NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

09 April 2020

March 2020 Quarterly Report

It has been a most extraordinary quarter for countries, communities, economies, and investment markets. Historically sharp economic downturns and market corrections normally occur when excessive financial conditions (the Great Financial Crises) have finally tipped over or a demand or supply shock occurs. This time the global economy has been brought to a standstill by a virus pandemic, or, more accurately - by government containment responses to the pandemic. Containment means we are having both a supply and demand shock for goods and services at the same time. This is unprecedented even by war events.

To counter the economic shock and help steady markets, central banks and governments globally have responded with extraordinarily aggressive monetary and fiscal policies. These policies are designed to sufficiently protect economies so they can recover and avoid a deep recession when activity is re-allowed. At the time of writing, we cannot yet see when or in what shape the commencement of activity will look like. History will judge if these containment policies were the right approach from a health perspective and worth the economic cost.

With the virus outbreak, investment markets went on a wild ride over the quarter, firstly trying to price in the extent of economic damage and then the positive impact from unprecedented policy support. Investment portfolios were sharply impacted in the quarter effectively giving up all 2019 returns. During such extreme market conditions our approach is to monitor portfolios for stress points but generally sit tight and hold onto the high quality assets that have become mis-priced in the mayhem. Your portfolio has a diversified mix of securities, asset types, currencies and manager styles which helps to reduce volatility. The active equity managers in the portfolio performed better than the market and will position their holdings to suit the shape of the rebound as they see it. We will look to rebalance portfolios, purchasing cheaper growth assets once market volatility drops to lower levels. However this may be some time away as markets are still trying to gauge the timing for an economic recovery.

You may be anxious about your portfolio so please contact us if you would like to discuss it.

Kind regards,

Wayne Ross
Director Investments

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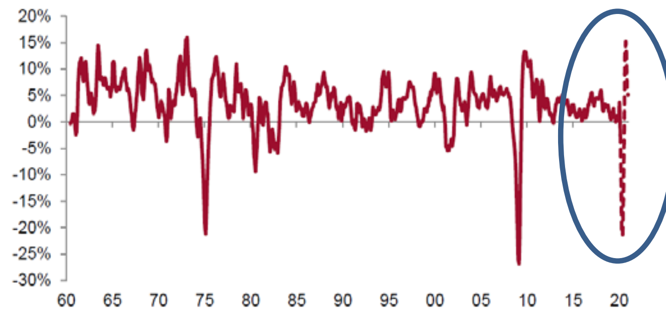
ECONOMIC AND MARKET SUMMARY

Global virus containment policies have effectively shut down economic activity. We will have an 'artificially' created recession as a result. Global growth for 2020 has now swung from a +2.7% outlook to -2.6% outlook. The recession is expected to be deep but also short-lived. Consensus economic commentary is presently looking for a rebound in global growth in the 3rd and 4th quarter of 2020. A full recovery could take several years as permanent damage will be done to some industries and sectors. Credit Suisse's forecast below shows a sharp fall and then recovery for global production activity.

Global Industrial Production Forecast

3m/3m annualized, dotted line forecast



Source: Credit Suisse, Thomson Reuters DataStream

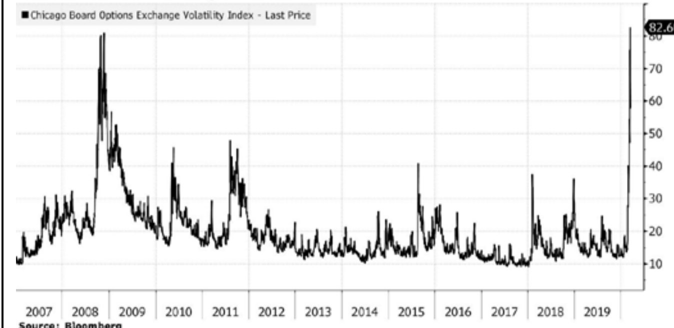
In the meantime, we are starting to see some record negative economic data which can only be expected. Surges in unemployment, severe contractions in services and goods production, and massive increases in credit demand show how extensive this economic stalling will be. New Zealand unemployment could rise to 11% (200,000+ lost jobs) and economic growth may contract -15% in the June quarter.

To cushion the impact, governments globally have announced record levels of fiscal stimulus (spending and lending) up to 15% and more of the value of countries entire annual economic output. These packages are extensive and very expensive and include wage subsidies, loans to businesses, tax relief and in some cases direct cash payments to households. Additionally, money is being spent on critical services areas including health. The aim of this spending is to keep money moving, businesses in business and people in work. In mid-March the NZ Government unveiled an initial $12bn support package which could be extended to as much as $50bn. Including the loss of tax receipts and other separate infrastructure spending, the total amount to be borrowed could be $65bn to $70bn over the next 4 years (20% of GDP). Fortunately, our Government accounts are in good shape enabling us to fund this. Our Reserve Bank also implemented supportive measures - cutting the cash rate to 0.25%, extended financing support for banks, commencing quantitative easing and other direct on-market operations. Global fiscal and monetary policy responses have been well received by investment markets and indicate the commitment to get through this coming recession in the best shape possible.

During the quarter investment markets initially did well anticipating better economic growth in several key markets including the US and China. The spread of the virus from China to Italy and Iran in February sent investors panicking as daily news confirmed the infectious nature of the contagion. The chart below demonstrates the extreme market concern which peaked in March higher than during the GFC in 2008.

Peak Fear

VIX closes at a record high



Sharemarkets experienced a 2-week sell-off in mid-March that broke records. As much as 90% of the trading volumes on major markets were being driven by programme trading (computer algorithms) hedge fund activity and indexed fund redemptions. This type of selling is indiscriminate with no interest in the real or intrinsic value of assets that is so important to longer term investors. The speed of market movement also started a liquidity crisis calmed only by aggressive central bank intervention. Fixed interest assets did not provide the level of protection normally expected as some investment grade bonds and even government bonds sold off on increasing liquidity and default concerns. Markets rallied in late March following central bank and government rescue policies. From here markets are looking for virus cases to peak and then for governments to end lockdowns and get economies back to work. China is presently leading the way and back up to 90% of pre-virus activity despite some recent reinfection rates.

