NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

Tuesday, 14 July 2020

June 2020 Quarterly Report

Following a tumultuous first quarter, investment markets rose strongly and recovered much of the prior period losses. After one of the sharpest market falls in history, we then had one of the fastest market rallies with investment portfolios performing well.

Continued supportive central bank policies and record amounts of government stimulus (spending) provided markets with increasing confidence that economies can look forward to a recovery from the present recessionary conditions. How much recovery we will see and when a return to pre-pandemic activity can be expected remains a source of daily debate.

At the time of writing, secondary waves of Covid-19 have broken out with record daily cases in the US and in other countries thought to have achieved containment. Developing countries are being very hard hit with limited testing and health services hiding the true extent of their infections. Politicians are finding it increasingly hard to implement ongoing containment policies let alone take populations back into more restrictive conditions. For those countries with extensive community transmissions, Covid-19 is now a health management issue that will be ongoing (possibly for years) and requiring medical solutions including virus vaccines.

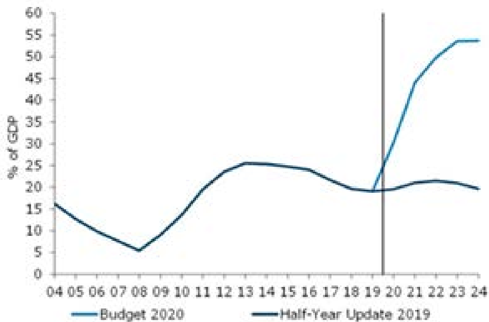
Despite the virus, economies have been recovering faster than expected on pent-up lockdown demand and government supported household incomes. We expect further volatility this quarter as markets grapple with rising market valuations, worsening Covid-19 news and with the many geo-political flashpoints ahead including US elections, Brexit negotiations and further trade and cold war rhetoric. Record low interest rates and further government spending will however continue to be market supportive.

Kind regards,

Wayne Ross
Director Investments

ECONOMIC AND MARKET SUMMARY

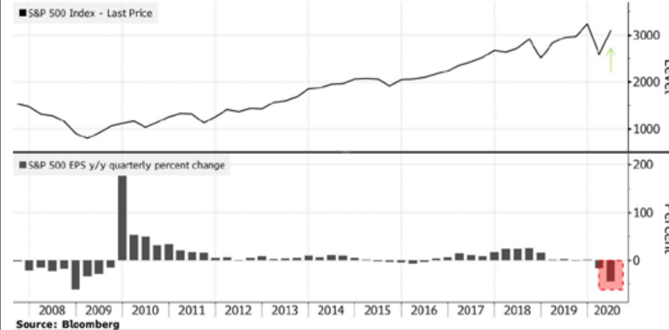
At the time of writing the WHO reported a one day high for global Covid-19 infections. In addition to second wave effects in countries that were containing the virus (US, Australia), emerging economies such as India, Indonesia, Brazil and Pakistan are now also reeling from the pandemic where cases and deaths are dramatically underreported.
Though recent economic activity has sharply lifted, the global economic impact of the pandemic may curtail GDP growth as much as -5.6% in 2021. This outcome includes the drastic monetary and fiscal policy stimulus being undertaken by world governments (some 10-15 times higher than during the Great Financial Crises). The cost of containment and then stimulatory policies looks like adding US$16trn of global debt this year with combined public and private sector borrowings rising past US$200trn for the first time or about 140% of global GDP. NZ's public debt is also looking to dramatically rise as the government borrows to preserve and then boost economic activity.



NZ Core Crown net debt (ANZ) Secondary virus waves will now stretch health management systems but also the political willingness and capacity to inject further financial aid (borrow more) into economies. It will also test their capacity to put their communities back into lockdown if required. Against this recently deteriorating backdrop, investment markets continue to perform strongly, having had their biggest quarterly rise in 30 years (after their sharpest fall in 50 years). How is this possible? Are markets so disconnected from the economic reality that Covid-19 brings? The answer is yes and no.

Over the short-term it is tough to see how markets can be so positive. Company earnings prospects, particularly for those sectors most directly impacted (tourism, travel, hospitality, and accommodation) are awful. Only 20% of US S&P 500 companies provided any earnings guidance over the last 3 months with most saying it was just too difficult. Dividends are also being cut as companies take steps including capital raisings to shore up balance sheets.

Different Directions
Stocks post best quarter in years ahead of worst earnings season since 2008



Despite the uncertainty, investment markets are looking beyond the short-term impacts of the virus. Markets are rallying because investors believe there is a recovery coming further down the road and that assets are good buying given these better prospects. An example of this is Auckland Airport whose earnings will be impacted for possibly years - but which remains an attractive asset for the long-term investor. The airport's recent capital raising was more than 5 times oversubscribed showing investors are very confident for the company's future. Those sectors best positioned for Covid-19 (including technology, communications, online entertainment, healthcare and biotech) are expected to continue to perform well despite already high share prices. Given many investment markets have risen back close to pre-Covid levels, how can we expect them to perform well from here with such a difficult economic backdrop? There are several supporting factors for this. Firstly, central banks will maintain cash rates at near 0% and keep longer maturity rates low by buying bonds (and other assets) on market. This provides liquidity in addition to price support ensuring easier access to borrowing while keeping borrowing costs low. Secondly, governments are committed to continued support through additional fiscal programs. With record debt levels, governments are relying on growing their way out of this situation (and via inflation) which is the only long-term solution. Thirdly, global cash levels & liquidity remain very high (NZ & US household deposits reached a record $189bn and $5.1trn respectively in March) and with cash rates near 0% these holdings can't be sustained and are re-deploying back into higher risk and returning assets. Finally, there are currently more than 100 coronavirus vaccine candidates with 4 of these already in human trials. These factors will continue to be supportive, but there is volatility ahead as the market grapples with valuations and short-term bad news over longer-term recovery possibilities. This investment cycle will likely end when growth becomes more sustainable and inflation jumps sufficiently to warrant central banks raising rates.

