NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

16th January 2020

December 2019 Quarterly Report

December quarter market returns were mixed with international and Australasian shares performing well while fixed interest investments were negative on rising longer term interest rates. Portfolio returns were positive and capped off a good year though most of the strong returns came in the first half of 2019.

The quarter started with a great deal of geopolitical risk and concerns for the outlook of a slowing global economy. With the exception of the recent US/Iranian turbulence, geopolitical risks generally subsided over the period. After a year of slowing global growth and concerns for recession, there are now early signs that global economic activity is also improving and providing a positive setting for 2020.

2019 provided a valuable lesson for investing and the importance of carefully sticking to one's target strategy. Too often investors are impacted by the negative noise of markets and media. Throughout 2019 there were consistent messages of impending recession and likely market corrections which did not materialise. Investors who stayed out of markets or reduced risk away from target would have lost significant returns during the year.

Of course, there will be recessions and bouts of market volatility, but these periods cannot be picked and timed. Our approach, as always, is to ensure portfolio strategies are appropriately designed for the risk and return needs of clients. We then invest into high quality assets and actively re-balance them to maintain the target strategy. This disciplined process removes the noise and emotion that can so often distract investors from their long-term investment intentions.

We presently undertaking an assessment of our long term expected returns from different asset classes. This is because cash rates are likely to remain lower for longer and this will have a flow on impact on the expected returns from other asset classes. When this work has been completed we will review the impact on the expected returns and risk from your investment strategy.

Kind regards,

Wayne Ross
Director Investments

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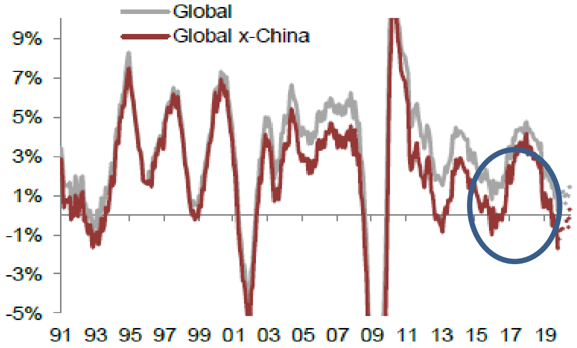
ECONOMIC AND MARKET SUMMARY

The global economy continued to slow over 2019 as trade activity and industrial production weakened. The US/China trade war and Brexit uncertainty resulted in weaker business confidence globally – which in turn impacted business investment. There were significant concerns for recession as bond markets started to price in a sharp slow-down. China was especially impacted turning in the lowest growth rate in 30 years, while global growth slipped to around 3% - the lowest since the Great Financial Recession. Persistent benign inflation enabled central banks to respond to the softening outlook by pivoting from a tightening policy outlook to actively cutting interest rates to record low levels - several central banks cutting rates to negative levels. Several governments also engaged in fiscal stimulation in 2019 with China, US, France and Spain all continuing with or announcing new spending programs. Britain, NZ and now Germany have also committed to joining in with the fiscal easing activity this year which will continue to ramp up demand.

Looking forward, full employment levels and strong consumer activity should combine with the monetary and fiscal policy stimulus to stabilize and improve global growth. At the end of the December there were early 'green-shoot' signs coming through with several economic leading indicators turning positive. The following chart from Credit Suisse shows that the very cyclical nature of industrial production (roughly 3-year cycle) looks to have bottomed out in 2019 and is starting to recover. Elsewhere, US growth is still running above trend and should continue to improve in an election year. Trump (who most likely will be acquitted), will be determined to keep the US economy on track which includes completing some form of initial trade deal with China. He will be especially keen on supporting the mid-west (farm exports) swing voter states.

Geopolitical tensions certainly ran high in 2019 but may abate this year on Brexit certainty, US/China trade progress and a cooling in China/Hong Kong relations. The Middle East remains unpredictable and could go either way - though some further escalation looks inevitable and may disrupt critical oil exports.

Industrial Production Turning Up?



Source: Credit Suisse, Thomson Reuters Datastream

The NZ economy also weakened over 2019 with 2.3% growth and considerably lower than in 2018. However, data did improve over the December quarter with business confidence finally higher suggesting we might be moving out of our soft patch as well.

Despite globally weaker economic conditions in 2019, investment markets performed strongly. Growth assets performed especially well. Global sharemarkets rose +26% with the NZ market up +30% and Australian market up +23%. Global listed property lifted +24%, NZ listed property +31.3% while NZ residential property moved higher by +5.9%. Global commodities were mixed but +7% overall. Fixed interest (bonds) were strongly positive earlier in the year but softened in the last quarter. Global bonds finished +6.9% and NZ bonds +4.9% for the year. Taking risk was clearly well rewarded in 2019 - a time when much of the market and media discussion was focused on recession. We expected some significant periods of volatility for 2019 which did not eventuate. Volatility readings actually fell over the year.

Improving economic conditions should also see company earnings rise with analysts expecting a lift in 2020 of between 5% and 7% (and may be much higher). At the time of writing, quarterly earnings reporting was about to get underway.

Our expectations are for lower - but still positive returns for growth assets in 2020. Valuations are historically high in most markets even based on forward earnings improvements. However, relative to the returns from cash and bonds, growth assets are still reasonably valued and yield seeking investors will continue to underpin demand for them. Investors seeking to enter the market for the first time at these price levels will need to be prepared for short term volatility and have a long-term focus for achieving their target returns.