We continue to monitor and manage portfolios to their return and risk objectives and despite the record fall in markets no portfolios have breached their design limits. We will look to rebalance portfolios and purchase cheaper assets once volatility levels permit.

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

Market Returns	Mar. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-6.8**	-6.8	-3.3	-2.6
$NZ v $US	**-11.6**	-13.2	-5.4	-4.6
$NZ v $AUD	**1.3**	1.5	2.0	-0.2
NZ Cash	**0.2**	1.2	1.6	1.9
NZ Fixed Interest	**3.5**	5.3	5.7	4.9
Intl Fixed Interest 100% hedged to $NZ	**4.0**	8.5	5.5	4.8
Australasian Equities 50/50 Indexes	**-19.4**	-8.2	4.1	6.3
NZ Listed Property	**-20.4**	-3.7	8.5	7.8
Intl Equities 50% hedged to $NZ	**-16.7**	-5.5	3.9	5.3
Commodities $NZ	**-12.7**	-10.6	-3.5	-3.3

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	-43.0%
Contact Energy	Energy	-23.1%
F&P Healthcare	Healthcare	36.9%
Fletcher Building	Building	-31.2%
Freightways	Transportation	-32.8%
Meridian Energy	Energy	-15.9%
Port of Tauranga	Ports	-22.0%
Stride Property	Property	-40.7%
Vector	Energy	-12.5%
Vista Group Intl	Software	-67.8%
Australian Equities		
BHP Group	Resources & Energy	-23.1%
Brambles	Professional Services	-9.8%
CSL	Healthcare	6.7%
IAG	Financials	-18.4%
National Australia Bank	Financials	-33.2%
Scentre	Property	-56.7%

- F&P Healthcare was one of the few companies to upgrade its earnings guidance for the coming year. FPH respiratory humidifiers and consumables are directly involved in treating patients with coronavirus. The company has ramped up global production to meet the significant increase in demand and is focused on providing operational support, user training and dealing with new customer enquiries. Profits also get a boost from the weak NZ dollar against the USD and Euro.
- Despite challenging conditions for collecting plasma during lockdown, CSL is continuing to see strong demand for its derived products. Lower collection access will impact on earnings but interestingly during periods of higher unemployment the number of new donors also generally rises. Most CSL products are considered life preserving for a variety of illnesses so will continue to be used in the crisis including demand for normal flu vaccinations. The company is also working with Japanese rival Takeda to develop a COVID-19 plasma treatment that uses antibodies of recovered patients to help the seriously ill. By working with competitor's both companies are trying to speed up delivery to market of a hyperimmune therapy that would provide a form of passive immunity. This approach has been used for other illnesses such as Polio, SARS, MERS, and Ebola.
- Auckland Airport has suspended dividends, cut staff pay and is reviewing capital spending plans as it prepares for strict border controls and lower passenger numbers over this year and next. The company has raised $1.2bn in new equity to shore up its capital base. The institutional offer was priced at a 7.5% discount to the last closing share price and was oversubscribed, attracting strong support from existing shareholders.
- Port of Tauranga is classed as an essential service and continues to operate under restrictions although some customers have had to suspend shipping during the lockdown. Key exports such as meat, dairy, kiwifruit, oil, and

Sonic Healthcare	Healthcare	-15.2%
Westpac	Financials	-32.8%
Woodside Petroleum	Energy	-45.4%
Woolworths	Consumer Staples	-2.4%

- NAB and Westpac. Lower interest rates have reduced net interest margin revenue for banks and weaker economic conditions will increase bad debts as some businesses struggle. However, bank balance sheets are in good order and central banks are additionally providing liquidity support, albeit with conditions. The RBNZ has instructed the big four banks, including NAB and Westpac, to stop paying dividends in order to retain capital. Australia's prudential regulator (APRA) has not followed suit, instead confirming that payment of dividends and variable remuneration remains a decision for boards to determine. APRA is aware of the potential impact that reducing dividends will have on savers already suffering from low official interest rates. Lowering dividends may also lower share prices and make it more expensive for banks to raise additional equity if needed.
- Contact and Meridian. According to Electricity Authority data, electricity demand in NZ has fallen 12% since NZ businesses entered the lockdown. Tiwai Point has also signalled they intend to reduce aluminium production by closing part of the plant which will reduce wholesale electricity demand further. Electricity suppliers and retailers such as Contact, and Meridian will be impacted to varying degrees from the drop in wholesale demand despite the pickup in consumer demand as everyone is based at home. Meridian has been growing its retail presence in NZ and Australia through Powershop.
- Woolworths has strongly benefited from the controlled and restricted access to food retailers, with sales volumes jumping in March as consumer stockpiled food supplies for lockdown. Their online division continues to show strong growth (+32%) and while it is currently only 5% of overall sales, this crisis may be the catalyst for a long-term change in consumer buying patterns. Less positive for earnings over the next 6 months has been the enforced closure of retail liquor outlets, pubs, and clubs.

medical supplies can be shipped but major earners such as logs to China is non-essential so the company cannot benefit from the rebuilding Chinese demand.