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

Market Returns	Jun. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**3.7%**	-0.9%	-3.1%	0.0%
$NZ v $US	**9.2%**	-1.0%	-4.1%	-1.2%
$NZ v $AUD	**-3.7%**	-0.6%	-0.6%	0.9%
NZ Cash	**0.1%**	0.8%	1.4%	1.8%
NZ Fixed Interest	**2.3%**	5.7%	6.0%	5.2%
Intl Fixed Interest 100% hedged to $NZ	**1.1%**	6.6%	5.5%	5.4%
Australasian Equities 50/50 Indexes	**18.9%**	1.7%	10.3%	10.0%
NZ Listed Property	**6.7%**	-8.3%	9.4%	9.1%
Intl Equities 50% hedged to $NZ	**14.2%**	3.9%	8.2%	7.1%
Commodities $NZ	**-3.2%**	-13.8%	-2.0%	-6.8%

SECURITIES RETURNS FOR THE QUARTER

During the quarter, the Australasian holdings were reviewed considering the current market environment and outlook and as a result, several changes were made. Extremely low interest rates are set to remain in place for some time and that will provide incentives for investors to seek out real asset exposure such as infrastructure, property, and company equity. The new company holdings added to the portfolio represent better opportunities to make the most of a resumption in global growth whenever that might be.

We have replaced National Australia Bank (NAB) with Macquarie Group (MQG). Margins in retail banking will remain under pressure with low rates and MQG have a lower retail banking exposure than NAB along with greater diversification from their fund management and infrastructure business. The company's asset management division (Macquarie Asset Management with $562 billion under management) and their banking and financial Services division (retail banking and cash management) are annuity style businesses which contribute around 60% of group profits. The remaining 40% comes from the group's markets facing businesses such as commodities, global markets, and investment banking. In a post pandemic world, with interest rates at zero and significant monetary and fiscal stimulus in most developed economies, it is expected the focus on infrastructure will assist MQG to deliver higher returns over the medium term.

We have replaced Scentre (SCG) with Goodman Group (GMG) who have less retail consumer exposure and more industrial exposure. GMG is a global property business comprising three main divisions: property investment which is the rent collecting business - largely industrial property with high occupancy rates and good lease terms; an international property development business focussed on industrial projects (development pipeline currently $10 billion); and a funds management business with external assets under management of $45.7 billion. Goodman's niche is industrial property with an emphasis on distribution infrastructure for online platform businesses which have benefited greatly from the growth in online shopping.

Finally, Vector (VCT) was replaced with Ramsay Healthcare (RHC). RHC operates private hospitals in Australia, Europe, Indonesia, and Malaysia. They have over 77,000 employees worldwide and over 8.5m admissions per year with reported revenue of more than A$11 billion. RHC offers the potential for consistent growth, as demand for healthcare and particularly hospital services remain well supported due to aging populations and a growing incidence of lifestyle diseases. Australia is a key market for RHC representing 60% of operating earnings in 2019. The market is highly concentrated and RHC has c. 36% market share. Around 35% of hospital beds in Australia are owned by private operations and private health insurance is high at over 45%. Elsewhere the company is growing its European business both organically and by acquisition. Funding for hospitals will continue to grow in line with demand and RHC is well placed to capitalise on this. In the short term, RHC has negotiated a contract with the government in its jurisdictions to offer hospital services for pandemic response whilst elective surgery is postponed. Post pandemic, we are likely to see a sharp lift and catch up in elective surgeries.

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	37.5%
Contact Energy	Energy	8.4%
F&P Healthcare	Healthcare	13.6%
Fletcher Building	Building	5.7%
Freightways	Transportation	29.6%
Meridian Energy	Energy	18.6%
Port of Tauranga	Ports	27.3%
Stride Property	Property	31.7%
Vista Group Intl	Software	29.7%
Australian Equities		
BHP Group	Resources & Energy	25.9%
Brambles	Professional Services	6.6%
CSL	Healthcare	3.8%
IAG	Financials	-3.8%
Macquarie Group	Financials	24.3%
Goodman Group	Property	16.6%
Ramsay Healthcare	Healthcare	9.0%
Sonic Healthcare	Healthcare	29.2%
Westpac	Financials	12.9%
Woodside Petroleum	Energy	23.4%
Woolworths	Consumer Staples	9.5%

- F&P Healthcare became the first NZ listed company to be worth $20 billion after reporting a 37% increase in profit and a higher dividend. Even before the impact of Covid-19 was fully recognised, the company's respiratory equipment had experienced strong demand from hospitals and its non-invasive Optiflow breathing aids have since gained acceptance as the preferred front-line treatment for Covid-19 as an alternative to ventilators. Demand has continued to rise with a further 300% jump in the June quarter and the company hopes the wider use of its devices will increase acceptance of FPH hardware to treat a broader range of respiratory conditions and therefore create higher demand for profitable consumables such as masks.
- Auckland Airport raised $1.2b of new equity, attracting strong interest from both international and local investors. We participated in the share purchase plan on behalf of clients. AIA has reduced its workforce by 25% and reduced wages by 20%, suspended consulting work and large capital expenditure projects. Despite these changes, given that international passenger numbers are only 5% of normal traffic and daily flight numbers down 80%, further staff layoffs are expected.
- Chevron announced the start of a formal sales process for its 16.6% interest in the Woodside operated North West Shelf project after receiving unsolicited offers. WPL has US$7bn in liquidity so they can afford the likely US$3.2-3.7bn price tag. A purchase by WPL (or another new buyer) would likely see the project progress more quickly and subsequently benefit from a market re-rating.
- Australian public hospital elective surgery waiting lists are rising and Ramsay Healthcare stands to benefit from the demand by those who can access private healthcare rather than waiting. There is also a move for private hospitals to contract with the public system to deliver services and the NSW Government recently announced an additional A$388m to allow public patients to be treated in private hospitals.
- Vista successfully raised $65m in additional capital from existing shareholders to improve financial flexibility while their customers are materially impacted by the pandemic. We participated in the share purchase plan on behalf of clients. The company has moved quickly to reduce costs and announced restructuring plans to realise $12-15m in annualised savings. Cinemas in some

