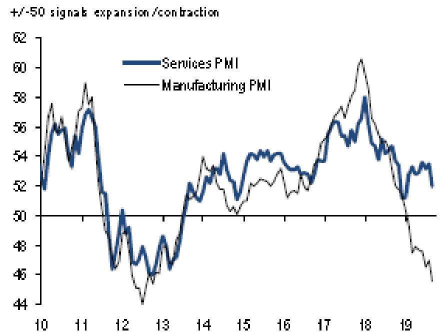
Sources: National Bureau of Statistics, Moody's Analytics emerging. The trade war is certainly impacting China with exports slowing and imports plunging (lower US imports) though much of China's slower growth is largely self-imposed. China continues to juggle the transformation of its economy to bring greater wealth to the masses and less prosperity to the business, bureaucratic and political elite. China suffers from the same wealth concentration issues as the rest of the world and the ruling party know that time is running out to share the benefits of their great economic achievements. President Xi continues to deal with the multi-pronged challenges of building domestic demand, strengthening China's vulnerable financial system and increasing their regional power and global influence. There is also a drive to raise nationalism, perhaps to steady the masses and retain their focus to the cause but, also to impose greater internal stability that is currently looking more precarious (Hong Kong). The recent parade in Tiananmen Square to celebrate 70 years of Communist Party rule looked like a throw-back to old-style Soviet displays of power. It was designed to impress the world and consolidate Xi's power. Xi said "no force" would stand in the way of the country's economic development and promised to maintain stability in Hong Kong. Whether or not China arrives at some trade deal with the US is becoming less relevant to the economies of both countries by the day. The focus has regrettably now become more militaristic and cold war based.

Xi Celebrating 70 years of Party Rule

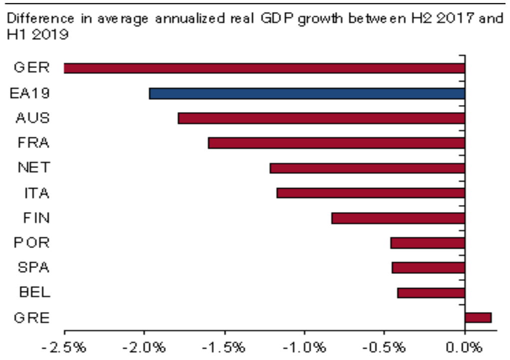
Europe & UK

Germany's manufacturing shrank at is fastest rate in 10 years as global orders retreat on trade war disruption and potential US trade import restrictions further weigh on German car makers. A hard Brexit risk also looms in the background and there has been a recent slump in exports to the UK. The downturn in German production is the primary driver behind Europe's weaker growth and Germany may now be in recession though recent business surveys have improved. Putting aside Brexit, the broader picture for Europe remains relatively steady with services industries robust and still expanding while employment and domestic consumption data is also supportive. The low inflation environment provides the ECB with room for further quantitative easing measures if required. The ECB recently cut rates to a more negative level (-0.5% from -0.4%). As monetary policy looks like reaching its limits there has been a significant push for fiscal stimulation - particularly from the historically conservative (financially) German government which may be keeping its powder dry ahead of a possible hard Brexit outcome. France recently announced it would reduce taxes on individuals and businesses by €10.2 billion.

Services Keep Europe Going



Germany – Greatest Euro Slowdown.



Source: Credit Suisse, Eurostat

The UK remains engulfed in constitutional crises. It appears that European officials have all but given up hope of finding a way forward for a Brexit resolution as Boris Johnson continues with his inflammatory rhetoric and quest for a general election. The Government has prepared a draft plan proposing customs clearance centers on the Irish border or for an entire Irish sea border as a solution to the Irish backstop. Ireland won't accept this. The move appears more designed to push parliament for a general election. Mr Johnson believes he can win this and return with a majority. With time running out to 31st October an extension with the EU appears the most likely outcome as opposition MPs don't want to risk an early election nor want to table a no confidence motion in the government. While the rest of the British economy is holding up remarkably well (1.4% growth rate), manufacturing like everywhere else in the world is contracting and business investment stalling on Brexit fears (see chart opposite).

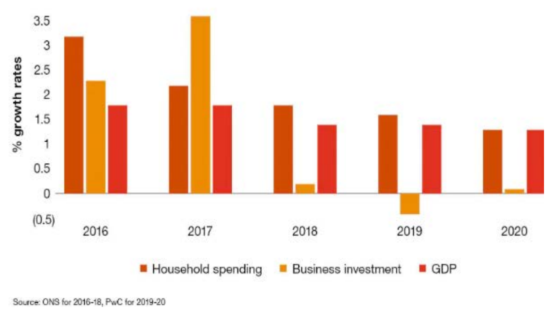
Japan

Despite a one sided mini-trade deal with the US in September (benefits the US), the downside risks to Japan's economy are growing. Exports are down on global trade disruption, but Japan's fundamental problem remains weak domestic demand and very low inflation. This month the Japanese government raised its VAT from 8% to 10% which is likely to further suppress demand - although the Rugby World Cup will inject some additional consumption into their economy this quarter. With a VAT increase and softer export outlook; Japan may again tip into recession. As inflation remains well below its target, the BOJ will likely cut rates again later in October from -0.1% to -0.3%. There is also an expectation the Government will implement some new short-term stimulus to offset the structural tightening of the VAT hike. Like other economies the race to the bottom for rates may keep currencies in check but do nothing for consumption particularly for economies like Japan that have such older demographics.

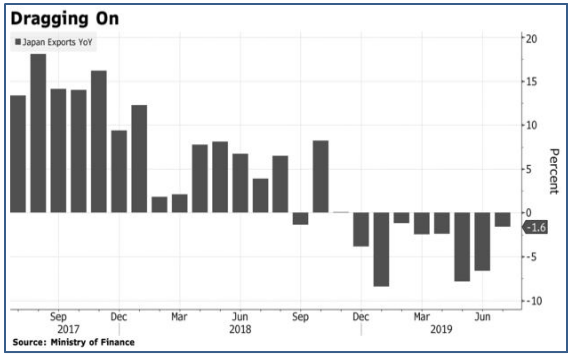
India and Emerging Markets

While some Asian countries are strongly benefiting from the US / China trade war (Vietnam in particular), others are being impacted by the changes to supply chains and slowdown in trade traffic. Foreign Direct Investment is also being impacted with the World Bank estimating about USD1.3trillion of outflows from emerging economies. In response to the slow down and capital outflows; Hong Kong, Thailand, South Korea, Indonesia and Singapore have all implemented or have announced they will implement substantial fiscal stimulus over the next year ranging from tax cuts, substantial infrastructure spending (Indonesia is looking to create a new capital city) easy access business loans and direct business subsidies. The Asian financial crises of 1998 resulted in authorities building up significant foreign reserves and stronger balance sheets and except for Japan, most Asian governments have small fiscal deficits and low debt levels enabling them to provide sustainable stimulus if required. Though it still faces significant structural challenges, India has the best outlook and is now likely to be the fastest growth economy at 7.0% (IMF). Elsewhere Russia has made little progress on re-modelling its economy remaining reliant on energy, timber and agricultural exports while their standard of living continues to decline. South American countries are running at below trend growth with Brazil and Argentina being squeezed by rising $US dollar debt servicing costs though better commodity prices have recently assisted.

Brexit - Weakening Business Investment



Japanese Exports Contract



Emerging Market Growth Lower