- Vista Group has been negatively impacted with the temporary closure of cinemas in many countries impacting on its core business. VGL has a diverse collection of assets however and some like the film studio product, have seen little disruption. VGL is focused on reducing costs and supporting staff and customers with a range of initiatives. The company cancelled its dividend and withdrew from purchasing an additional 14.5% of Vista China until conditions improve. Already in China, several customers are reopening cinemas with new content.
- Woodside was negatively impacted by the breakdown in OPEC+ with the oil price plunging 30% after Saudi Arabia responded to Russia's unwillingness to cut production by slashing prices and ramping up plans for a dramatic increase in crude oil production. Lower oil prices directly impact LNG prices however Woodside is the most conservatively geared producer and can survive on very low oil prices for a long time with current production costs of US$5 per barrel.
- BHP's main commodity exposure is iron ore (60% of earnings) which has held up well despite lower global growth expectations. In part this is because domestic Chinese production, initially impacted by containment measures, is now picking up again as China gets back to work. China is also expected to increase infrastructure spending which will benefit bulk commodities. BHP and the mining sector in general, is in much better financial shape post changes enforced by the GFC in 2008/9 which led to corporate restructuring, asset sales and equity raisings to lower leverage.
- Shopping malls closing in NZ and restrictions in Australia have impacted on the short-term outlook for Scentre. The company may need to assist with tenants by offering rental holidays while centre access is closed or restricted. Although with over 12,000 tenants across 42 shopping centres, and core tenants providing the bulk of income, the risk of a material impact due to some firms going out of business is considered low. The company may need to raise capital to meet gearing or interest covenants, but this would require earnings to collapse for an extended period. Current capital needs across the business are low with no major retail developments underway and a share buyback scheme has already been halted.

AUSTRALASIAN EQUITIES

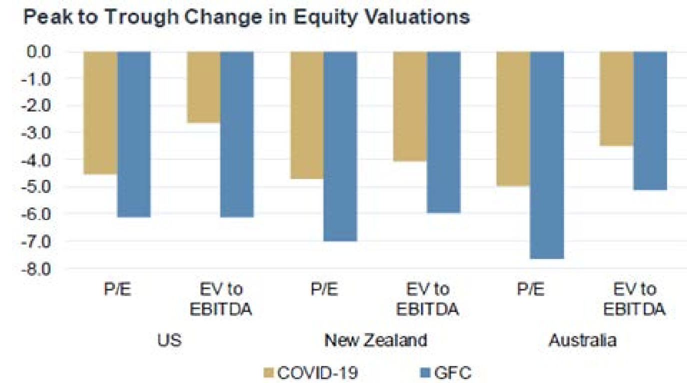
The Australian market ended down -24.1% in NZ dollar terms and the NZ market fell -14.8% but that return was more in line with other markets (down -20.6%) if you excluded the return from just two stocks F&P Healthcare and a2 Milk. Stocks directly exposed to the retail, education and tourism sectors have been severely affected and forced to remove earnings guidance, cancel dividends and where possible begin the process of recapitalisation.

With economic growth is expected to plummet in the next 3-6 months, NZ and Australia have already announced substantial fiscal and monetary policy stimulus measures which should lower the impact of job losses and business closures. Both countries have also benefited from a lower currency acting as a shock absorber.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	-20.4%	The fund performed broadly in line with the market benchmark over the quarter. Holdings in FPH, Coles, a2 Milk and Chorus helped performance while Vista and Scentre detracted. The manager exited Kathmandu and Air NZ which are expected to face material risks over coming months as they effectively halt their business. Ramsey Healthcare (RHC) was added to the portfolio when its share price fell due to concerns about elective surgery volumes during shutdowns. RHC is a private hospital provider with facilities in Australia, Europe, the UK, and Asia. Despite the outperformance of the NZ market during the quarter this was narrowly based and the manager sees more potential in Australia. Prior to the Covid-19 sell-down the Australian economy was already dealing with impact of the devastating bushfires so company management was generally cautious during the reporting season. However their share market benefits from having companies involved in a wide set of sectors, including Healthcare and Utilities which have proven to be very resilient. It also offers exposure to the Energy and Materials sectors which will be among the first to benefit from a recovery in markets when central bank and government stimulus takes effect.
Harbour Australasian Equity Focus Fund	-23.0%	The fund underperformed the market benchmark over the quarter. The portfolio is biased towards stocks that benefit from structural change that can sustain and grow earnings and dividends through what may remain an imbalanced global economic growth environment. While the local profit reporting season ended on a soft note, underlying corporate profitability remains robust and balance sheets are in good order. A sustained period of economic weakness may test some more cyclical businesses but may provide opportunities for stronger businesses to grow organically or by acquisition. The pronounced weakness over the quarter may have been bordering on irrational, with markets driven by fear rather than fact. Monetary and fiscal policy easing (already occurring) will provide some stabilisation to economic activity and to markets. With the market 'on sale' the manager will look to add to quality stocks at what may prove to be medium term discounted prices.

INTERNATIONAL EQUITIES

Global sharemarkets declined 22.4% over the quarter with Price to Earnings ratios (P/E) back to 14.4x from 19x and already factoring in a global -13.3% downgrade in earnings. No individual markets were spared from the carnage with the US down -20.5%, Europe -25.3%, Germany -25.0%, UK -23.8% and Japan -19.2%.



Source: Harbour Asset Management

The US market has seen its Price to Earnings ratio (P/E) fall back to 16.3x and this includes an assumed -12% earnings downgrade for companies, Australian P/Es fell back to 14.7x and assume earnings downgrades of -9.2% and NZ sharemarket P/Es while still high, have moved down to 25x - reflecting earnings downgrades of -8.2%. Using either current P/E numbers or risk premium valuation methods show sharemarkets have priced in a global recession.

Earnings prospects are likely to go lower as the extent of the economic stop translates more directly into company results. We have already started to see cuts to dividend payments and substantial capital raisings as companies seek to re-build their balance sheets and some will be positioning to take advantage of weaker conditions for acquisitions and other opportunities. Most of the damage has been done to those leveraged services companies directly impacted by the containment including, travel, tourism, education, and accommodation. Other including, construction, dining, and entertainment should recover faster.

Massive monetary and fiscal stimulus support has calmed markets over the past few weeks. From here, equity markets will need assurance that the pandemic is firstly peaking and secondly that economies can start to be put back to work. Market prices will respond quickly to better news. Though markets may have bottomed, any new major virus outbreak or steeping of the case curve, would see them retesting their recent lows.