- Fletcher Building is to repay US$300m of US$ debt early to save NZ$17m a year in additional interest costs. This debt was issued in 2012 with an average interest rate of 5.4%. After repaying this amount, the company still has $1.1b of short-term liquidity available if required.
- IAG is proposing to shut its 53 AMI retail stores and move 350 staff to digital and contact centre roles. The move reflects a decline in visits to retail stores that has been exacerbated by Covid-19 as more customers engage through online channels, email, and phone. IAG NZ is the largest general insurer in the country trading under the brands of AMI, State, NZI, NAC, Lumley, and Lantern.
- Freightways is back to normal freight volumes across their NZ Couriers, Post Haste and Castle Parcels businesses. While some have speculated that large increased volumes have been the cause of delivery delays, the company advised that it is more related to the fact that residential deliveries (which previously only accounted for 20% of volumes) take longer and cost more per delivery. Most (98%) of deliveries are completed within 2 days. In response to media comments about tougher working conditions, CEO Mark Troughear commented that average courier earnings of $103k p.a. were competitive.

parts of the world such as NZ have begun to re-open albeit with social distancing and limited new film content. Vista have released a Cinema re-opening kit with refreshed technology support for managing seating capacity and contactless food and beverage purchases.

- Following the end of the quarter, Rio Tinto announced they were closing the Tiwai aluminium smelter due to high energy costs and the challenging outlook for aluminium prices, despite producing a high-quality product. The smelter consumes 13% of all New Zealand's electricity and when the supply contracts with Meridian Energy are terminated in August 2021, this excess supply cannot be redirected north where it is needed until Transpower complete key transmission upgrades (earliest June 2022). Meridian Energy and Contact Energy will be negatively impacted in the short term with profits down and dividends potentially cut. In the medium term they should be able to rebalance assets to replace higher cost plants and accelerate a shift towards low-carbon electricity at a lower cost and improved profitability.

AUSTRALASIAN EQUITIES

The Australian market ended up 20.9% in NZ dollar terms driven by a 28% lift in resource stocks as global demand improved, while there was profit taking in Healthcare and Consumer Staple stocks which had been the best performers last quarter. The NZ market rose 16.9% with Fisher & Paykel Healthcare (FPH), a2 Milk and Auckland Airport (AIA) the largest contributors to index performance while EBOS, Precinct and Goodman Property were the largest detractors. The broad NZ market is now largely unchanged for the year to date however that masks some very different individual company outcomes. FPH for example is up 60% year to date and represents 16.5% of the index, while companies such as AIA, Ryman and Fletcher Building are all down over 20% as investors weigh up the short term impact of rising unemployment, weak order books and lower migration against the positive stimulus of record low mortgage rates. The quarter saw a number of capital raisings, large changes to earnings guidance and initial optimism followed by deflation regarding the possibility of a Trans-Tasman bubble.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	15.2%	The fund performed broadly in line with the market benchmark over the quarter. Metlifecare, F&P Healthcare, Coles and Genesis Energy helped performance while Oil Search weakened on falling crude prices. The manager notes the divergence in performance between growth stocks and value and high dividend stocks. Usually during a market correction value (cheaper) stocks and those offering high dividends will perform better than growth stocks. This unusual behaviour may be to do with a growing retail interest in shares (where investors tend to buy good investment stories rather than worry about valuations) and the large volume of passive index buying which favours large companies. It may also be impacted by the fact that already 27 NZ companies have cancelled, deferred, or reduced their dividends due to the impact of Covid-19. NZ has historically been a high dividend paying market and now offers less from a cash yield perspective than Australia (3% vs 3.2%). That said, dividends still offer a better return (albeit with more risk) than term deposits and this may provide the catalyst to unlock part of the $190bn sitting in retail bank deposits. With an estimated $20bn currently in direct equity ownership even a small re-allocation from cash could have a meaningful impact on local share prices.
Harbour Australasian Equity Focus Fund	25.0%	The fund outperformed the market benchmark over the quarter, benefiting from investments that can grow through a period of slower economic growth. The announcement of commercial arrangements for Pacific Edge Biotech with major US customer Kaiser Permente (endorsing and adopting their bladder cancer testing products), positive export data for a2 Milk, increased retirement unit sales for Summerset and an earnings upgrades for Xero and Pushpay all boosted returns. Detractors included Sanford due to difficult trading conditions for food sales and weakness in Ebos as a large long-term shareholder reduced their stake in the business. Also helping returns was the additional purchase of shares in companies that were significantly oversold in March (Fortescue, Summerset, Serko, Mainfreight, Scales and Volpara) and participation in 10 capital raisings (several of which were offered at a large discount). The manager tracks a number of real time indicators in order to gauge the economic mood and believes measures such as card spending, electricity demand, traffic counts, Google mobility data and Trade Me job advertisements all point towards the worst of the drop in economic activity being behind us.

INTERNATIONAL EQUITIES

The benchmark global share market index rose 19% over the quarter, the best quarterly performance in 11 years after an ebbing in coronavirus infection rates across developed countries allowed governments to ease restrictions on everyday life and policy makers provide yet more stimulus. All 11 market sectors rose with Information Technology leading (+31%) as IT companies reported robust earnings and with Utilities as the laggard (+6.2%). Across developed markets, performance was mixed with the NZ market up +17%, US and Australia +20%, Japan +18%, Europe +18% and the UK +9%. Much of the sharp rebound has been driven by heavy cash flows re-entering the market following the seemingly endless fiscal and monetary policy support.

