NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

18 October 2017

September 2017 Quarterly Report

It was a positive quarter for the global economy with increasing synchronisation of economic activity and better investment market returns despite heightened geo-political risks including here in New Zealand.

Economic data over the period was consistent with growth remaining on track for all major economies with Japan, Europe and China surprising on the upside while the US is slower than expected as Trump's government so far fails to deliver the fiscal stimulus (tax cuts and government spending) promised.

We expect global economic growth to remain steady through to the end of the year.

Valuations for some markets are now historically high and interest rates are expected to rise as inflationary forces finally impact. Rising interest rates and elevated valuations may provide short term headwinds for markets despite supportive economic conditions.

We remain wary of the many geo-political risks at play including North Korea which may trigger a round of short term market volatility. Volatility has been surprisingly absent this year.

We continue to keep portfolios appropriately balanced with any exposures to fixed interest securities limited to shorter term maturities to provide protection against rising rates.

Kind regards,

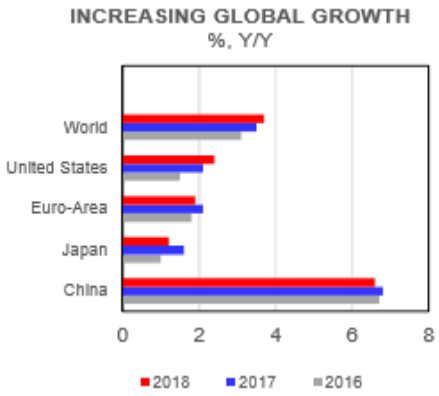
Wayne Ross
Director Investments

T 09 377 5777 | PO Box 2683 | Shortland Street | Auckland 1140 |www.newtonross.co.nz

ECONOMIC AND MARKET SUMMARY

Global growth has run steadily since the start of this year with both developed and emerging economies sustaining reasonable momentum.

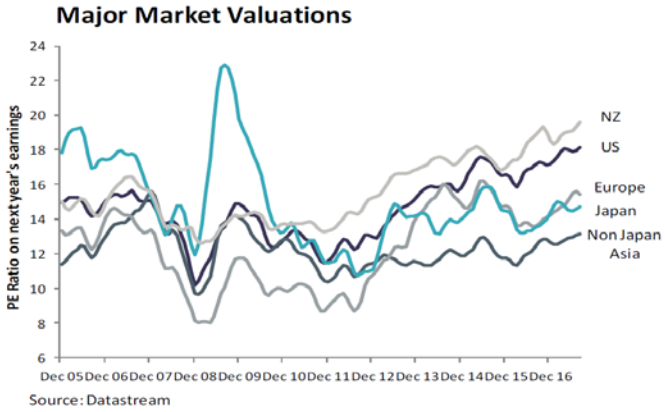
The pick-up in global economic activity continued at pace over the quarter with some surprisingly good performances coming from Japan, Europe and China while the US is lagging and waiting on the promised fiscal impulse of Trump tax cuts and increased government spending. The Trump stimulus is likely to be delayed into 2018 and growth subsequently weaker than was expected at the beginning of the year. UK growth is also expected to slow as it moves further into Brexit negotiations. None the less, as the OECD economic outlook chart below shows ,there has been better broad economic performance in 2017 vs 2016 while some moderation is expected in China, Japan and Europe in 2018.



Global growth remains on track for 3.5% growth in 2017 and 3.6% in 2018. While improving, growth is still below the rates experienced before the Great Financial Crisis.

There are a number of medium term risks to the growth outlook including the many geo-political concerns (led by the North Korean crisis), increasing Chinese financial system instability and prospect of central banks tightening interest rates as signs of core inflation start to appear. Of these risks, rising interest rates are likely to have the greatest impact on global capital flows and investment market volatility. Well signaled central bank intentions should reduce some of the risk but we expect some tipping points for bond prices will be reached and result in increased market volatility over the short and medium term. Market volatility has been unusually absent so far this year. The US Federal Reserve, despite still weak inflation, is expected to raise their cash rate (84% chance) before the end of the year.

With a backdrop of good economic conditions, investment markets performed better again over the quarter including in New Zealand. Share market valuations are however stretched on an historical basis with NZ now expensive and requiring companies to continue achieving or beating their forecast earnings growth to justify price levels. Better value can be found offshore.



During the quarter global sharemarkets rose 5.8%. The US sharemarket reached another new high and was up 4.5%, Europe was much stronger rising 4.8% while Japan rose 2.3% and the UK 1.8% and Australia 0.9% respectively. Our local share market rose 4.2% in the period with investors shrugging off the uncertainty of local election outcomes and company earnings largely came in as expected.

The weaker NZ dollar assisted returns from offshore investments particularly from Australia. Bond markets produced modest positive returns being up 0.9% in NZ and 0.8% for global bonds driven by weaker global inflation data and nervousness around North Korea. Residential property prices were weaker across New Zealand and notably in some key offshore markets such as London. We are seeing a sharp slow-down in New Zealand property sales on tighter bank lending and uncertainty about future migration and property tax policy settings. Returns from New Zealand listed property trusts were slightly up over the quarter. Commodities were generally higher on rising energy, metals and materials prices while dairy prices were softer and may put Fonterra's payout forecasts under pressure.