Central banks will likely pause from any further rate cuts in 2020 and this may be interpreted by markets as the start of a neutral to tightening outlook which would see long bond yields rise - particularly if inflation starts to edge higher. This means long dated bonds may not perform well this year and we will continue to cautious fixed interest keeping investment terms short for all our clients accordingly.
The table below shows the gross returns (before tax) from the benchmark index for each asset class.

Market Returns	Dec. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**5.1**	0.5	-1.7	-1.4
$NZ v $US	**6.8**	0.4	-1.1	-3.1
$NZ v $AUD	**3.3**	0.6	0.0	0.0
NZ Cash	**0.3**	1.7	1.9	2.3
NZ Fixed Interest	**-2.9**	4.9	5.0	4.8
Intl Fixed Interest 100% hedged to $NZ	**-1.6**	6.9	4.2	4.6
Australasian Equities 50/50 Indexes	**1.3**	26.6	14.5	12.4
NZ Listed Property	**-0.6**	31.3	17.6	13.9
Intl Equities 50% hedged to $NZ	**4.9**	26.0	12.5	10.5
Commodities $NZ	**-3.0**	7.0	0.2	-1.1

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	-2.7%
Contact Energy	Energy	-16.5%
F&P Healthcare	Healthcare	29.6%
Fletcher Building	Building	-1.2%
Freightways	Transportation	4.6%
Meridian Energy	Energy	-3.7%
Port of Tauranga	Ports	22.5%
Stride Property	Property	3.1%
Vector	Energy	3.6%
Vista Group Intl	Software	-6.2%
Australian Equities		
BHP Group	Resources & Energy	2.6%
Brambles	Professional Services	1.9%
CSL	Healthcare	15.7%
IAG	Financials	-6.7%
National Australia Bank	Financials	-16.5%
Scentre	Property	-5.7%

- Port of Tauranga announced a special dividend of 2.5 cents per share over the next 4 years as part of reporting an 11% lift in earnings last year. Higher log volumes offset weaker log prices although the key profit driver remains increasing container volumes as NZ progressively moves towards a hub and spoke model for shipping goods. POT is NZ's largest port by trade volume. They own 50% of Primeport in Timaru and 50% of Northport in Northland which made headlines following a Government sponsored study which recommended spending $10bn on rail and road infrastructure to close Ports of Auckland and develop Northport.
- Freightways posted a strong profit result however organic growth slowed in line with the weaker domestic economy. The company is raising prices in order to lift both revenue and widen margins in key segments such as express packages where the average residential price per item will rise to $8.25 from $7.50. The company also announced the purchase of Big Chill Distribution which operates a fleet of 200 refrigerated trucks and trailers.
- Meridian Energy and Contact Energy were negatively impacted by the announcement that Rio Tinto is reviewing its continued operation of the Tiwai aluminium smelter. Rio can give 1 years notice to close the smelter - which is in the bottom quartile of global smelter efficiency due to relatively high energy and transmission costs during a period of weak aluminium prices. If the smelter shuts down then the lines companies are impacted due to water for hydro power generation effectively being trapped in the South Island with limited means to redistribute this supply to the North Island where it is needed without significant capital investment over several years. At this stage it seems likely that a negotiated agreement will be reached to continue - although some commentators are suggesting a better medium to long term solution would be to spend $ on improving critical infrastructure now rather than later.
- National Australia Bank and Westpac continue to work through the impact of ongoing regulatory action and costs needed to remediate past issues with

Sonic Healthcare	Healthcare	-0.8%
Westpac	Financials	-16.9%
Woodside Petroleum	Energy	2.8%
Woolworths	Consumer Staples	-6.6%

- Vector agreed to sell the Kapuni gas treatment plant to Todd Petroleum. Todd holds the licence to extract gas from the South Taranaki field and the companies have entered into a long-term natural gas and LPG supply arrangement. This allows Vector to focus on reselling opportunities and Todd to further develop Kapuni and adjoining sites.
- Fletcher Building is the first building materials and construction company in Australasia to set a science-based target for carbon reduction. FBU has committed to reducing direct and indirect carbon emissions by 30% by 2030. The company's carbon emissions come primarily from the manufacture of cement and electricity usage so it is not just a matter of reduction strategies, with cement alternatives also being investigated and assistance being provided to help improve the carbon footprint of the company's entire supply chain.
- FBU also opened its giant new high tech pre-fabricated house building factory. Clever Core manufactures wall, floor and roof components complete with insulation and joinery and allowances for wiring and plumbing before shipping to site. This reduces the on-site build time for a weathertight core from 22 weeks to 6-10 weeks and will be used for at least 500 new homes each year.

inadequate financial advice and corporate governance. The most recent announcements include the Australian Prudential Regulation Authority investigating whether Westpac breached the Banking Act or contravened APRA's prudential standards, and the Australian Securities and Investments Commission filing their legal claim against NAB for the fees-for-no-service identified during the Royal Commission enquiry. A negotiated settlement is expected from these proceedings and a capital raising from the new management teams is likely to meet any obligations.