Valuations for many sectors are too difficult to determine given the uncertainty of earnings and as profit estimates decline at record rates. Though this seems counterintuitive for the rally, investors are clearly looking past the current recession believing better times lie ahead. US market forward valuations have jumped from 16.5x to 25x reflecting how difficult earnings estimation is. In comparison the NZ market has jumped from 24x to 38x earnings, but much of this has been driven by our two most successful stocks A2 Milk and Fisher & Paykel Healthcare. Growth stocks continue to perform better than Value stocks as the large technology, online trading and entertainment players continue to perform well through the pandemic. With the massive increases in money supply and ultra-low interest rate settings, the TINA trade (There is No Alternative) is well in play. From here we expect markets will grind higher particularly if early vaccine treatments become more viable. Conversely, if second wave virus scares become imbedded as a significant health management issue and lead to further lockdowns - then markets will become more nervous and retreat on greater earnings uncertainty.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	5.0%	The fund was up 1.2% in A$ terms for the quarter. The manager has maintained a very cautious approach to the resurgent share market, believing that investors have gotten ahead of an economic recovery which depends on economies getting back to work. They point to the extreme divergence between market winners and losers and the concentration of the bull market in a narrow range of mega-cap stocks such as Microsoft, Apple, and Amazon. Strong performance in health care, semi-conductor and logistics holdings has not been enough to offset the sell-down in more cyclical Energy and Materials companies while short positions have lost value as extreme stock valuations have moved even higher. The good news is the market turmoil has uncovered some positive investment opportunities over the next 3-5 years and exposure to the heavily sold down travel sector has been achieved by new investment in on-line booking platforms and jet-engine production.
Monks Investment Trust	19.2%	The fund was up 31.3% in GBP terms for the quarter and has done extremely well relative to the benchmark during this volatile period. The manager puts this down to a focus on the future and a range of long-term secular growth trends which have isolated the portfolio from some of the current pressures facing more traditional industries. The pandemic is accelerating trends that were already in play, driven by technological change and environmental necessity. The most obvious being the growth of digital

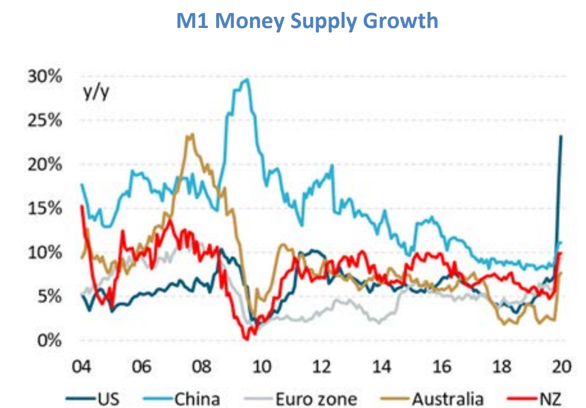
		solutions to consumption, entertainment, healthcare, and business operations. There is also the possibility of significant new developments, for example in the impetus towards addressing global warming through policy and tax changes. Some of the most recent share sales reflect the difficult operating environment expected over the next few years but in general the portfolio is well positioned with low levels of indebtedness across holdings, minimal exposure to the energy sector and only modest exposure to cyclical or economically sensitive companies. Over the last year a total of 17 new stocks were purchased and 16 sold which is consistent with an average holding period of 6 years. As well as taking profits in companies where valuations have reached expected long term worth, the manager has also added to positions which have done very well already (such as Alphabet, Microsoft and Naspers) where they believe the investment story still has further to run.
Magellan High Conviction Fund	9.9%	The fund was up 5.9% in A$ terms for the quarter. There were no detractors in performance in local currency terms while the biggest positive contributions came from Microsoft, Tencent and Facebook. Microsoft gained after reporting better margins in its cloud and server businesses which increased revenue by 15% to US$35bn. Facebook advanced after the social media company saw revenue rise more than expected by 17% to US$18bn in the March qtr. as the number of daily active users jumped 11% (despite recent advertising issues). Tencent announced it will spend US$70bn in digital infrastructure over the next 5 years in alignment with the Chinese governments desire to use IT to restart the economy. Tencent operates WeChat (similar to Facebook) which is China's leading social network and communications platform with 1.2 billion users on-line for an average of 100 minutes every day. Tencent has leveraged that user base to offer additional services such as online gaming, digital payments, cloud computing, video, music, and news, with the result that Tencent apps represent roughly 40% of all Chinese mobile user time.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	18.6%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZ dollar which means values are not impacted by currency movements.
iShares Russell 2000 Index Fund	14.8%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD and the 9.2% rise in the NZ dollar against the US$ over the quarter reduced returns.
Vanguard FTSE All-World ex US Small Cap Index Fund	13.0%	
Vanguard Emerging Market Index Fund	8.5%	The fund provides passive exposure to companies listed in emerging markets and is also valued in USD which assisted returns.

COMMODITIES

While there is still significant uncertainty about the pace of the reopening of the global economy, the recovery in the Chinese steel industry and supply constraints has provided a sound backdrop for iron ore prices. Oil prices are still waiting for global transport networks to recover; however, an agreement between Saudi Arabia and Russia to reduce supply helped sentiment. The uncertainty around the inflationary impact of massive government spending and loose monetary policy has seen gold prices rise to multi-year highs. NZ commodities have generally improved on better offshore demand with dairy, horticulture and timber up – although rising shipping costs will start to impact timber exports.

FIXED INTEREST

Central banks continue to pump money into their economies with increasing quantitative easing actions driving down yields across the curve and sending money supply growth to near record levels. Subsequently, bonds continued to do well over the quarter with the NZ Composite Investment Grade bond index up +3.5% and NZ government bond index +2.25%. Despite a recovery in credit spreads over March and April, investors remain more wary of non-investment grade issues. Quality and longer duration provided better returns. Though central bank actions have successfully provided liquidity and stabilized markets, markets remain cautious about inflation as global demand returns and global supply chain risks rise on de-globalization trends. For now, central banks have signaled a preparedness to let things run hot as economies recover. Money supply growth normally leads to inflation, and an inflation spike remains the greatest risk for fixed interest and growth asset markets alike. We consequently continue to remain conservatively positioned and short of market duration.