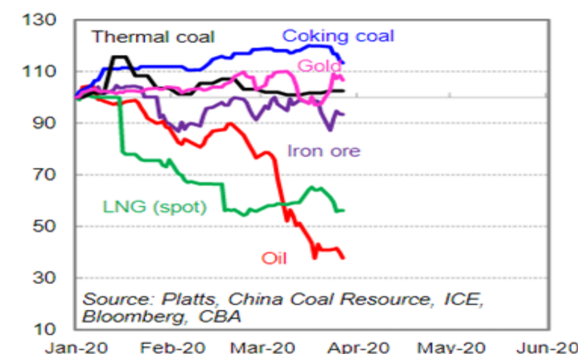
While the extent of the overall sell down is significant, especially when considered against the record market highs seen in February, the level of volatility experienced has been just as extraordinary. In March for example US stocks dropped -10% in a single day (their worst one-day decline since 1987 and 3rd worst ever) before later in the month jumping over 20% during the best three-day rally since 1931. Daily trading volumes have been exacerbated by algorithm driven electronic trading, the equity market being used to provide liquidity as riskier corporate bond markets effectively closed and frightened investors who had never experienced this level of volatility the longest ever market bull run since 2009. We will wait for this extreme share price volatility to settle back to more normal levels before rebalancing client portfolios by taking profits and buying cheaper growth assets.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	-12.5%	The fund was down -11.4% in A$ terms for the quarter with negative returns largely attributable to investment in the energy, materials and industrials which were hit with the double whammy of the oil shock and economic paralysis due to the Covid-19 response. The key drivers for holding companies in these sectors (e.g. required capital expenditure on offshore oil and the adoption of electric vehicles) remain in place despite being delayed. The fund was 71% net invested in markets at the end of February with the manager cautiously considering the progress being made towards a vaccine/cure and the cessation of economic activity as governments around the world scrambled to act in the interests of their increasingly nervous populations. Holding high levels of cash and short selling stocks in not unusual for the manager who was already concerned about high valuations of stocks in sectors such as software and defensives. Despite the recent rebound in markets from very oversold levels they caution that this is consistent with bear market behaviour and it is unlikely that markets race higher from here. That has not stopped the team finding excellent investment opportunities and they have added a US semi-conductor maker and a leading travel technology company which is expected to enhance its dominant position when restrictions are lifted.
Monks Investment Trust	-9.7%	The fund was down -14.6% in GBP terms for the quarter. The manager expects further short-term volatility but believes at present the crises is driven by liquidity (short term) rather than solvency (long term) concerns which makes it fundamentally different to previous crisis such as the GFC and Asian crisis. They believe there is a reasonable likelihood that the threat will have abated within 6 to 12 months if the right measures are taken to protect people and economies. At this stage demand is being delayed rather than cancelled altogether. Companies held in the portfolio are bought with a minimum 5-10-year view, have low levels of debt, and are well positioned for future growth prospects therefore there have been no material portfolio changes although all companies remain under review. Key themes driving stock selection include the future of power and the great energy transition from fossil fuels; the changing face of capitalism as more companies place a greater emphasis on employees, customers, suppliers and the government right alongside shareholders; how to attract the attention of customers with the seemingly endless digitisation of news, social interaction, gaming, retail, TV music and films; and finally just how far along are we with the cloud based revolution.
Magellan High Conviction Fund	-11.3%	The fund was down -10.0% in A$ terms for the quarter. The manager actively increased the defensiveness of the portfolio, reducing the exposure to stocks that are more exposed to recession. Cash levels were raised to 28% and held in USD. The fund is invested 35% in enterprise software companies (Microsoft, SAP, Alibaba, Tencent) which are expected to be extremely resilient during any downturn. An additional 18% is in two technology companies (Alphabet, Facebook) which will see a decline in activity due to their cyclical exposure and lower customer advertising spend - although both have significant financial strength and are well placed to leverage their evolving business models. Other key holdings include payment platform provider Visa, Estee Lauder and Starbucks. All three companies have been negatively impacted in the short term but have balance sheet strength and businesses which will quickly recover. Estee Lauder owns many of the world's strongest brands and sources 33% of sales from Chinese consumers who are expected to be the first to recover.

		The manager is assessing the economic and investment implications of COVID-19 based on predictions of three fundamental issues: the duration of the output gap (how long economic activity is shut down); policy responses from government and central banks (interest rates near 0%, financial system liquidity, business and employee support packages); and, future changes in consumer behaviour (less travel, changing work environment, hygiene habits). While it is difficult to predict the next 12 months, policy responses are expected to lead to a U-shaped recovery in most developed markets rather than a deep recession.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	-20.7%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZ dollar which means values are not impacted by currency movements.
iShares Russell 2000 Index Fund	-21.4%	These funds provide passive exposure to smaller companies in the USA and around the world. The funds are valued in USD. The sharp 9% fall in the NZ dollar against the US$ over the quarter helped add to returns.
Vanguard FTSE All-World ex US Small Cap Index Fund	-19.9%	
Vanguard Emerging Market Index Fund	-14.3%	The fund provides passive exposure to companies listed in emerging markets and is also valued in USD which assisted returns.

COMMODITIES

Saudi Arabia showed appalling timing by announcing on the 8th March a price war with Russia which triggered a plunge in oil and associated energy prices. US oil fell -34% and crude oil by -26%. Covid-19 shutdowns in late March then created a collapse in global demand sending oil prices even lower. The Saudi move has backfired with reports the Saudis need $90 per barrel oil prices to balance their budgets. A new meeting has been finally agreed to discuss production, but any cuts are not assured with Russia in a better financial position to negotiate. Meanwhile, significant damage is being done to energy producers and their lenders.