Given the supportive global economic outlook we expect market returns will continue to deliver positive returns but expect some volatility to appear over the balance of the year on the prospects of rising interest rates and the possibility of a geo-political shock. Closer to home the uncertainty of coalition policy settings (at the time of writing) will continue to impact business, investor and consumer confidence.

We continue with our shorter maturity position for client's fixed interest investments to provide portfolio protection and the opportunity to purchase better yielding assets in the future.

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

Market Returns	Sep Qtr.	1 Year p.a.	3 Yrs p.a.	5 Yrs p.a.
$NZ v TWI	**-2.7%**	-0.8%	0.2%	1.0%
$NZ v $US	**-1.7%**	-0.8%	-2.5%	-2.9%
$NZ v $AUD	**-3.6%**	-3.0%	1.1%	2.9%
NZ Cash	**0.4%**	1.8%	2.5%	2.6%
NZ Fixed Interest	**0.9%**	0.3%	5.2%	3.7%
Intl Fixed Interest 100% hedged to $NZ	**0.8%**	-0.3%	5.4%	5.6%
Australasian Equities 50/50 Indexes	**4.3%**	10.4%	10.4%	11.4%
NZ Listed Property	**0.4%**	-1.0%	11.1%	10.8%
Intl Equities 50% hedged to $NZ	**5.8%**	19.2%	10.0%	13.2%
Commodities $NZ	**3.8%**	0.3%	-8.1%	-7.9%

SECURITIES RETURNS FOR THE QUARTER

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

AUSTRALASIAN EQUITIES

Company	Sector	Quarterly Performance In NZ$ terms
New Zealand Equities		
Auckland Airport	Ports	-9.7%
F&P Healthcare	Healthcare	11.5%
Fletcher Building	Building	3.3%
Freightways	Transportation	4.2%
Meridian Energy	Energy	2.6%
Port of Tauranga	Ports	-0.3%
Stride Property	Property	3.5%
Trade Me	Consumer	-11.7%
Vector	Energy	1.5%
Australian Equities		
APA Group	Energy	-5.3%
BHP Billiton	Resources & Energy	18.3%
Brambles	Professional Services	-2.3%
IAG	Financials	1.8%
National Australia Bank	Financials	5.1%
Scentre	Property	3.5%
Sonic Healthcare	Healthcare	-8.3%

- Share price growth of over 500% over the last 5 years has led to Fisher & Paykel Healthcare now becoming the largest company on the NZ share market with a market capitalisation of $7.45b. The company has doubled revenue and quadrupled profit through a focus on R&D, gaining market share in profitable new product categories and excellent operational execution as they insourced US hospital distribution and shifted production capacity.
- Vector profit results were as expected during the quarter. The company's regulated earnings are likely to remain relatively flat (supporting a stable dividend) so future additional growth prospects will rely heavily on the success of investments in the company's technology division. An example of this is the charging stations for Electric Vehicles (EV) which will become more critical as the government looks to double the number of EV's in NZ every year. Vector is also looking into how EV's can become mobile power sources which can charge at cheaper overnight rates and then be used to power the household during the more expensive peak periods.
- Fletcher Building had a volatile quarter as it booked yet more losses on key projects in the Building & Interiors division. While the scale of the losses relatively to the size of the business is not that material, the negative impact on confidence and credibility of yet another downward revision was apparent with the board replacing CEO Mark Adamson with Interim CEO Francisco Irazusta (he currently runs the FBU International Division). The other FBU divisions are performing well and the problematic B&I division now has an experienced GM in David Kennedy who has 30yrs experience in the sector across multiple international markets. Despite an immediate drop in the share price the market was actually pricing in a worse outcome and this is reflected in the slight positive price gain over the quarter.
- Trade Me posted a good profit result, up 12% for the year, and announced a significant technology infrastructure spend over coming years as they continue to innovate in response to competition. TME has a good track record in

Westfield Corporation	Property	%
Westpac	Financials	7.1%
Woodside Petroleum	Energy	4.1%
Woolworths	Consumer Staples	5.3%

- A change of message from BHP management post their latest results has been welcomed by the market and reflected in a higher share price. There is now a clear strategy to divest all non-core activities and the hurdle rate for capital investment in future projects has been lifted. In particular the company owns significant US onshore assets which are likely to find willing buyers at attractive prices well above their balance sheet value. The prospect of share buybacks to better manage the company balance sheet would also prove positive for investors in the short term although long term value is more likely to come from strategic investment in well chosen resource opportunities.

generating a reasonable pay-back for $ spent but there is always a large degree of uncertainty with the future value of tech spend. TME is the dominant NZ market player and has strong cash flows however their share price took a knock following the announcement that online giant Amazon was establishing a business in Australia.

- Sonic Healthcare will be negatively impacted by the US Medicare draft decision to cut funding for laboratory fees by around -9.5% (more than the expected -5%). SHL gets 22% of its revenue from US operations and 20% of this US revenue is funded via Medicare (80% is commercial funding). The proposed change will amount to a US$16m drop in earnings, assuming no cost offsets, or around 3% lower net profit. SHL has actively been looking to reduce specific market and supply risk by building a global footprint and they recently announced a 12 year joint venture contract with the UK National Health Service which will contribute over GBP12m per annum to their UK business.