- CSL performed strongly following an investor R&D day which highlighted future prospects for gene therapies and flu vaccines. This was despite CSL launching a court action against Pharming, their main US competitor. The company alleges Pharming and a former CSL senior medical officer misappropriated trade secrets when they took 25 gigabytes of data (i.e. tens of thousands of documents). The alleged theft was identified by the company's cybersecurity team when the staff member left with evidence including emails and texts offering to steal information in exchange for a job.
- F&P Healthcare profits were in line with forecasts, reflecting strong hospital demand due to the bad flu season and greater use of nasal high flow therapy products due to the growing body of clinical evidence supporting this treatment. Homecare revenue on the other hand was flat and FPH will be hoping their new sleep apnoea mask can build momentum against competitor offers.

AUSTRALASIAN EQUITIES

The Australian market ended up +0.7% and finally broke through to a new all-time high set prior to the global financial crisis. The +23% return for the full year was the best annual return for the market since 2009, led by stellar returns from companies in the healthcare (+44%) and technology sectors (+34%). Looking ahead inflation remains persistently below target and with the bush fires denting confident the Reserve Bank Australia may look to cut interest rates. The New Zealand market continued to shine, driven largely by large company returns and high dividend payers, ending the quarter +5.2% to close out the year ahead +30.4%. Despite relatively high valuations the NZ market continues to be underpinned by strong export prices, full employment, a pick-up in housing, increased government spending and improving confidence. Single digit company earnings growth is expected over 2020 and should actual results exceed expectations then equity market returns may grind higher.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	0.9%	The fund slightly underperformed the market benchmark over the quarter. Positive contributions came from Port of Tauranga, Kathmandu (acquired Rip Curl) and Metlifecare (MET). MET proved to be the highlight as the company entered into a Scheme Implementation Agreement under which Asia Pacific Village Group Ltd, an entity owned by EQT Infrastructure IV fund, agreed to acquire all outstanding shares at a 67% premium to the current share price. While retirement operators are notoriously hard to value $7 per share was considered a good price. The retirement sector was also supported by the recovery in housing prices with much of their future earnings potential linked to the property cycle. Z Energy saw a dip in its share price after reducing earnings guidance, citing greater competition and price discounting against a backdrop of flat total demand. The manager also sold their holding in Coles following a strong share price performance post their demerger from Wesfarmers Group.
Harbour Australasian Equity Focus Fund	6.3%	The fund outperformed the market benchmark over the quarter due to a recovery in the share price of retirement village operator Summerset (takeover activity in the sector) and solid returns from core holdings in Mainfreight, CSL, Xero (new subscribers) and a2 Milk (despite the surprise news that CEO Jane Hrdlicka was leaving after such a short time at the helm). While the announcement was poorly handled the manager continues to see strong growth prospects (+30% p.a.) for the company. Stocks to detract from performance included Goodman Group which remains under pressure as investors switched into more cyclical stocks with the risk of recession fading. Profits were taken in Scales which signalled a more challenging year ahead with higher cost pressures associated for planned orchard re-development program. Scales has a strong balance sheet and is expected to look at further acquisitions in time. The portfolio is actively positioned in companies which will benefit from structural changes such as urbanisation, the impact of rapid technology disruption, accelerating medical innovation, demographic change and the rise of sustainability as an economic force.

INTERNATIONAL EQUITIES

The performance of international equity markets was strong over the quarter with the world index ending up 7.8% in local currency terms. Emerging markets outperformed developed markets over the quarter, especially across Asia with China up +10%, Taiwan +11.6% and even Hong Kong +6.5% despite the anti-government protests. Declining global trade risks and continued central bank monetary support helped solid gains in most major markets with the US +9.1%, Japan +8.9% and Europe +5.2%. The UK continued to be weighed down by Brexit negotiations however the landslide general election victory was viewed favourably for domestic orientated stocks. Key to returns for NZ investors was the rise in the NZ dollar against the US dollar (+6.8%) and Australian dollar (+3.3%) over the quarter, with the strong currency reducing NZ dollar returns for un-hedged international investments.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	0.3%	The fund was up 3.6% in A$ terms for the quarter - which was lower than the market, largely reflecting the 84% net exposure of the fund to markets. While this increased over the quarter (from net 73%) the manager continues to view record low interest rates as an anomaly and inconsistent with a global economy where; employment is at record levels (the US has added 10 million jobs in the last 5 years and Europe almost 9 million), commodities' markets are tighter, there is a trough in manufacturing activity and a strong services sector. Calls for governments to spend more in fiscal pump priming are likely to lead to higher interest rates and selling pressure on stocks with record valuations such as software and e-commerce growth stocks and perceived market safe havens such as utilities, real estate and consumer staples. The key exposures in the fund avoid these areas and instead are focused on semiconductors, energy, materials, auto, financials and companies exposed to the domestic Chinese economy. Reflecting on returns over the decade the fund returned 8.9% p.a. which was below the market return of 11.5% p.a. This in part reflects the average net exposure to the market of just 76% with the manager too cautious early in the decade but also reflects their tactical decision to manage risk by remaining underweight the US market which has been a stand-out performer. Over the decade the US market gained 16% p.a., Asia and Japan 9% p.a. each and Europe 8% p.a.
Monks Investment Trust	6.3%	The fund was up 6.3% in GBP terms for the quarter which was above the market. The manager has been actively building the exposure to healthcare in the portfolio (now 8%) and the latest addition is Teladoc which is an online platform that facilitates medical consultations in the US. The company is a market leader and gaining traction in both the public and private health markets. In addition to the core holdings in technology enabled platform businesses (such as Amazon and Naspers) new investment has been made in earlier stage tech companies such as Appian which is a leading 'low-code' platform that enables enterprises to code bespoke system solutions more efficiently and at lower cost. The share prices of several holdings outstripped growth prospects and they were sold (First Republic Bank and Verisk (data provision and