The Reserve Bank of NZ increased the scope of their potential bond purchases from $30bn to $60bn in May to cover the increased issuance by Treasury. The large-scale asset purchase program was successful to the extent that 10-year NZ Government bond yields fell from 1.3% in March to a record low of 0.6% in mid-May. The RBNZ purchases were so successful NZ 10yr yields dropped below the equivalent Australian and US rates (by 0.4% and 0.1% respectively), and consequently demand from foreign investors fell and yields lifted again by the end of the quarter. The outlook for company earnings remains uncertain, but despite the heightened risk corporate debt remains in strong demand with few new issues coming to market and investors chasing extra yield given the sharply lower cash and term deposit rates.

The move to Level 1 restrictions has seen a partial rebound in consumer confidence and business activity. However, unemployment is set to rise further and there is little sign of inflation. The RBNZ has been able to stabilise the level of interest rates by directly buying bonds – although to stimulate the economy sufficiently and to achieve their dual targets of full employment and inflation between 1% and 3% - they may determine even lower short term rates are required. The assumption is that a negative OCR would lead to lower retail lending rates which in turn leads to higher demand and consumer spending. There is much debate however about how well this works in practice with concerns over bank profitability reducing credit supply and the evidence from offshore markets is mixed. If the RBNZ does decide to use a negative OCR as

a policy tool, then we would expect short term bond rates to also move negative and the value of the NZ dollar fall. As we saw in June however the relativity of our interest rates with the rest of the world remains important to attract and retain foreign investor capital since non-residents hold 50% of NZ Govt bonds (down from 70% a few years ago). Longer term rates may need to remain relatively high to attract sufficient capital to support NZ government spending initiatives. The additional spending announced so far will see NZ bond issuance explode from $65 billion to $210 billion and net crown debt rise from 20% to 60% of GDP.

<table>
<tr><th>Security</th><th>Quarterly Performance In NZ$ terms</th><th>Commentary</th></tr>
<tr><td>AMP Capital NZ Fixed Interest Fund</td><td>4.6%</td><td rowspan="2">The manager has reduced their long duration bond exposure position by selling government bonds as supply concerns outweigh the impact of RBNZ buying. The easing of lockdown restrictions also reduces the likelihood we will see the OCR in negative territory. However, the longer-term outlook still looks bleak and is likely to require ongoing central bank support. Any lift in yields would see the manager repurchase longer dated bonds. They have a neutral view on credit with an overweight position in senior bank bonds which offer a pick-up in yield while limited supply has been boosting prices. Looking forward, expected returns in fixed interest are likely to be lower than recent years with the OCR near-zero, bond yields historically low and demand for safe-haven assets waning with the rally in equities. Despite that yields are not expected to significantly rise any time soon as the RBNZ continues with its bond buying program in an effort to support the economy.</td></tr>
<tr><td>AMP Capital NZ Short Duration Fund</td><td>3.8%</td></tr>
<tr><td>Harbour Wholesale NZ Core Fixed Interest Fund</td><td>3.0%</td><td rowspan="2">The manager began the quarter conscious of the tremendous uncertainty surrounding the impact of Covid-19 on corporates and the measures by central banks to support their local economies. This meant initially holding a slightly longer duration position than market but reducing this after the RBNZ began buying assets. It also meant a strong bias to high quality debt such as Kainga Ora (Housing NZ) and Local Govt while avoiding corporates with more leverage or for who equity raising could be challenging. The fund outperformed the benchmark and remains cautiously positioned to guard against rising longer-term rates despite a recognition that this is unlikely in the near term. The fund also has some exposure to inflation-indexed bonds which hampered recent returns given the short-term deflationary shock to both supply and demand from Covid-19. Longer term, deglobalisation is likely to increase business costs and the cash being handed out by governments to both businesses and consumers will be spent rather than saved leading to higher inflation.</td></tr>
<tr><td>Harbour Enhanced Cash Fund</td><td>1.1%</td></tr>
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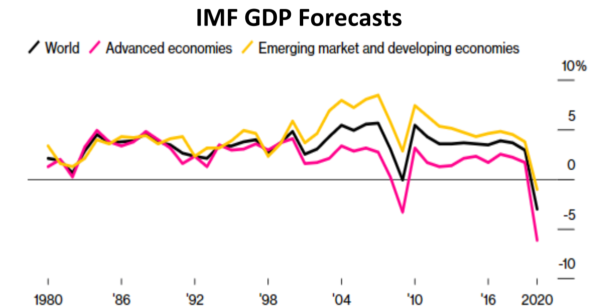
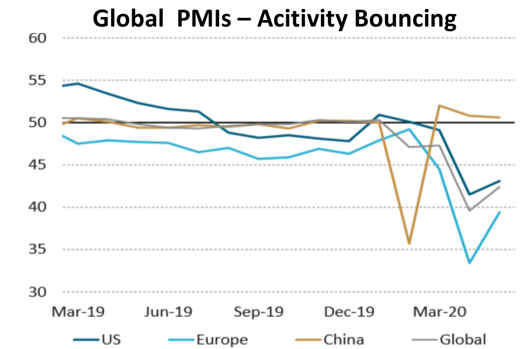
ECONOMIC COMMENTARY

Summary

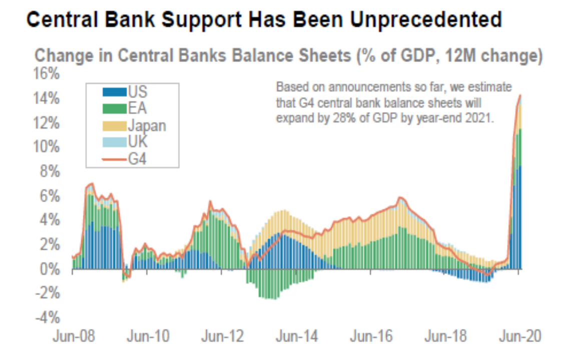
Everything but the kitchen sink. That is what is being thrown at the global economy by central banks and politicians desperate to keep their economies afloat and to ensure they are well positioned to rebound from Covid-19. The political response to virus containment has put the world into recession. Governments are now balancing the cost of these actions against the economic damage being inflicted. The longer the containment, the greater the potential for very long-term damage. To date, the economic interruption has been funded by a debt fuelled spending spree globally, with such loose fiscal policies previously only seen in wartime. Some $US11trn has been spent by global governments already and as much as $US16trn will be spent by the end of the year. This is about 11% of global GDP. Added to this, central banks have maintained a near zero interest rate policy and have rapidly expanded their balance sheets buying government and corporate bonds (and in some cases equities as well). This has provided unprecedented liquidity, cheap borrowing and mounds of excess cash looking to find a home. The stimulus has allowed economies to hibernate on very borrowed time, but at an incredible cost that only history will judge if appropriate.