Change in recommended securities – NAB replaces CBA

As part of our ongoing review process for the Australasian portfolio with Devon Funds Management we replaced Commonwealth Bank of Australia (CBA) with National Bank of Australia (NAB) during the quarter. Despite being some of the strongest banks in the world, all of the Australian banks have been placed under pressure lately by regulators concerned about their exposure to residential housing and the need to maintain sufficient capital standards. CBA came under yet more pressure when the Australian regulators filed a claim against them under Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) regulations due to the way their ATM machines recognised and accounted for larger cash deposits. While the investment implications of this are very uncertain it is likely to put additional pressure on CBA which has for many years traded at a premium to its peers. We accepted Devon's recommendation to switch our sector exposure to NAB who have a larger business client focus (so less residential exposure), a stronger capital position and the opportunity for cost reduction benefits.

Lower wholesale pricing for Australasian Managed Funds

Due to our business scale NEWTON ROSS and NZ DIMS have historically been able to negotiate discounts off the retail fund charges when investing in a number of the managed funds we recommend for clients. As a licenced Discretionary Investment Management Services provider we also have the benefit of being able to access lower cost wholesale fund structures on behalf of clients. We seek to improve the bottom line return for clients wherever possible and our continued growth in funds under management has allowed us to recently negotiate lower charges for the Australasian Equity assets overseen by Devon Funds Management and Harbour Asset Management. 100% of all fee reductions are passed directly on to clients by way of either better fund performance or fund manager rebates.

AUSTRALASIAN MANAGED FUNDS

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	3.8%	The manager has reviewed holdings post the end of the reporting season and increased exposure to recent poor performers Brambles, Trade Me and Fletcher Building. All 3 companies have been sold down for a various reasons and in Devon's view the market is too heavily discounting the quality of these businesses and their respective strong cash-flows. CSL was also added to with increased confidence in their ability to leverage a globally competitive position in plasma and immunoglobulin. The manager's investment style is to focus on high quality companies with good fundamentals which are priced at a discount to their fair value. This strategy is proven to add value vs the market over time but there can be periods of relative underperformance when certain high flying stocks are not owned. A recent example of this is A2 Milk which has been responsible for a large part of the NZX return over the last year. Devon has concerns over the sustainability of the company's distribution model in markets outside NZ and particularly into China (via Chinese nationals purchasing goods in Australia to resell in China). In their view the potential risks outweigh the long term expected returns from the business and consequently they prefer to exclude it at this stage. It is important to us that our fund managers continue to manage their portfolio in accordance with their stated style and resist the temptation to chase returns. We recognise that they will not get every call right but expect them to add value over time. This is also why we combine managers who manage money is different ways and therefore typically have a number of different holdings with different allocations over time. Harbour for example do hold A2 Milk in their portfolio and clients have benefited from this exposure.
Harbour Australasian Equity Focus Fund	9.4%	The fund outperformed the market benchmark with positive contributions from A2 Milk, Gentrack, GTN and Xero. Some profits were taken in F&P Healthcare and Aveo Group was exited. The manager believes financial markets will remain relatively calm as we work through determining the direction of the new NZ Government. Polls pointed to a coalition deal and by international standards both major parties appear relatively centrist, have shown solid fiscal responsibility and the RBNZ is likely to remain independent. What is more likely to create volatility this year is the potential for rising long term interest rates globally which will negatively impact those companies which are trading at historically high valuations. Stretched valuations in some sectors together with the potential for political change influencing business and/or consumer behaviour (for example in NZ residential housing and net migration) could mean individual stock returns are widely varied despite the generally positive backdrop of global growth.

INTERNATIONAL EQUITIES

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	9.5%	The fund was up 6.8% in A$ terms and above the market benchmark. Relative performance was helped by strength of markets the fund is more highly exposed to such as China (up +12%), Emerging Markets (+5%) and Europe (+4%). These compare to the USA which makes up over 50% of the benchmark and was up only +2% in AUD terms. The manager is focused on investment opportunities associated with changes in the automotive industry as demand grows for Electric Vehicles (EV) and autonomous vehicles. All large car manufacturers will offer EVs by 2019 and are required to sell a certain amount to meet their fleet emission quotas. For instance 1 in every 10 cars sold in China in by 2019 must be new energy vehicles. Currently EV production is supported by generous Govt subsidies which are likely to be cut back so lower battery prices will be the key to widespread production and technology advances are quickly improving battery size and life. Rather than the car or battery manufacturers themselves the manager is focused on investment options for the raw material inputs which will be used to make the latest generation batteries such as nickel, copper and cobalt.
Monks Investment Trust	7.2%	The fund was up 4.4% in GBP terms. The strongest contributors to performance were Alibaba (ecommerce), Prudential (insurance) and Naspers. Naspers has grown earnings by 40% yoy with significant stakes in online businesses such as Tencent (Chinese social media and gaming platform) and online classifieds advertising businesses. Stocks to struggle included Seattle Genetics (cancer treatment) and TD Ameritrade (online brokerage). Exciting new growth companies have been added recently to the portfolio including Abiomed, a US healthcare business which manufactures the world's smallest heart pump, and Infineon a German designer and manufacturer of power semi-conductors used in applications such as EVs. Despite a positive outlook with both developed and emerging markets accelerating together for the first time since 2010 the manager has also taken profits in some US cyclical companies which have become overvalued.
Magellan High Conviction Fund	7.3%	The fund was up 3.6% in A$ terms. The manager has positioned the portfolio to reflect what they see is the two most important drivers for markets at present; global monetary policy and technology disruption. While they have not put an exact timeframe on when events might unfold, they do have a view that the probably direction of long term interest rates is a rise in the short to medium term as central banks exit quantitative easing. However rates are not expected to go as high as pre-GFC levels before technology disruption over the longer term acts as a deflationary force and we again see interest rates moving down. Their view is technology led business disruption will see potential winners being consumer tech platforms (Google, Facebook, Apple), payments networks (Visa, PayPal) and cloud computing platforms (Amazon web, Microsoft). Losers are likely to be bricks and mortar retail (Walmart, Target), automotive supply chain (Caltex, GM) and the fossil fuel industry (BP, Glencore). Sectors likely to be unaffected include communications infrastructure (Crown Castle), biological goods (L'Oreal, Yum, Starbucks, McDonalds) and water utilities (Aguas Adninas, American Water)

Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	4.4%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD. The hedge detracted from performance this period as the NZ dollar fell against the major currencies. Global equity markets moved beyond the geopolitical tensions between the US and North Korea for the time being and focused on the continued global economic upswing. Sentiment was helped by proposed US tax cuts, European manufacturing showing the strongest growth rates in over 6 years and the Japanese Government looking to go to the polls to strengthen their mandate.
iShares Russell 2000 Index Fund	7.6%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. Investor demand for smaller companies was helped by good economic growth numbers, low unemployment numbers and the renewed prospect of US tax cuts. In non-US markets the prospects for small cap stocks in sectors such as health care, energy, materials, financials, telecommunications and technology appear even brighter with markets in an earlier stage of their business cycle relative to the US. Also helping returns from small cap stocks is a more general switch this year by investors from value orientated stocks to growth stocks due largely to valuation concerns.
Vanguard FTSE All-World ex US Small Cap Index Fund	8.0%	
Vanguard Emerging Market Index Fund	8.5%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Company valuations remain attractive across many Emerging Markets and investors favoured high growth companies in markets which have been sold down over the last year and now show signs of more stable political environments. Brazil was a standout with strong jobs growth and lower interest rates while Russia benefited from the higher oil price and their lowest ever recorded inflation rate at 3.3%. Positive economic growth in China saw the market jump higher before concern over high debt levels saw S&P moved to cut their sovereign credit rating for the first time since 1999.
iShares S&P Global Infrastructure Index Fund	4.6%	The fund provides passive index exposure to listed infrastructure assets and is valued in USD. The positive global growth story and likely increase in interest rates as central banks unwind excess liquidity is weighing on infrastructure companies which typically act as a yield proxy when interest rates are low. Many infrastructure companies are also a good hedge against inflation as their prices are often inflation linked, however inflation remains at very low levels in most economies.

COMMODITIES

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	4.3%	The fund provides passive index exposure to commodities and is valued in USD. Energy prices were 10% stronger over the quarter as oil recovered to above US$50 a barrel. Global energy demand has been rising and at the same time Oil & Gas supply has been adversely impacted by US hurricanes and the low cost shale oil producers suggesting they will not be able to increase supply as much as first thought.

		Positive growth in China and the growth in battery production saw increased demand for industrial metals (up +10%) however this was offset by lower agricultural prices (down -6%) as favourable weather conditions in the key growing areas helped production and increased stock piles. Excess supply was also an issue for NZ dairy farmers as prices moved lower, raising concerns about the level of the potential Fonterra dairy pay-out.

NEW ZEALAND FIXED INTEREST

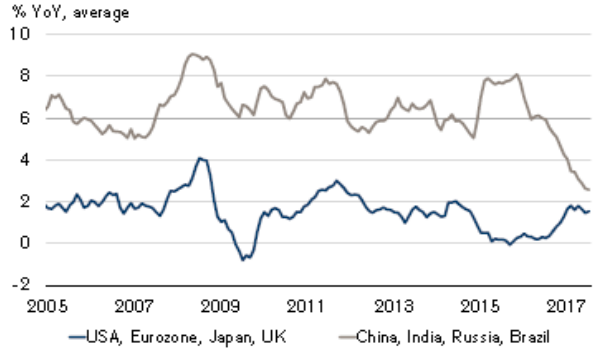
Security	Quarterly Performance In NZ$ terms	Commentary
NZ Government Fixed Interest	0.9%	Global interest rates initially rallied (yields moved lower) early in the quarter due to geo-political concerns and low inflation outcomes however September saw a sell-off across government bond markets as the UK, US and European central banks all indicated they were ready to start the withdrawal of monetary stimulus over coming months. Currently central banks buy US$175b of bonds each month and own most of the worlds sovereign debt (US Fed owns 12% of US treasuries and 20% is owned by other foreign Govt's, Bank of Japan owns 45% of their bonds, ECB 20% and Bank of England 30%). Central bank buying has forced other investors to look to the corporate bond market for bond exposure and this excess demand has not only driven yields to record low levels it has also narrowed the interest rate differential between high grade and low grade corporate bonds dramatically. As central banks begin to unwind this monetary stimulus it poses the question of just how liquid will some of those riskier corporate bonds be if investors wish to sell quickly to reposition portfolios. The Reserve Bank NZ is not expected to raise short term interest rates until late next year due to weaker than expected inflation numbers and signs that the NZ housing market is finally taking a breather. Longer term rates moved in-line with offshore bond markets and ended the quarter largely unchanged. One potential outcome from the negotiations currently underway to form the next NZ Government is a continued sharp reduction in net migration. Given much of our recent real GDP growth has come from an increasing population rather than improved productivity this is an area the RBNZ will no doubt be watching closely, particularly since a slowing property market will lessen the positive wealth effect for consumers and may result in lower levels of consumer spending.
NZ Corporate Fixed Interest Investment Grade Rating	1.2%	