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		analytics) while profits were taken in MarketAxess (bond trading) and Shopify (online commerce). Sale proceeds were redistributed to a company providing governance services to the financial sector and BMW's partner in China. Around 1.2billion people across Asia are expected to join the middle class before 2025, 6 times more than the rest of the world. This improvement in levels of health, education and wealth has taken hundreds of millions out of poverty and the manager believes insurance as an essential next step for many as they seek to secure what they have in markets with no social security systems or a tradition of a welfare state. Established companies such as Prudential and AIA are seen as huge beneficiaries given the scale of their distribution and existing client base, while China-only Life insurer Ping An has enviable access to a market which has massive scale, limited existing penetration and high barriers to entry.
Magellan High Conviction Fund	6.8%	The fund was up 10.2% in A$ terms for the quarter which was ahead of the market and brings the annual return to just under 30%. Key to this strong result has been the high (40%) exposure to internet and eCommerce companies with an additional 16% in information technology and 9% in payment systems. Of course technology is impacting on all areas of the economy and medicine is increasingly in the spotlight. Dubbed medtech, technological advances are occurring in biotech, immunology, surgery and neonatal care to name a few with robot surgery and 3d printed organs. Artificial intelligence software trained on data form digitalised health records and devices can spot problems faster and more reliably than humans. For instance, portfolio holding HCA Healthcare, the largest for-profit hospital operator in the US, now uses algorithms trained on 31 million cases to detect the sepsis infection that kills about 270,000 people a year in the US alone. Medtech is not a 'cure all' however with progress often slowed by the cost involved, ethical issues (e.g. gene-editing) and limited progress in kay areas such as obesity. There is also the interesting issue of a rise in self-diagnosis (Dr Google and self-monitoring devices) where incorrect diagnosis can lead to unwarranted anxiety and unneeded treatments
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	7.7%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZD which means values were not adversely impacted by a sharp rise in the NZ dollar against the AUD and USD.
iShares Russell 2000 Index Fund	2.8%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. Smaller companies have recovered well after the sharp losses in the December quarter last year with gains across most sectors. In the US, 70% of the Russell 2000 companies posted positive returns with half gaining more than 20%. Information technology, Industrials, Health Care and Real Estate led the way with 10 out of the 11 sectors positive (Energy was the only detractor).
Vanguard FTSE All-World ex US Small Cap Index Fund	4.0%	
Vanguard Emerging Market Index Fund	4.6%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Easing trade tensions benefited China, South Korea and Taiwan with tech stocks posting solid sales data and improved earnings. The announcement of further production cuts in 2020 saw a pick-up in crude oil prices which was supportive of Russia and Colombian markets. In contrast Chile, Turkey and India were all negatively impacted by mass public protests over inequality and corruption.

COMMODITIES

News of the US-China deal helped the outlook for global growth and was generally positive for commodities. In agriculture, coffee (+25%) and wheat (12%) were notably strong and precious metals such as gold and silver also advanced. Energy led the sector higher however as OPEC+ (the 14 strong Organisation of Petroleum Exporting Countries + 10 oil producing nations) announced further production cuts to ease oversupply concerns. State-owned oil giant Saudi Aramco raised a world record US$25.6bn in its initial public offering in December despite concerns about climate change, political risk and a lack of corporate transparency which saw international investors question the company's valuation.

Security	Quarterly Performance In NZ$ terms	Commentary
iPath Dow Jones UBS Commodity Index Note	-1.9%	The fund provides passive index exposure to commodities and is valued in USD. Commodities prices rose 4.4% in US dollar terms with oil prices around 15% higher than a year ago. This amounts to an increased input cost for most NZ exporters however our primary producers have been insulated from this by a 20-30% increase in meat and dairy prices.

FIXED INTEREST

Long term global yields increased (meaning prices fell) in all major bond markets. The US 10-year yield rose from 1.66% to 1.92% while their 2-year yield dropped 0.05%. This steepening of the yield curve indicates investors may be taking a more optimistic view of the economy. Global fixed interest rates remain at the same levels (or lower) than those experienced during prior periods of significant weakness in the global economy such as the 2012 European sovereign debt crisis, the 2016 Chinese investment slowdown and the Global Financial Crisis. However, despite slower global manufacturing the world is not in a recession and strong employment in most economies suggests interest rates reflect central bank policy rather than the underlying level of economic activity. With global rates near or below zero there is little room left to manoeuvre since depositors will not accept negative rates forever and the total level of indebtedness of government, businesses and households continues to rise. It is not surprising central banks have been putting pressure on governments to increase fiscal spending and make hard policy decisions to stimulate growth.

In December Sweden's central bank increased its rates from -0.25% to 0% despite a weak economy due to concerns about the market distortions low rates can create. Lower rates mean higher (and potentially misleading) valuations for other asset classes such as equities and property, a lower hurdle rate for real investment (leading to poor capital allocation) and investors being forced to seek higher yields despite economic and geo-political uncertainty and therefore crowding into some sectors (defensive and high growth companies) at the expense of others with potentially better long term prospects. All this will take some time to work through and with no clear solution yields are expected to trade in a broad range during 2020 with some upside rate risk if inflation settles above 2% in key markets.