Activity plummeted in nearly every country during February through May. But as economies have opened-up again, we are now seeing a sharp reversal of pent up demand but also some resumption of core activities (see the chart opposite) with China nearly back to pre Covid-19 levels. Investment markets have also been rallying on the back of this massive fiscal and monetary stimulus and heartened by the subsequently strong recovery data as well. Is the bounce sustainable? Are we in a V shaped, L shaped, U shaped or W shaped global recovery? The debate continues to rage with each scenario justified with different analysis. Morgan Stanley believe a strong V shaped economic recovery is still underway with other economists less sure. It is certainly hard to look through the negative recessionary backdrop for the global economy this year (tracking for -5.6% GDP) and see how company earnings can come back anytime soon. Valuations for shares are looking expensive when considering the weak earnings outlook, but they still look reasonable in comparison to interest rate alternatives. For investors prepared to look beyond the poor near-term earnings, then valuations still look ok on an historically priced basis as well.



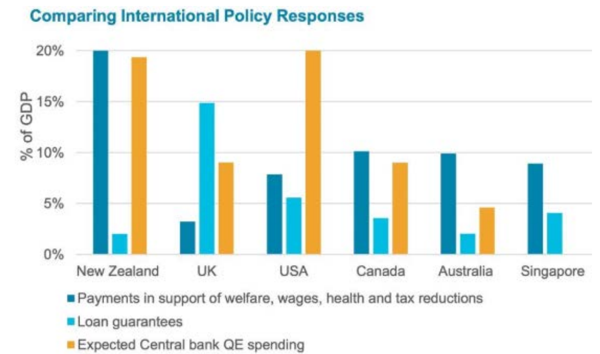
Over the medium term of 3+ years, it is reasonable to expect that we will deal with Covid-19 through a combination of health management solutions - including vaccines. In the shorter-term, markets will be pulled back and forth as they are firstly buoyed by continued government spending and zero interest rate



Source: Fed, ECB, BoJ, BoE, Morgan Stanley Research estimates; Note: June 2020 fc the US is as of June 10, for the euro area is as of June 5, and for Japan is as of June 1 UK Jun-20 value is per Morgan Stanley estimates.

policies and then retreat on second wave virus outbreaks and mass infections in developing countries. There are also additional geo-political risks ahead including the US (and NZ) elections, Brexit negotiations and accelerating Chinese cold and trade war tensions. The shape of the coming recovery, while unknown, will eventually happen. It will also incorporate the new themes of de-globalisation, increasing online consumption, climate change and energy use, aging demographics and eventually inflation as well. Through this, longer-term investors will need to maintain that long term focus while portfolio management needs to be active and alive to the challenges ahead.

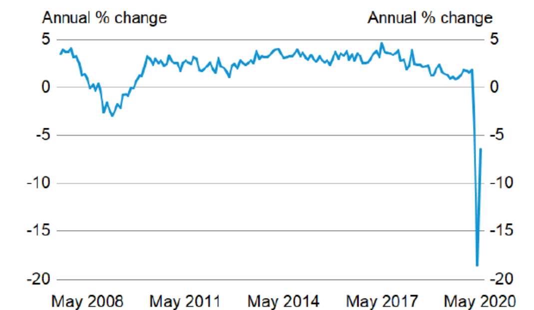
NZ, Aust., US Fiscal Stimulus % GDP – OECD



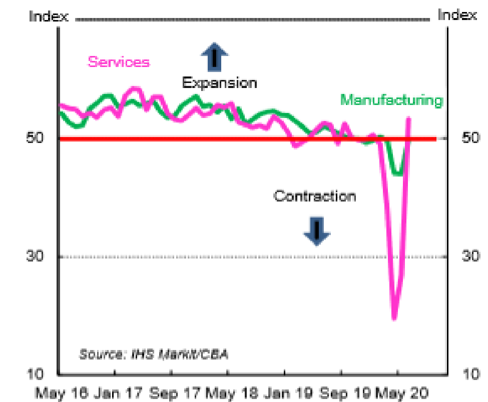
New Zealand

Go early and go hard. In keeping with the Covid-19 elimination approach, our government has applied the same philosophy to spending future taxpayers' money. The chart opposite shows our fiscal stimulus intentions compared with Australia and the US. Relative to GDP, we are certainly not chancing the risk of underspending. The question is whether the $62 billion of budgeted spending will be effective in getting the right productive responses from our economy and in a sustainable way. Containment has allowed our economy to re-boot by more than anticipated to date. This is a very good outcome, but the harder work now comes in replacing the sizable hole left by our border restrictions and all the associated industries attached to it. This includes education services, tourism and accommodation activities, sport, entertainment, retail, and hospitality activities. Treasury estimates our containment approach could create a negative GDP impact between -3.8% to -8.8% depending on how you define the lock-down restrictions. Previously, conservative finance ministers have kept our net public debt levels down to internationally envied levels. This has provided room to borrow for this crisis, but the government's fiscal recovery spend will move our debt to GDP ratio closer to 55%. This is less than many other advanced economies but given our weak net international investment position (what we owe the world) very great care is now required to not endanger our international credit standing. The chart opposite shows the encouraging bounce in our economic activity, supported considerably by wage subsidies and lower mortgage servicing costs. Households have been and spending again though remain cautious about larger purchases. Business confidence has also lifted but is still negative which will impact investment and hiring intentions. As the wage subsidy ceases in September, household incomes will fall as unemployment rises. Overall, there is a clear risk that the economy could stall, requiring the government to then apply the additional stimulus ($20bn) it is holding in reserve. Fortunately, the demand for our exports has been steady and recently rising on much stronger Chinese and Australian demand. The world continues to want our premium food which also presents a growth opportunity. Next, we need to open our boarder further - although our elimination strategy makes this increasingly difficult without better testing technology and a vaccine.