ECONOMIC COMMENTARY

Global

Last quarter we talked about the low core inflationary environment and continued absence of inflationary impulses and the overwhelming disinflationary forces headlined by weak wages growth, technology disruption and aging populations. Over the September quarter, fuller employment data and reducing capacity in some markets (US and Europe) is beginning to influence central bank thinking despite still flat inflation numbers. There is also a growing school of thought that low interest rates create a negative feed-back cycle for inflation and rate rises are actually required to increase input costs. We have been in a zero or ultra-low interest rate environment since the Great Financial Crises and while it has undoubtedly assisted the banking system and indebted government and household finances it has also led to misallocation of capital and abnormally low market volatility.

Convergence of Inflation for Emerging and Advanced Economies.

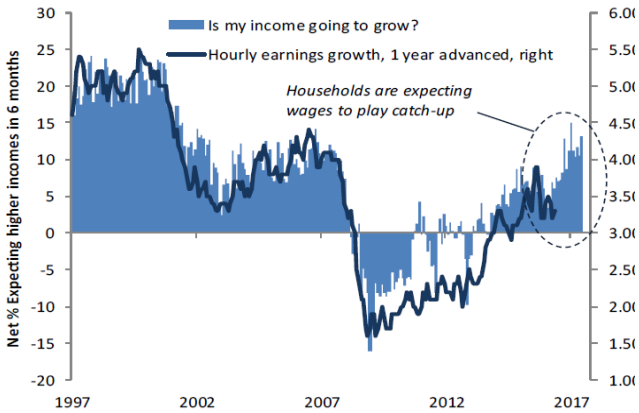


Source: Datastream, Credit Suisse. Last data point: July 2017

Rising Rates

Low volatility also means risk is increasingly being forgotten by investors who continue to chase yields from higher risk investments. We see this behaviour with the creation of higher risk income funds investing in shares, the resurgence of geared property products, structured yield products and general investor expectations that capital growth is a given. Investors have incrementally moved (or not re-balanced assets) to growth assets to make up for poor yields and this is leading to overvalued assets. We expect there will be significant disappointment when inflation finally bites and central banks respond faster than market expectations. There has been much noise around the raft of geo-political risks currently dominating headlines but the reality is that such events have a historically short term impact on markets. Of much greater significance are interest rates and central bank policy settings. We may be in a new paradigm of low interest rates forever but it is unlikely. Though the prospects for long term rates are lower than they have been historically there is an increasing expectation by households that their wages will rise. The graph opposite shows actual household earnings growth in the US vs household's expectations for future income growth. There is now a significant mismatch. With rising employment it is only a matter of time until wage pressure starts to pop in the US and indeed in most advanced economies including parts of Europe (Germany), Japan (on a declining workforce) and certainly here in New Zealand. Rising wages will directly impact corporate profitability but also provide a much needed boost to household incomes and consumer demand. Central banks will have to respond and while they may decide to let wage inflation run, markets will have already priced in rate rises. This will create greater market volatility in the future and remind investors of the need to focus on quality assets.

Wages: expectations versus outcomes



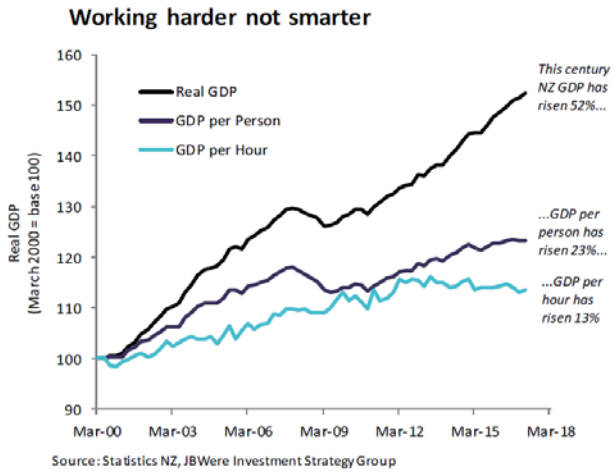
Source: The Conference Board, Atlanta Fed, JBWere ISG

New Zealand

All about Migration

The uncertainty of the General Election outcome weighed on business confidence over the quarter (and was still unresolved at the time of writing). Own business expectations remain steady and supportive for investment and employment while capacity pressures are starting to be felt and implying near term price inflation. 41% of firms in the building sector report labour shortage as the biggest constraint on their growth while tighter finance is also impacting construction despite strong demand for residential and commercial buildings being underpinned by our rising population. This is translating to reasonable building consent numbers but flattening activity. The Lions Tour and Masters Games contributed to higher tourism numbers and record service sector exports over the period while the rest of our export sector continues to shine due to better prices and is contributing positively to our strong economic performance. Recent softer dairy prices may however place Fonterra pay-out forecasts under threat. The outlook for NZ remains steady at 3% target growth this year but this depends on favourable export conditions and our increasing reliance on record net migration numbers. Though our total real GDP continues to rise the graph from JB Were opposite shows it is being primarily driven by rising population growth, while GDP per person is flat and GDP per hour worked is going backwards. This suggests falling productivity per head of population and remains a major concern for our economy and likely the reason why households feel they are not getting ahead. This may be exacerbated by softening house sales and recent weaker house prices particularly in Auckland.