NZ bond yields rose across all maturities with the 10-year government bond rate up to 1.65% in December from a low of 1% in October. Rising bond yields mean falling bond prices and the benchmark index dropped -2.9% over the quarter. The rise in yields was due to improving business and consumer confidence lowering expectations of any immediate Reserve Bank easing of cash rates. NZ firms expectations of their own activity is the highest since 2018 (albeit still low) with greater intentions to hire, while the housing market has stabilised and an additional $12bn of capital spending was announced by the Government which is forecast to add 1.4% to economic growth.

The Reserve Bank of NZ finalised its changes to the capital adequacy framework for NZ banks during December. The new regime will increase the capital requirements for banks and alters the mix of acceptable capital structures which will impact on the demand for retail term deposits and ultimately their level of interest rates. Bank management continue to comment that the changes are excessive, with local banks already among the most strongly capitalised in the world, however the extended seven-year timeframe to fully comply was well received.

Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	-2.0%	The manager is holding a slightly longer than benchmark duration position across fixed interest portfolios. They expect global economic data to remain soft and tighter credit conditions in NZ to remain as banks meet their new capital requirements. The RBNZ is expected to leave the OCR at 1% at its next meeting however weak Australia data will likely cause the RBA to ease policy later in 2020 and the RBNZ may need to follow suit if our dollar keeps strengthening. NZ bonds are starting to look more attractive against global peers however potential extra fiscal spending in the run-up to this year's election is likely to influence spreads and demand.
AMP Capital NZ Short Duration Fund	-0.4%	
Harbour Wholesale NZ Core Fixed Interest Fund	-1.6%	The manager reduced duration during December but the largest contributor to performance was from relative value trades where their long-held view that NZ bonds were expensive relative to US treasuries was rewarded. Inflation indexed bonds and corporate bond spreads were stable and therefore had little impact on performance. The portfolio is positioned for further yield increases, most likely in the 2-5-year maturities, as inflation rises above 2% and the RBNZ moves (cautiously) away from further reductions in the official cash rate. Any policy change is not expected until later in the year assuming the positive momentum in the domestic economy is maintained.
Harbour Enhanced Cash Fund	0.3%	

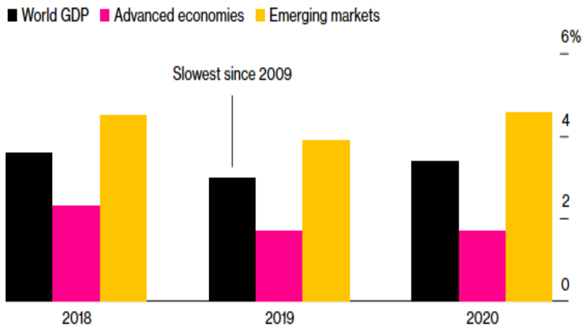
Global Outlook

Global growth slid further in 2019 as the US/China war impacted business confidence and investment. Supply chains were particularly disrupted resulting in slowing industrial activity - especially in China, Japan and Europe (Germany). A few developing countries benefited (China proxies), while re-homing of some production to the US improved their trade imbalance and made Trump look good. Brexit also weighed on global activity with Britain barely escaping recession and the exit uncertainty impacting Eurozone production as well (again mainly Germany). Has the bottom been reached? The chart opposite from the IMF shows a better expected outlook in 2020 as emerging economies contribute a greater share to global activity. December and early January activity data suggests there is an improvement in key markets including China and Europe and positive growth revisions in the US. When we combine the stimulatory monetary policy adjustments made in 2019, and the fiscal stimulus programs (either announced or implemented in 2019) with the better geopolitical risk outlook, then global economic growth should accelerate in 2020. However, this positive view needs to be balanced with the significant ongoing structural challenges of global power shifts, de-globalisation, climate change, technology bi-furcation (US and China), technology redundancy, demographic shifts (which will impact both positively and negatively on growth prospects) and inflation. The shape of how the global economy works is quickly changing and will accelerate in this new decade.

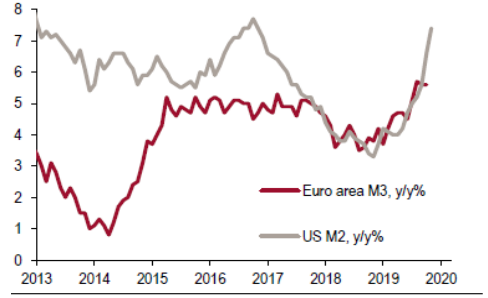
Investment markets surprisingly read right through the slip in economic growth in 2019 - with improving prospects now priced into many asset prices. This will invite periods of volatility as investors balance current and future value expectations. Despite the improving economic landscape, it is difficult to see how asset class returns can repeat the feats of the 2019. It is instead, more likely that returns were effectively 'brought forward'. There is also an expectation that central banks are unlikely to cut rates further bar some external shock and will mostly remain on the side-line this year. Indeed, they may be preparing to let conditions 'run hot' as inflation remains stubbornly benign. Recently, both Europe and the US have shown an unexpected uptick in wage inflation data.