NZ Activity Index – Treasury, RBNZ, NZ Stats



Australian PMI Indexes – CBA



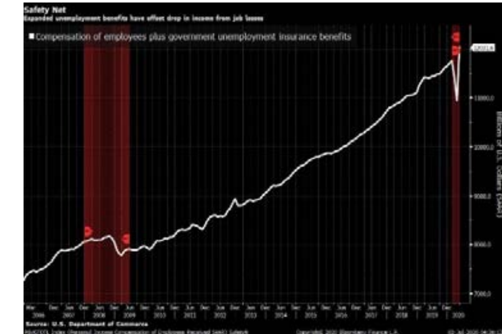
Australia

It has taken Covid-19 to finally drive Australia into recession. After a remarkable 29 years of continuous growth their economy has entered a recession and is on track to contract about -3.3% over 2020. Using a slightly different containment approach, Australia has managed to weather the virus' economic impact better than NZ and with less social disruption. Despite the recent resurgent of cases in Victoria that are forcing an additional lock-down, Australia will emerge relatively better off than most countries. Resurgent Chinese demand for iron ore, coal and agricultural exports is delivering positive current account numbers - despite the rising cold war between Australian and China that has led to trade threats and Australian residency offers for Hong Kongese. As with NZ, Job Keeper support has preserved household income sufficiently for now to ensure a bounce in post lockdown demand. Whether this demand can be sustained as support is removed will be key. Household incomes have been growing too slowly for far too long while high debt levels have also hindered consumption and will remain a continuing challenge for their economy. Like NZ, Australia's closed boarders are also limiting those sectors reliant on international travel. A return to pre-virus growth levels is not expected until the beginning of 2022.

US

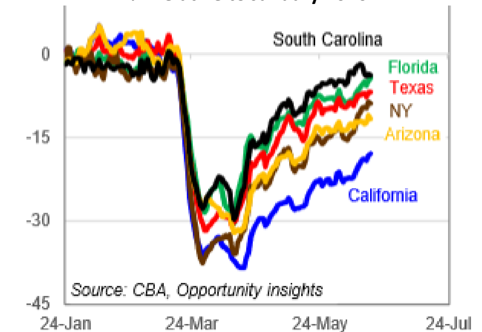
Desperate to get the economy back on track leading into the US elections, President Trump has continued to downplay Covid-19 and has encouraged States to open their economies as quickly as possible. After signs of declining (North East) or flattening cases (elsewhere), containment restrictions have been lifted with varying degrees of success. Broad economic activity has consequently jumped sharply in the last two months and by more than expected. The top chart opposite (though hard to read) shows the key reason for the bounce. When including government benefits, the US compensation of employees is now actually higher than before Covid-19. This will be the first recession where income levels are higher, even if they are artificially supported. This is underpinning consumer spending which is at the heart of the US economy. The chart opposite shows a jump in consumer spending by even the worst virus affected states. The US has budgeted to spend some $2.2trn on pandemic relief this year with more likely to come and it will push their net government debt levels to an incredible $24trn. Unlike NZ and Australia, the US has allowed workers to lose their jobs rather than provide wage subsidies. This has seen the unemployment rate jump up from 3.5% to a post-depression high of 14.7% in April. Businesses, however, are moving quickly to re-hire with a record 4.8m jobs added back in June which lowered the unemployment rate to 11%. The US is now at a second wave crossroad. Case numbers are rising sharply with approximately 1% of the total US population having tested positive while medical facilities are stretched, particularly in Texas. Some states will need to introduce new containment measures or enforce stricter social distancing and mask wearing rules. Given the 'rebel inside' it seems unlikely the US can deliver a co-ordinated national response to the virus and it will suffer unnecessary cases and deaths accordingly. Their economy will remain more open

US Compensation of Employees including Government Benefits

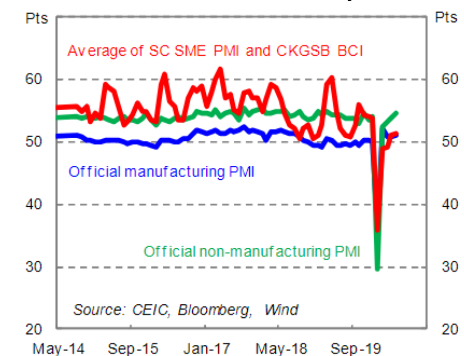


Daily US Consumer Spending in Most Affected States

% Relative to January 2020



China Business Surveys



than it probably should as they focus on health management solutions and wait for a vaccine. With tighter boarder restrictions, pending elections, increasing cold war/trade tensions with China and rising trade tensions with Europe, the US is becoming more isolated and increasingly inward looking.

China

China's stringent response to Covid-19 enabled them to open their economy much faster than anyone else and it has continued to recover sharply through this June quarter. The chart on the previous page from the CBA shows their bounce in activity and a move back into positive economic growth territory. Apart from Eqypt, China is the only country currently showing positive annualised growth and may finish up +1.5% for 2020 which would be a stunning achievement. Further interest rate cuts and large infrastructure investment will assist their recovery, although consumer spending is still weaker than pre Covid-19 levels - as is the foreign demand for Chinese exports. At the time of writing China was battling various secondary outbreaks, but in typical central government style they have aggressively locked-down these areas and implemented mass testing programmes. China's recovery is crucial to rebooting global trade, with Australia and NZ exports particularly reliant. Chinese trade relationships are now being further tested as China becomes more openly assertive in regional and global power plays where they see an opportunity to advance their interests while the rest of the world focusses on their internal problems. Despite the trade threats we are certain China will remain pragmatic when it comes to meeting their key commodity needs.