NZ Productivity Growth Stalled

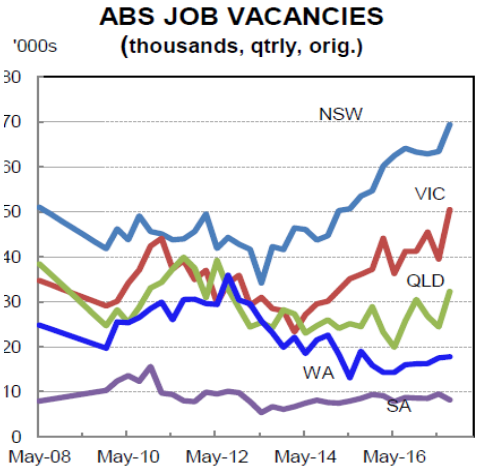


Australia

Lucky Again

The lucky country may be getting lucky again. A sharp surge in job vacancies (up 15.4% over the year) in the eastern states and stabilisation in the mining states suggests their economy is starting to successfully diversify into non-mining activity including construction, transport, manufacturing, health and education. Increasing business investment (+7% yoy) and better commodity prices for miners on stronger Chinese demand is combining to lift overall economic activity. Eastern state governments continue to fast track long overdue infrastructure projects including major commuter rail, public building and roading programmes. The Reserve Bank recently voted to keep interest rates at 1.5% but issued upbeat commentary about the improving prospects for the Australian economy. Tighter employment conditions are likely to lead to wages growth in the near future though the RBA is signalling interest rates will be held in check until late 2018 while the recently higher AUD is providing some headwinds for exporters.

Australian Jobs Jump



US

The US economy continues to improve with Q2 GDP growth confirmed at 3.1% annualised (a positive revision) and at a 2 year high. Growth for 2017 should come in at 2.4%. Recently strong manufacturing numbers (a 13 year high), higher home prices (+5.7% yoy), strong services data (a 12 year high) and better

consumer confidence suggests the impact from hurricanes Irma and Harvey may not be significant on overall GDP numbers.

Despite better economic performance and low unemployment (4.5%) wages growth remains worryingly subdued as more, lower paying jobs soak up employment capacity. This is a global theme and is contributing to stagnant core inflation in the US. The Federal Reserve remains cautious on rate rises with Janet Yellen suggesting the recent fall in inflation "a mystery". 11 of the 16 board members are still expecting one more rate rise in 2017.

Missing Stimulus

The missing ingredient for US GDP acceleration is fiscal stimulus. Trump has consistently failed to get the cost cutting in place (Obamacare reforms) he requires to deliver his promised infrastructure spending and tax cuts. Trump recently announced a tax reform package though with little detail about how it will be budget neutral and also how fiscally stimulating it would be. Some market commentary is guessing 1%+ to GDP. With the forthcoming fiscal budget negotiations it is difficult to see how Trump will implement his cuts or provide the infrastructure spending he wants. At the fringe, Trump has been able to bully manufacturers into sourcing from US suppliers, keeping jobs in America, getting tariffs on imports (e.g. Canadian aircraft maker Bombardier in Northern Ireland had the US recently impose a 219% trade levy) and re-homing activity to the US. The chart opposite shows the level of US Public Construction spending since 1993 peaking in 2008 but not recovering to those levels. More is needed to stimulate growth.

China

The OECD recently lifted its forecast for GDP growth in China for 2017 to 6.8%. Activity is being driven by strong credit growth but that is also leading to higher asset prices. This raises concerns about the quality of activity the credit is being applied too as well as increasing financial system risk. Central authorities have been taking a much more active role in ensuring credit is being applied to appropriate activities and encouraging borrowers to use funds for 'patriotic' purposes. Chinese offshore investing has taken a significant hit on greater restrictions and being felt around the world particularly in residential real-estate investment (such as Auckland). The chart opposite shows how China's debt levels have surged over the last few years and are now about 260% of the total economy. This has funded massive capital investment, the engine for Chinese growth. While national debt levels have risen they still represent less than half the value of Chinese government's assets suggesting a still robust balance sheet. China continues to focus on domestic growth while addressing supply side reform through reducing capacity in non-productive areas. This includes better management of pollution, closing inefficient factories and decommissioning poor infrastructure. Additional attention is being paid to corruption (several high profile convictions), shadow

Structural Reform Accelerating

US Public Construction Spending since 1993

China's Contribution to Global Growth Critical

China Debt to Assets

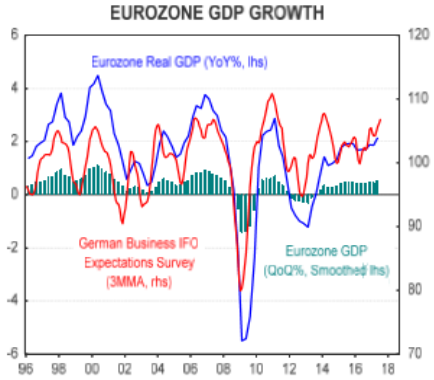
banking regulation and management of excessive property prices. This month the 19th National Congress of the Communist Party of China takes place with a focus on political succession. The changes will signal policy direction for China.