Growth assets are likely to rise further this year as earnings improve and as investors seek better yields than those available from income assets. Bond yields may modestly rise delivering low and possibly negative returns overall with the risk that any inflation spike may cause yields to jump sharply. We have been considering the likely long-term rates of return from different asset classes based on the likelihood that cash rates have structurally changed and will be much lower for much longer, impacting on expected long term portfolio returns.

IMF Growth Projections 2020

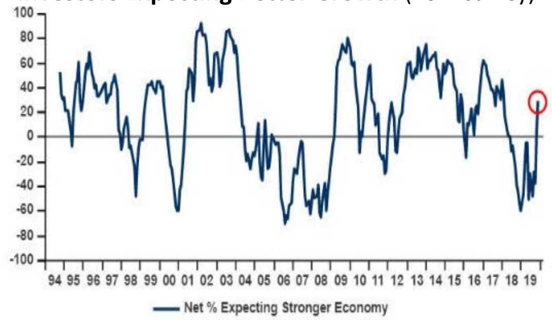


Money Supply Growth Stimulating



Source: Credit Suisse

Investors Expecting Better Growth (BofA survey)



New Zealand

The NZ economy lost momentum early in 2019 with poor business confidence, slower trading partner demand, softer tourism growth (Chinese driven) and a weakening housing market. The worst may now be behind us, as both business confidence (see the ANZ chart opposite) and consumer confidence improved in the December quarter. House prices have also recovered sharply while commodity prices also firmed up recently. Lower mortgage servicing costs, firming house prices and tight employment conditions are underpinning household confidence and consumption while the forthcoming lift in the minimum hourly wage to $18.90 will also assist consumer activity in 2020. In their business confidence survey, the ANZ noted the services and manufacturing sectors as being the most upbeat while construction was the least optimistic but still improving. Auckland house prices have now fully recovered from their 18-month decline hitting new record highs. The REINZ national index is up 5.6% on a year ago.

On the stimulus front, government spending is running about 8% higher than last year - being supported by better than expected budget surpluses. During the quarter, the Minister of Finance announced an extra $12bn of capital spending over the next 4 years. This is equivalent to about 1.4% of GDP and will be largely invested in transport while non-capital spending increases are expected for the health and education sectors. Combined with easier monetary conditions this fiscal stimulus will assist growth through 2020. The recovery trajectory suggests NZ GDP should lift to 2.6% in 2020 and rise further to 3% in 2021.

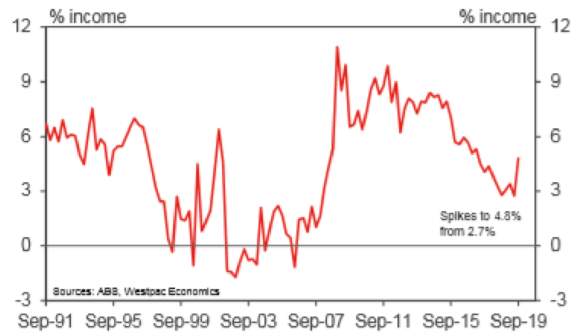
NZ Government Net Debt to GDP %

It is important to note that despite the additional government spending, there is no expected net increase in NZ Government Bond issuance until 2022. Our public net debt to GDP (opposite) continues to compare well against similar countries and the reason behind our good credit rating and strong NZ dollar. The RBNZ released its commercial bank capital requirements in the quarter which provided more flexibility and time for banks to shore up their balance sheets. The RBNZ expects the additional cost of capital for the banks will add only 0.2% p.a. to borrowing costs.

Australia

Australia continues to run below its trend growth rate of 2.75% p.a. with the recently revised Q3 GDP modestly rising to 1.7% p.a. The RBA has a target growth rate of 2.8% for 2020 which looks like a real stretch at this stage and relies entirely on a substantial pick-up in business investment and private construction this year. While public spending is strong, private sector demand remains flat. Consumer confidence has been improving on the back of the recovery of Sydney and Melbourne house prices but the increase in household disposable income - arising from tax rebates and lower mortgage servicing costs - are being used to reduce mortgage levels and increase household savings rates rather than being spent. Consumer spending therefore is not likely to improve long-term without any real improvement in wages growth. The RBA kept rates on hold in the quarter (0.75%)

Australian Households Savings Rising



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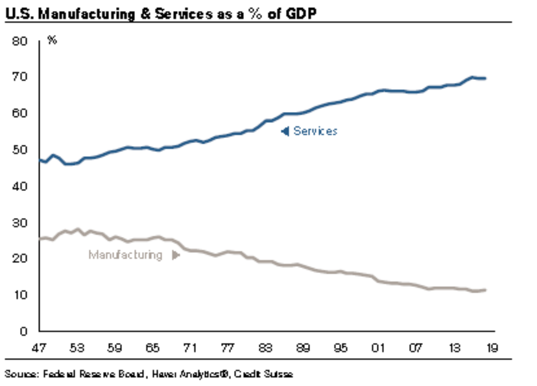
but maintains an easing bias and as a result Australia could be one of the few central banks likely to cut further in 2020. Both the Federal & State governments are embarking on significant capital spending programmes but there is also additional pressure coming on for the government to ease further by bringing forward its proposed personal tax cuts that are currently slated for 2022.

The recent sharp drop in confidence data in late December seems almost entirely driven by the terrible bushfire season that continues to pound south eastern Australia in particular. The short-term economic impact for the affected regions will be negative while government aid spending and reconstruction will be positive in the long-term. Meanwhile, Australian company profits improved in the third quarter and were up strongly to finish +11.1% for the year.