Europe & UK

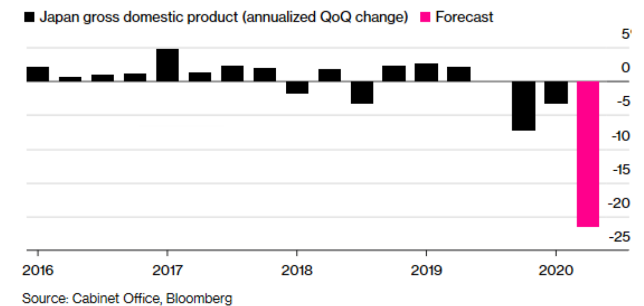
Europe has done remarkably well to recover from the first virus wave disaster by showing unexpected solidarity with implementing border closures, community lock downs and most importantly strong ECB support through on-market asset purchases and direct bank funding. The ECB added an additional $600bn for asset purchases for a total of $1.35trn or 11.3% of EU GDP. Money supply will grow at its fastest rate ever to around 15% of GDP by the end of 2020, providing a solid kick start for activity. Additionally, the EU is in the later stages of agreeing to its first ever fiscal support package of $750bn which is a large philosophical leap particularly, for Germany. The EU is starting to open its borders and industrial production improved sharply after falling -17.4% in April. Consumer activity is also lifting but as elsewhere, it remains to be seen if it is sustainable. The top chart opposite shows the sharp rise in activity is broad across all member states but still well below pre-Covid 19 levels. Even with recovery, the EU is still expected to contract around -7% in 2020, though estimated to recover to around +1.5% in 2021.

To date, the UK has experienced the highest virus death toll in Europe (45,000 deaths) and is third globally (only exceed by the US and Brazil). Their pandemic response has at best been confused (and not assisted by Boris Johnson's own severe illness) with initial firm domestic lockdowns and open border policies now

Euro Area Recovery Outlook

UK – 20 years of lost growth?

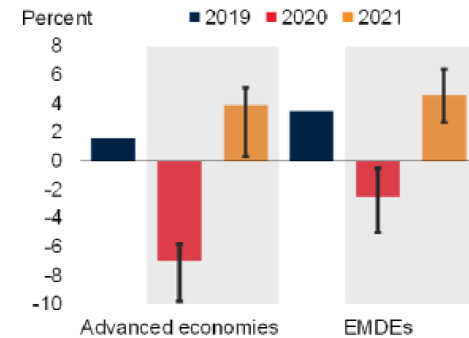
Sharp Contraction Expected to Reverse



being completely reversed. The UK is also estimated to have one of the most infected populations overall. Accordingly, the UK economy has also been one of the hardest impacted by Covid-19, contracting nearly -25% - the same amount as it has grown in the last 18 years. Since the crisis began, the BOE cut the cash rate to 0.1% and provided stimulus of approximately £300 billion into the economy. The government recently announced an additional GBP30bn fiscal package aimed at supporting businesses and jobs, but significant further fiscal stimulus will be required. PM Johnson, like President Trump is increasingly keen to get the economy on the front foot especially as they move into the final stages of Brexit negotiations. Given the virus impact and the EU exit deadline, the UK has now abandoned its plan to introduce full border checks with the EU next year - even in the event of a hard Brexit.

Advanced vs Emerging Economy Growth

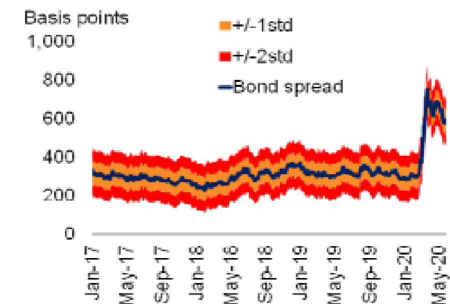
World Bank June2020



Japan

After successfully containing the first wave of the virus, Japan is also having to re-lock down areas where new cases have appeared. A high density but highly disciplined culture has enabled Japan to weather the pandemic well, although its export reliant economy has suffered from collapsing global demand. Growth for the June quarter will be down as much as -22% annualized but it will likely move up in the second half of the year and is presently forecast to come in at around -6.7%. Given Japan is constrained by already easy monetary policy their government has provided two stimulus packages of more than $US2trn with more stimulus expected. The services sector of the economy is steady and there will be a stronger pickup in industrial activity on stronger Chinese growth and as prospects improve in other parts of Asia as well.

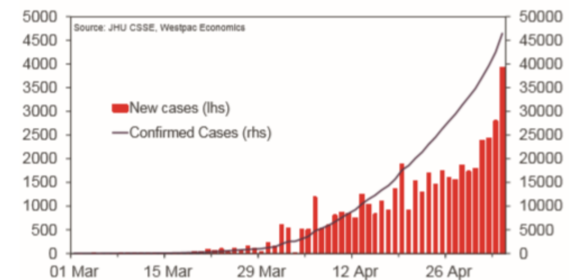
Rising Borrowing Costs for Emerging Economies



Emerging Economies

Emerging economies are increasingly bearing the brunt of the global pandemic as infection rates and deaths rise sharply. While initially taking longer to reach their communities, the virus has now dramatically taken hold in all emerging markets including Central and South America, Eastern Europe, MENA, Asia, and areas of sub-Sahara Africa such as the Congo. With more limited financial resources it is not possible for most of these economies to provide enough offsetting stimulus. Rising borrowing costs, foreign investment outflows and falling commodity prices (particularly oil) have added to the health burden. With limited testing available, the extent of virus spread may never be known. As an example of the challenge they face, India, who has implemented some of the strictest lockdown measures in the world, now has a second wave outbreak that has become uncontainable with new cases increasing exponentially.

India Covid-19 Cases Rise Sharply



Emerging economy growth is expected to pick-up as developed economy activity improves the demand for commodities and manufactured goods. Those economies extensively relying on tourism and services are facing a protracted downturn.