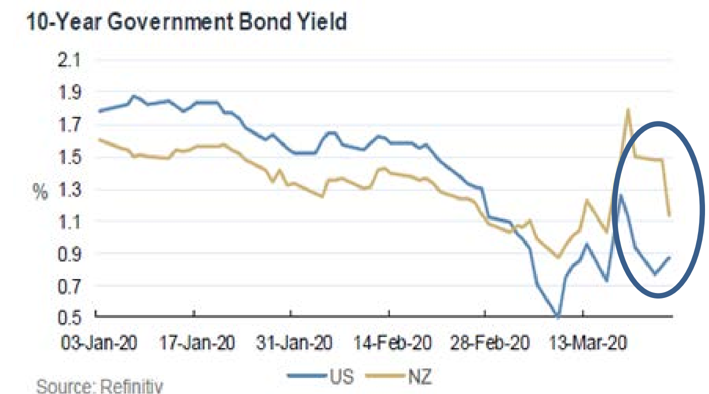


Sharply lower Chinese demand impacted NZ primary exports over the quarter although the weaker NZ dollar provided significant protection. As China gets back to work, demand and prices should improve for our commodities though some supply is being constrained by drought conditions and Level 4 restrictions in NZ which restrict the movement of some products. Horticulture has held up well but is now entering into the picking season when labour will be impacted by restricted internal travel and effectively closed international borders.

In February we sold down our small direct commodity holding for clients and reallocated the investment to International Equity managers. This provides the portfolios with a more cost effective and diversified exposure to commodity producers and suppliers as opposed to the direct investment product.

FIXED INTEREST

Globally, central banks have cut official cash rates to near 0% levels with several considering negative rates - although interestingly, Denmark raised rates citing negative rates as ineffective. These historically low cash rates are expected to anchor the front end of the fixed interest yield curve for at least a year and possibly longer as recessionary conditions put the risk of inflation firmly to one side. As safe-haven assets, government and investment grade bonds normally provide some price protection against falling growth asset markets. Although this was the case initially in February, once the pandemic firmly broke out, bond markets started to break down in mid-March as investors starting panic selling for liquidity. Energy company issues, bank issues, travel related corporate issues and sub-investment grade bonds were the hardest hit as investors assessed higher risk for these assets. For comparison, in the US, High Yield debt (sub-investment grade) fell -12.9% during the quarter compared to a +7.6% gain for US Government debt.



In mid-March, central banks (including the US Fed with an unlimited budget), stepped into markets aggressively to provide liquidity; buying bonds and mortgage backed securities and fixed interest ETFs. This action has calmed these critical credit markets and yields have moved lower again over recent weeks as can be seen in the chart above. Additionally, various business lending schemes will support corporate issuers though the risk of default or at least a downgrade for some industries and companies has certainly risen.

Closer to home, the Reserve Bank of Australia, and the Reserve Bank of NZ both slashed short-term cash rates to 0.25% and committed to keeping them low for some time. New Zealand fixed income markets followed a similar path to offshore markets with interest rates generally moving lower but with diverse performance between Government and Corporate bonds depending on their perceived level of risk. All bond prices fell during March resulting in low or even small negative returns from bond funds which mark to market the value of their bonds (even though they typically hold them to maturity).

Government borrowing (by issuing new bonds) needs to rise sharply to fund the various stimulus packages. This sharply increases supply driving bond yields higher. To support the market and provide liquidity the RBNZ has committed to a $30bn quantitative easing plan which so far includes purchasing Government/Local Government bonds and supporting the major banks by providing liquidity via short and long term facilities, easing capital restrictions and assisting with loan and home mortgage support.

Global debt levels are rising dramatically and despite the short-term yield curve fluctuations, the overall outcome will still see interest rates remaining relatively low for several years. At some stage, solid economic growth and inflating asset prices will be required to repay these loans. NZ is a small player in global debt markets and with a significant amount of our debt being owned by international investors, liquidity is always a consideration, however our strong financial position (even including our additional government borrowings) should continue to ensure future investor demand.

Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	1.3%	The manager is holding a slightly longer than benchmark duration position across fixed interest portfolios but has reduced the size of this position following the shift lower in interest rates. Credit spreads have widened reflecting the fact that investors need a higher yield to compensate for liquidity and credit risk. If there are more corporate earnings downgrades, or even corporate failures, then the significant proportion of BBB rated debt in global investment grade indexes could be problematic should we see forced selling in a market already struggling for liquidity. Such an outcome would further strain already stressed markets. The credit position in the portfolio remains conservative and therefore less exposed to these risks. In fact, the portfolio is well placed to add credit risk at higher yields when markets stabilise. Looking ahead, the manager will continue to look for opportunities to add duration on any bounce in yields although the outlook remains highly uncertain and the pressure remains for lower interest rates should sentiment further deteriorate.
AMP Capital NZ Short Duration Fund	-0.0%	
Harbour Wholesale NZ Core Fixed Interest Fund	1.6%	The manager began the quarter positive about the NZ economy and positioned for reasonable growth with slightly overweight positions in credit and inflation indexed bonds. This initially helped performance as investors sold growth assets and bought bonds. However a lack of liquidity across all bond markets saw yields rise (prices drop) sharply in mid-March with the NZ 10 year bond yield rising over 1% within a few days as investors sought the safety of cash and or were forced to redeem to meet obligations. Central banks acted swiftly and stepped into the market as buyers. This has seen yields once again drop back to levels consistent with the expected drop in economic growth. During this volatile period the manager was active, shifting the focus of the portfolio to shorter duration (1-3 years) bonds where the greatest scope for further reduction in yields was expected and trading corporate bonds where the company outlook remains uncertain. With credit spreads still volatile much of the current focus is reviewing how companies will be impacted by Covid-19 and lower growth. This could be a direct or indirect impact from restrictions, issues with gearing, access to funding lines or available support from owners or the Government. While corporate bond yields have begun to reflect the different company prospects the manager believes there is more to come with some sectors such as property not yet reflecting the difficult trading environment moving forward.
Harbour Enhanced Cash Fund	0.1%	