Europe

Domestic Acceleration

During the quarter, economic growth projections were revised up for Germany, France, Italy and Spain. All performed above expectations due to a greater contribution from domestic demand. The chart opposite shows a strong pick-up in manufacturing in France (blue), Germany (pink) and Eurozone total (white). Eurozone total manufacturing is now at its highest level since 1997. Euro-area economic confidence has risen to its highest level in 10 years with both industry and consumer sentiment increasing and Eurozone growth is expected to be above 2% for 2017. The European Central Bank is forecasting 2.2%. Despite the buoyant conditions and improving employment, inflation actually fell to 1.5% and well below the ECB target of 2%. The stronger Euro has reduced import price inflation but producer prices are weak as is wage growth. This means the ECB will maintain easy policy settings though a further reduction in their bond purchase programme is expected at their next meeting in late October. Despite a messy coalition outcome, the German elections have delivered Angela Merkel another term and provide much needed stability while the Eurozone deals with several unity issues including Spain (Catalan nationalist movement) and Brexit.

Eurozone Manufacturing Takes Off

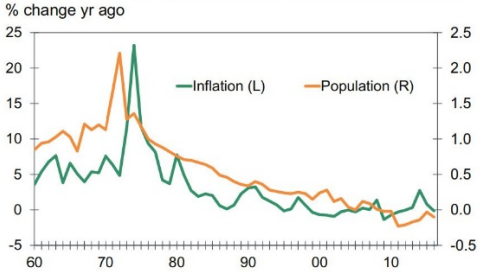


UK

Slowing

UK economy is starting to decelerate as Brexit negotiations stumble on and Theresa May struggles to keep her own party in line (leadership challenge soon likely) after the disastrous May elections.
Construction unexpectedly shrank for the first time in more than a year in September as Brexit weighed on investment in commercial buildings and financial services providers accelerated plans for moving offshore As a result London residential prices have fallen this year. The low pound however continues to assist with manufacturing and services exports (services was above expectations in September) while the purchasing managers index moved into contraction over September signalling weaker economic prospects. Inflation jumped on higher import prices and unemployment (at 4.4%) remains at its lowest level since 1975. Business confidence is however falling and wage growth is declining in real terms. It will be interesting to see if the Bank of England stays the course for a much publicised rate rise this year.

Chart 1: Slow Population and Inflation in Japan



Sources: Japan Statistics Bureau, Census Bureau, Moody's Analytics

Japan

Aging Country

Japan is on track for 1.3% growth outcome in 2017 (a relatively good result) with continuing strong export activity, on the weak Yen, and better domestic growth. Manufacturers' confidence hit a 10 year high while inflation remains at 0.5% and well below the BOJs 2% target. Shinzo Abe has called an early election to seek a mandate for another term and get the support he needs for new structural reform policies. It is hard to see how Japan can achieve long term sustained growth with is aging population.

MARKET COMMENTARY

Cash

Weaker than expected inflation and now falling house prices are moderating the NZ Reserve Bank's outlook for interest rates. No change is expected to our 1.75% cash rate until late 2018. This is despite our relatively brisk economic growth rate and the increasing capacity constraints (particularly in construction). Though the cash rate is anchored, borrowing rates are increasing as bank funding costs rise on more expensive offshore funding.

Currency

The NZ dollar was weaker across the quarter but stronger in September on reduced RBNZ valuation concerns. Despite our strong terms of trade, recently lower dairy prices, lower core inflation and stronger offshore economic activity is likely to keep the NZD in check for now.

Fixed Interest

Long term rates in our local bond market continue to be driven by global developments. Weak inflation data, delays to the Trump stimulus packages and rising geo-political risks supported higher global and NZ bond prices (lower yields) over the quarter despite stronger global economic data. Credit spreads also narrowed further over the period rewarding those holding higher credit risk bonds.

Expensive

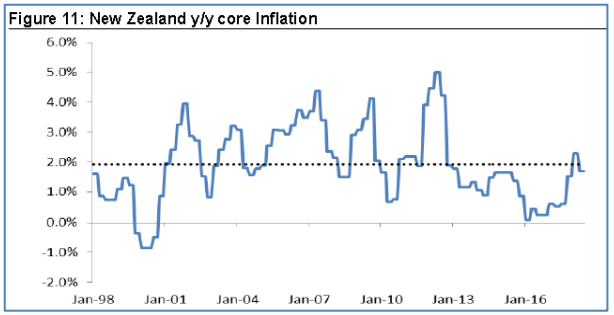
Bonds remain historically expensive and vulnerable to any inflation surprises. We expect yields will lift in the last quarter of the year as the US Federal Reserve tightens rates once more and begins to unwind its balance sheet with bonds sales. This will impact global bond pricing and we continue to remain cautious on long dated bonds and those bonds with lower credit quality.