US

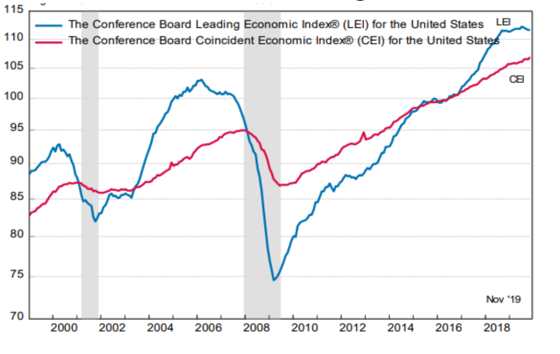
Following an easing pivot by the US Federal Reserve in early 2019, a slowing US economy responded positively to 0.75% of rate cuts with consumer confidence and spending higher due to lower mortgage costs, full employment (50 year low unemployment) and robust house prices (strong building consent numbers). As a 70% services driven economy (see chart), consumer confidence and spending play a vital role in the US economy. The ISM Services index jumped to a 4-month high in December beating expectations. Like elsewhere in the world, manufacturing is soft - though automobile production bounced in the quarter. After a weak start to the year, the US economy has continued to run along at an above trend growth rate of 2.3% in 2019 (2% trend rate). The trade war with China has impacted US farm exports but it has been an overall positive for their trade deficit which moved to an 18-month low. With it being an election year in the US, we expect the phase 1 trade deal with China will include provisions for specific US farm export targets to China ($50bn+) - appeasing the critical swing seats that Trump needs in the mid-west. Trump will be acquitted of impeachment and is, remarkably, looking on track for another term as president. The Chinese will want to further engage with Trump given his chances of a second term are increasing and particularly as an alternative Democratic led GOP by Sanders or Warren may be a more difficult negotiating prospect for China. For now, the US Federal Reserve has indicated it will remain on hold for further rate cuts. An inflation spike is possible this year given unemployment levels are at 3.5% and wage inflation is also creeping in (as shown in the chart opposite). The Fed is likely however, to let inflation run above target to ensure growth is embedded. The S&P 500 is now trading on a forward-looking price earnings ratio (PE) of 18.5x making it historically fully valued, although earnings growth is likely to recover after a very flat 2019 assisting prices. Compared with cash and bond alternatives US shares remain attractive. US treasuries may be more volatile due to potentially lower offshore demand (Chinese and Japanese buying in particular) - especially if investors believe interest rates cuts are bottoming.

USA Services Driven Economy



US Hourly Earnings Rising

The Conference Board US Leading Economic Index®



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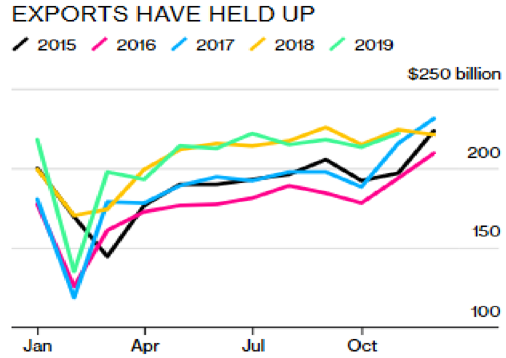
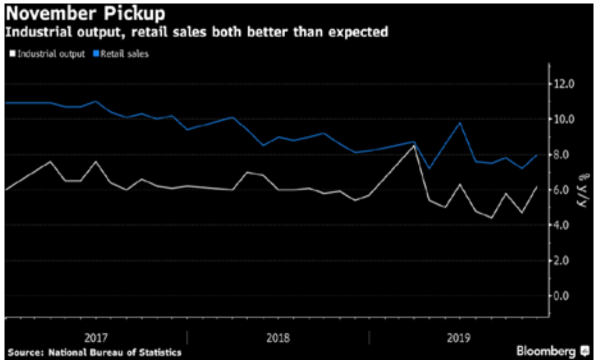
China

Chinese economic growth slowed sharply during 2019 with the 3rd quarter registering the slowest activity in 27 years. Growth will come in around 5.8% for the year. Falling exports to the US provided a small negative impact with overall Chinese exports remaining relatively steady compared to 2018 (see opposite chart). Most of the downturn in China came with deliberate domestic de-leveraging as officials sought to restrict un-official credit lines (shadow banking) and shore up their increasingly exposed financial system. Tighter credit conditions impacted investment, in particular - construction. Activity lifted in the December quarter with manufacturing moving back into expansion territory and large imports of iron ore imply a planned ramp-up in construction activity. A first phase deal in the trade war with the US sees a rolling back of some US tariffs which will also assist exports in 2020 while the US has removed its ‘Currency Manipulator” status on China. Further progress will be made before the US elections - particularly if Trump polls well. Additional fiscal stimulus was provided throughout the year with China running a much higher than average budget deficit while some recent monetary stimulus of approximately $115bn has been added to provide additional credit availability. It is a balancing game for President Xi, simultaneously leaning on old stimulus levers while trying to transform his economy away from its reliance on exports and construction. Xi continues to be overextended with his aggressive reform agenda and becoming more authoritarian by the day (more than a million officials punished for corruption under his regime). It will be interesting to see if the cracks widen further in 2020 (Hong Kong, Uighur internment, US power clash) and if China can get its economic growth rate back on track (6.5% target).