ECONOMIC COMMENTARY

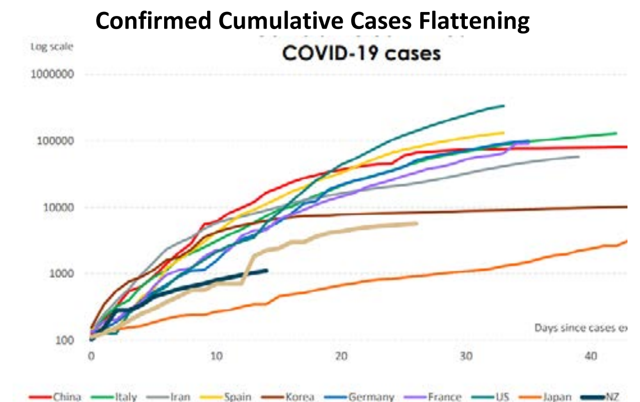
Summary

So much has happened in the last few weeks of the quarter that even a day seems like a long news and market cycle. Covid-19 broke out from the Chinese province of Wuhan in late January and by mid-February was causing havoc in Italy and starting in Spain. Since then, it has spread to every continent except Antarctica. Readers will be well informed as to the highly contagious nature of the virus and its deathly nature particularly for the aged. Governments have since put in place a raft of measures to slow the pace of infection and provide time for health services to prepare as best as they can. Each country has adopted a different approach to suit their geographic, demographic, and cultural attributes. At best a vaccine for the outbreak is 12 months away (front line health workers may get one sooner) meaning countries either manage for a steadily infected population with corresponding health support or seek means to more aggressively contain and isolate the virus for now. These alternative approaches have different economic costs. Given our geographic isolation, New Zealand has opted for an aggressive lock-down to either remove the virus completely or to a sufficient level that enables the economy to get back to work (with ongoing targeted containment measures).

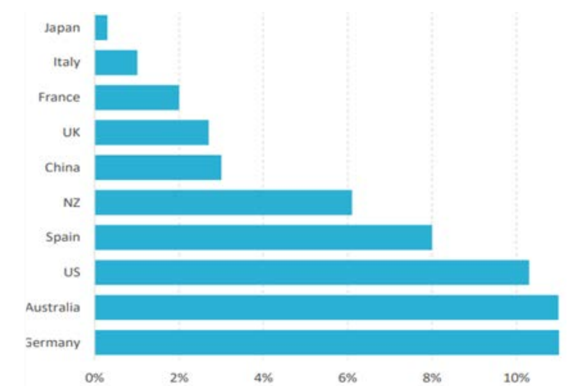
The world is facing its biggest economic contraction in modern times so governments and central banks have put in place historically large rescue or stimulus packages to try and limit the economic damage that must ensue. The world will go into recession in the second quarter and this may extend into the 3rd quarter if the virus outbreak does not peak. The recession, because it is artificial, is expected to be short-lived with recovery in the last half of the year. The sudden stop or hibernation of economic activity will unfortunately be terminal for many businesses. Those particularly hard-hit include travel, tourism, education, and accommodation services. It may take these sectors years to recover and the way we do business in general may also permanently change.

Investment markets recently stabilized on central bank intervention though remain on edge as investors try to work out how much damage the recession will have. It is also very difficult to ascertain the current value of assets when, at present, their future earnings are so unknown. However the recent sharp fall in prices means they are certainly much cheaper than they have been and indeed, in some cases – cheaper than they have been in years.

Confirmed Cumulative Cases Flattening

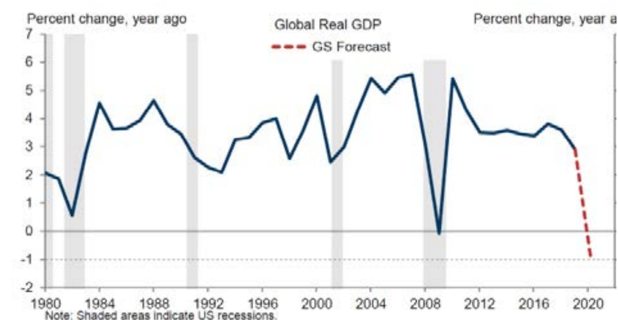


Fiscal Rescue % of GDP
(source: Harbour Asset Management)



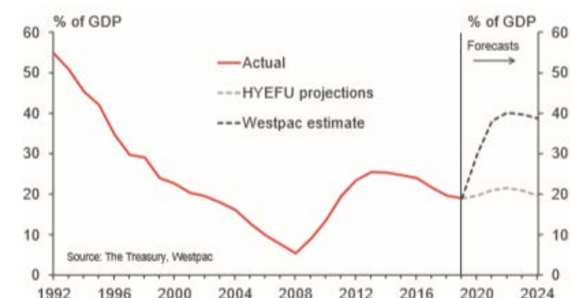
We expect markets will remain volatile as they try to guess the prospects for economic resumption. We will of course get through these very trying times. Although our economies may be in a very different shape - they will survive and recover. The long-term intrinsic value of assets and the ability of those assets to grow over time is much more important to long-term investors than short-term market pricing. In addition to us rebalancing portfolios to pick up cheaper assets, the active managers in our portfolios will also seek to best position their holdings for the downturn and recovery when it comes. Markets have recently rallied and if virus rates peak over the next 3-4 weeks, then may have already found a bottom.

Global GDP Impact Severe but not Eternal



New Zealand Our government has adopted a total lock-down approach to try and eliminate Covid-19 from our shores. This is an ambitious and economically expensive strategy from which it will be hard to successfully exit. Elimination means we are not immune so our border closure would need to stay in place pending some successful anti-body, anti-viral and or vaccine availability. From a health perspective, the lockdown response is to be applauded - as is the massive fiscal support of $19bn in direct spending or 6.3% of GDP + other business and house mortgage guarantee schemes. The economy will still contract up to -15% this June quarter, the biggest decline ever seen. The fiscal rescue package will not stop the recession, but it will help protect businesses and household balance sheets sufficiently to enable a speedy recovery and avoid long-term or permanent damage. The cost of this fiscal support will be felt intergenerationally. Fortunately, the government accounts were in good shape leading into the crisis, though our total net government debt will now rise from around 19% of GDP to 40% of GDP by mid-2022. The record government bond issuance required to fund this debt must be met by a market also absorbing debt from other countries and corporates that are out borrowing. The Reserve Bank will play a vital role by buying bonds up to $30bn in the secondary market to keep bond pricing in check. The RBNZ also cut the cash rate to 0.25% for a year and are working with banks to ensure access to funding, loosening their capital requirements and assisting them with providing business loan and home mortgage support. Looking forward, presuming virus case numbers peak by mid-April, some resumption of activity can be expected in May or June. This will allow for a bounce in economic growth in the September quarter, although overall we expect a contraction for 2020 of up to -7%. Services industries which make up about 65% of our economy and employ the most people will be the worst affected over this contraction period.