Equities

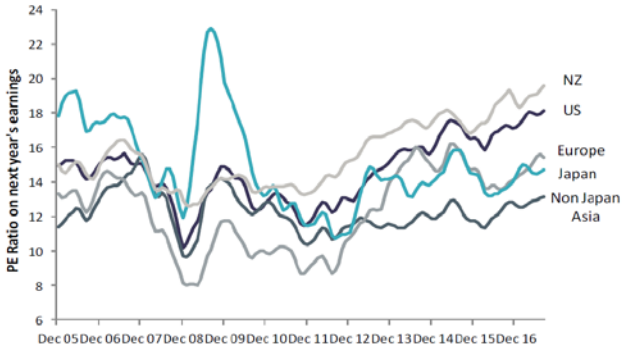
NZ Expensive

Many share markets hit all-time highs in the quarter buoyed by good economic data and reasonable company results and earnings forecasts. NZ company earnings rose (+3.8% yoy) over the quarter lifting our market back up near the all-time valuation highs reached in 2016 (forecast 12mth Price/Earnings 22.6x). A very strong performance from A2 Milk had a significant impact on the market index in the period (up 200%+ YTD) and skewing relative returns for managers not holding the company vs index returns. Meanwhile, several larger companies in the index sold off due to earnings concerns and the opportunity to take profits. The middle chart opposite shows how market valuations have risen since the GFC based on a price to earnings basis but justified by good company performance. NZ remains one of the most expensive markets and vulnerable to price correction on any weaker results or lower forecasts.

NZ Inflation Weakens



Major Market Valuations



Source: Datastream

Aging Bull: Post-War Bull Markets

Source: Datastream, Global Financial Data, JBWere Investment Strategy Group

Bull Market Run

Offshore, companies also reported good results with European companies particularly strong. There has been more commentary this quarter than usual on how long the present 'bull-market' can run. This is always a spurious debate that should not affect investors with long term investment intentions. The bottom chart on the prior page from JB Were shows the duration of previous 'bull-markets' with each driven by its own set of unique conditions. The present "bull" run to date is shown by the orange line. We expect markets will continue to improve from here on better co-ordinated global economic growth though we also expect volatility will rise as we start to move into a slow long term rate tightening cycle.

Property

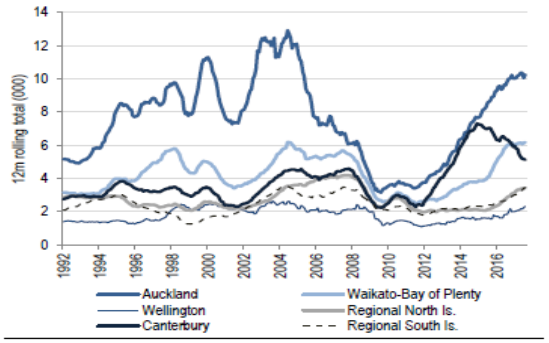
Despite significant supply/demand imbalances, the New Zealand property market is turning down. REINZ reports that residential sales were -20% lower across the country in August while Auckland median prices are now –1.2% year on year. Auction clearance rates are down -55% on the same time last year and auctions now only represent 14% of sales nationally while days to sell has also increased from 30 to 37 days. The top chart opposite from Forsyth Barr shows declining residential consents in Canterbury and flattening consents in Auckland. Non-residential consents are also down -8.1% year on year in August. These numbers may seem surprising given our continued strong net immigration.

The chart in the middle opposite shows the link between house affordability on an incomes basis and population growth. This is the key to the problem and despite our population growth, houses are simply unaffordable at current levels. LVR restrictions, bank credit rationing, slightly higher mortgage rates and increasing construction costs and capacity constraints are all impacting our ability to address the supply/demand imbalance. Coalition government uncertainty also raises questions about several significant policy risks including immigration control, foreign ownership, capital gain and land taxes and accelerated infrastructure spending. Similar issues are playing out in the US, UK and Australia. While pent up demand should ensure a floor, prices could move lower from here in the short term.

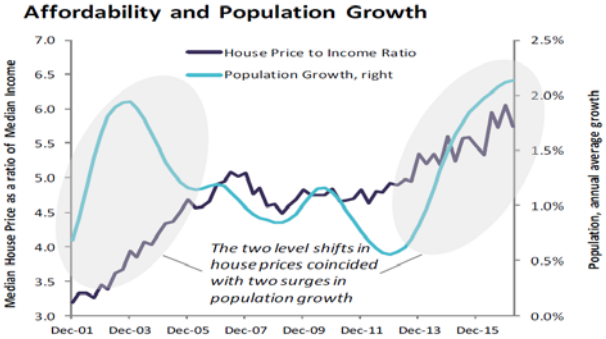
Commodities

Broad commodity prices continued to improve over quarter with metals, materials, agriculture and energy rising on better Chinese and European demand. The September ANZ commodity price index (prices in NZD) chart is shown opposite. NZ export commodities were generally stronger over the period with meat, seafood, timber, aluminium and horticulture prices all higher while dairy proved the only disappointment due to lifting global supplies. Our Terms of Trade are continuing to improve and running at historically high levels. This is a positive for rural incomes and regional growth.

Figure 5. NZ residential consents by region



Source: Statistics NZ, Forsyth Barr analysis



Source: Interest.co.nz, Statistics NZ, JBWere Investment Strategy Group