Chinese Exports Marginally Lower in 2019



Chinese Industrial Output Stabilising



Europe

Sharply lower industrial production in Germany and Italy dragged European growth down over 2019 which looks like coming in around 1% and well down on 2018. Much of the lower output can be contributed to the fall in manufacturing exports as the impact of trade wars reverberated around the world - Germany nearly entered a recession in the 3rd quarter with Auto makers particularly hard hit. On the bright side, employment conditions continue to get better and are supporting strong consumer demand especially in France and Spain. The ECB maintained easy monetary conditions as inflation sits well below target. In November they recommenced QE activity through their asset purchase program (€20 billion per month). Fiscal policy is also expected to contribute to a growth recovery in 2020 with both France and Spain running larger budget deficits and Italy having more budget room due to lower debt funding costs. Germany is also likely to spend as the Social Democrats seek budget agreement changes in order to roll out funds to compete with popular Green’s policies. The pick-up in global trade activity should help manufacturing conditions, although the US is now likely to turn its attention to the €180bn trade imbalance it has with Europe after concluding its phase 1 deal with China. UK Brexit negotiations will also commence in earnest with Boris Johnson in a more powerful position given his majority Conservative government and preparedness to accept a hard Brexit if required.

German Manufacturing vs Services

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UK

Brexit uncertainty and a near constitutional break-down pushed British politics into crises and the economy to the edge of recession in 2019. Although growth slowed sharply to 1% (from 1.5% in 2018) the UK has been remarkably resilient in the face of such uncertainty. With an emphatic election win, Boris Johnson now provides for Brexit certainty on the 31st January which may not be popular but enables businesses to focus on a post Brexit world. Johnson has also promised significant additional fiscal stimulus in the budget this year to assist with the transition impact and to try avoiding recession. The UK now has 2020 to complete European negotiations. In the meantime, they will seek to establish new direct trade terms with the rest of their key trading partners.

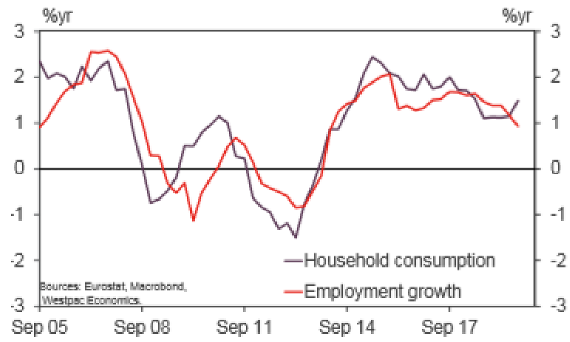
Japan

Japan has also been buffeted by the global trade slowdown with much weaker Chinese orders hurting exports. The government counterintuitively increased sales tax from 8% to 10% in October which brought forward some domestic spending (and RWC expenditure) and inflated the 3rd quarter GDP data to 1.8% annualized. This is expected to unwind in the December quarter on much weaker spending. They also sustained structural damage from the recent typhoon and have an increasingly costly trade spat with South Korea on the boil. Business investment remained the one bright spot for the year with corporates being resilient. Growth in 2020 should get better as global conditions lift but Japan looks set to trundle along at its anaemic 1% growth rate at best and continues to fail to address the structural problem of an aging society. The graph opposite shows the new participation rate of employees is failing to offset the shrinking working age population. This will continue to place a drag on productive labor capital and hinder Japan until it is addressed.

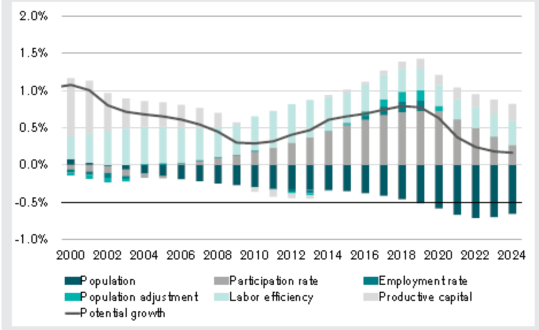
Emerging Markets

The IMF outlook has growth in developing economies bottoming out at 3.9% in 2019 then recovering on improving global conditions to 4.6% this year. After dipping sharply through early 2019, factory output from Asia improved sharply towards the end of 2019. The recent Purchasing Managers Indexes for South Korea, Thailand and Taiwan all moved above 50 in December. Asia is expected to bounce back to 6-6.5% growth in 2020. Some of this activity relates to proxy China production particularly in Vietnam. Eastern European countries are doing well on strong domestic demand while Russia and Turkey are implementing stimulus packages to boost growth. Latin America had a particularly tough 2019 with Brazilian mine closures, the financial crises in Argentina and the continuing humanitarian crises in Venezuela. Some recovery is expected in 2020 as Brazil delivers both a new fiscal package and eases monetary policy further. Growth also remains problematic for MENA countries with ongoing and intensifying conflict, trade embargoes and volatile oil prices and production continuing to drag on the region.

Euro Area Consumer Supported by Job Gains



Japan: Aging Employment Base not being Replaced



Last published data point: 2018, thereafter Credit Suisse forecast.
Source: OECD, Credit Suisse

Asia: Jump in Manufacturing Activity - December

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