NZ Govt. Net Debt to rise to 40% of GDP



NZ Business Confidence Tanks

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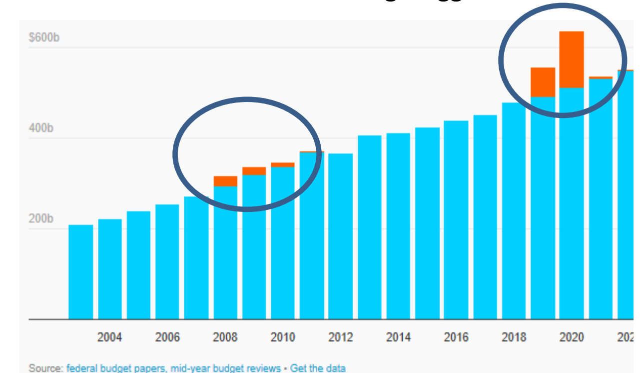
Australia

Slower to respond than New Zealand (mainly due to State and Federal Government coordination issues), Australia has now moved into their own version of a lock-down to contain Covid-19. Their slower response means their infection rates are higher, will peak later and they face a longer period of enforced hibernation. Any meaningful recovery in economic activity will be late 2020. Like New Zealand, the Australian government also announced record fiscal support including a similar wage subsidy programme called Job Keeper. The total package cost is around A$200bn or 10.5% of GDP. Recent estimates have their unemployment rate peaking at 11% and GDP contracting in the June quarter by -9%. The Reserve Bank of Australia also cut their cash rate to 0.25% while providing enhanced funding lines for banks, supporting them to provide business loans, and conducting direct market operations to keep bond markets functioning. Like New Zealand, Australia relies significantly on exports to China which is now approaching 90% of pre-virus activity. This will assist both countries' exports - although plummeting oil prices have severely impacted energy producers and exporters.

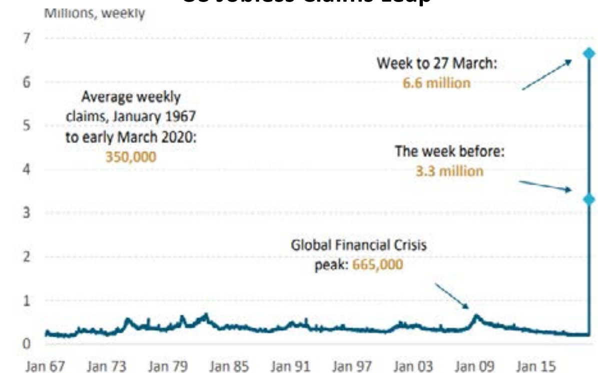
$200bn Australian Fiscal Package bigger than GFC



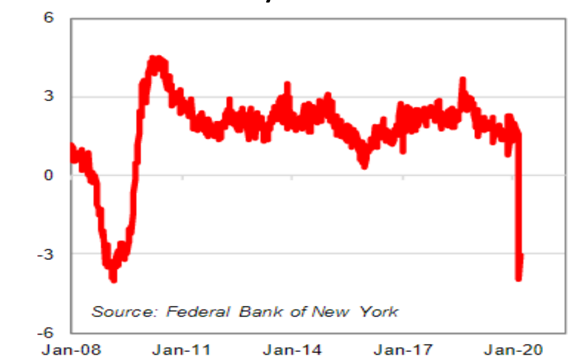
US

President Trump initially called Covid-19 a hoax then "China Virus" revealing both his pre-election economy and China cold war focus. Reluctantly dragged into reality, Trump and his equally reluctant advisers responded with a significant bi-partisan deal to provide a 10% or $2.2tn fiscal rescue package and targeted health system support which includes emergency production of ventilators and PPE. Despite this boost and the unprecedented US Federal Reserve actions, the US economy will contract sharply and by as much as -25% (annualised) in the June quarter and by -5% for 2020 overall (-5.3% in 2008). The slow US response to Covid-19 was to be expected given city, county, state, and federal co-ordination challenges but the disruption to American life is now massive and greater than it could have been. New York city is currently the epicentre for infections and deaths although, at the time of writing, death rates in NYC were plateauing giving cause for a market rally. Trump's health team estimate that as many as 200,000 Americans could die from the virus, although other modelling suggests it will be far less than this. Given the transient and disparate nature of US society, they will likely try to return to work and just manage the health consequences as they go. The US administration has found how reliant it is on overseas manufacturing for health care equipment and a consequence of the virus will be the re-homing of critical supply production. Jo Biden is likely to win the challenge for Presidency and unless the economy bounces significantly by September, he may well be the next President. This would see many of Trump's policies and programmes rolled back and a far less business friendly administration. Meanwhile, US economic data is breaking all records with weekly jobless claims (graph opposite) showing an unprecedented jump and unemployment sharply rising and probably already at 10% and could rise to 12% in the June quarter. The broader weekly economic index shows activity falling back to GFC levels.

US Jobless Claims Leap

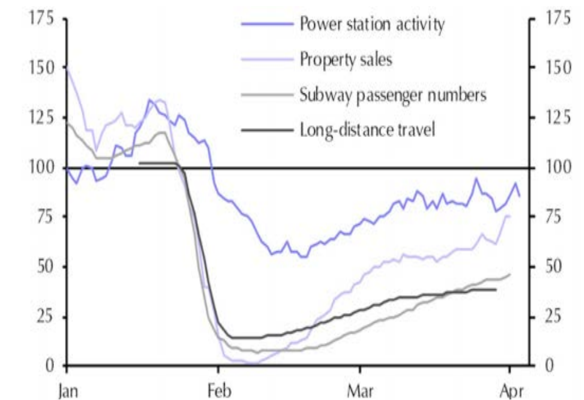


US Weekly Economic Index



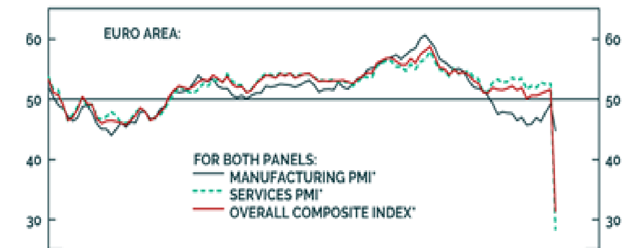
China First in, first out? The authoritarian nature of Chinese society has enabled them to respond the most aggressively to their source of the break-out of the virus – Wuhan province. We may never know the actual infection and fatality numbers, but absolute containment appears to have worked for them. Some recent breakouts in Henan and other provinces are mostly said to be linked to overseas returnees. More aggressive county containment is again in place and increasing bans on travel and nationals coming home. Their economy tanked hard in February but the chart opposite shows that it is re-bounding and total production is up to around 90% of pre-virus levels. Exports are still contracting as offshore orders (virus impacted) fall away, though domestic activity has lifted sharply on resurgent demand. The Chinese manufacturing purchasing managers index rose from 35.7 to 52.0 in March, and the services index rose even more sharply up from 29.6 to 52.3. This rapid improvement provides hope for the rest of the world that some form of V-shaped or at least U-shaped recovery is possible with stringent containment strategies. Also, as the world's largest importer, an early recovery in China will assist the world and in particular, its key trading partners. China's sharemarket has also recovered quickly and while still down around -10% in local terms, is now positive in NZ$ terms year to date.

China % of 2019 Activity **(Source: CEIC, Capital Economics)**

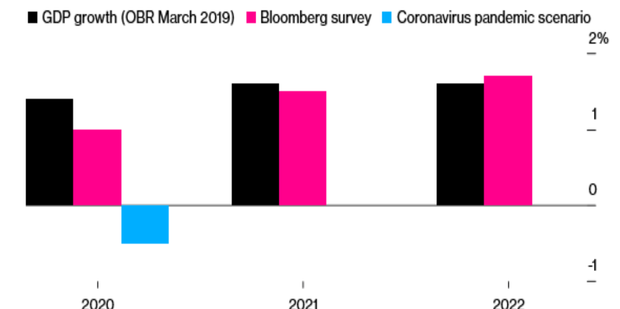


Europe & UK Already under pressure from the US/China trade war fallout, parts of Europe have also been the hardest hit (outside the US) by the virus for number of cases and fatalities. Europe has responded with different containment approaches ranging from complete lock-down in Italy and Spain to social distancing and mask measures only in Sweden. Belarus' President Alexander Lukashenko was quoted as saying ""It's better to die standing than to live on your knees". The London Imperial Collage modelling suggests Italy may have had an infection rate of 10%+ of their population while modelling from the University of Oxford suggests up to 50% of the UK could have been infected already. Antibody testing (when kits are available) will help to ascertain the true levels of infection. Like everywhere else, the economic impact has put Europe and the UK into recession. The chart opposite shows the sharp downturn in European services industries while manufacturing, already under pressure since mid-2019, has also declined further to an 8-year low and new orders fell to an 11-year low. Norway's unemployment rate jumped startingly from 2.3% to 10.9% in 25 days (highest since 1930's) and announced it will withdraw $13b from its sovereign wealth fund to help Norwegian stimulus. German unemployment has been surprisingly resilient to date and only increasing slightly in March. Regardless, Germany has put aside its constitutional debt restrictions to announce a €600bn rescue fund for troubled companies. The European Central Bank will also spend more than €1trn for asset purchases and other support measures to ensure financial market and system stability. Boris Johnson's (currently in hospital with Covid-19) government has allocated more than £57bn for spending and pledged more stimulus than during the GFC to help offset the economic impact. With most European

Euro Area Activity Plummets

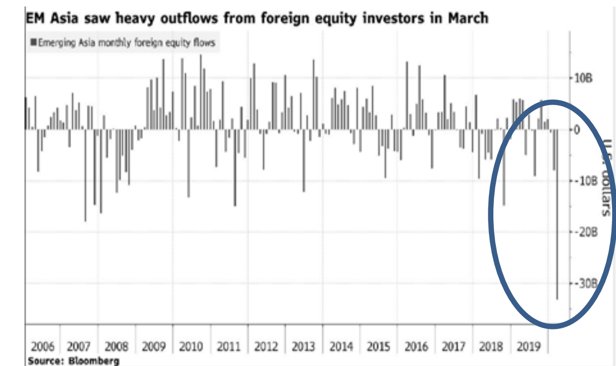


Virus putting UK into Recession



governments having excessive public debt levels, this additional cost of saving their economies will be hard to manage with net debt levels set to soar by a further 20% of GDP. Greece, Italy, and Spain will be the most affected and this may have structural consequences for the EU as weaker states push for federalization of their debts. At the time of writing there are indications that authorities in Europe are getting the pandemic under control with fewer new cases reported in Italy, Germany, France, and Spain (lowest overall new cases since March 25).

Emerging Asia – Massive investor Outflows



Japan

Though Japan has been largely unaffected by the virus some recent outbreaks have seen Shinzo Abe declare a state of emergency in seven prefectures including Tokyo and Osaka as they also prepare for a potential surge in infections. Abe today released a massive stimulus package of USD989 billion to help offset the economic impact from the virus and from the postponement of hosting the 2020 Olympics.

Emerging Markets

Elsewhere, countries are responding as they can - although many heavily indebted emerging countries and those with poor health systems have a more limited capacity and will be more adversely impacted by the pandemic. Adding to their economic woes, foreign investment has been flooding out of emerging markets (see chart opposite) and back to safe haven assets. This capital flight weakens their currencies putting more pressure on any US dollar borrowings. On a positive note, the virus appears to be less contagious in warmer climates which may assist many emerging countries as well as Europe and the US as they move into the warmer season.

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