NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

14 October 2021

September 2021 Quarterly Report

Investment portfolios finished the quarter slightly down as markets contracted through September after starting strongly in July.

The recent market pull-back is attributable to a range of rising concerns including inflation surges, global supply and manufacturing problems, energy shortages in China and Europe and Covid-19 Delta outbreaks that are putting some economies into rolling lockdowns.

Though vastly improved over the last 12 months, global economic growth is still in a recovery phase from the deep recession in 2020. Global demand remains very strong. Not only are Governments continuing to spend (and borrowing to do it) but households and businesses are also catching up from lockdown inactivity and have record financial capacity to spend. This should underpin global growth and company earnings for several years.

However, global supply is struggling to keep up with all this demand and the imbalance is presently worsening. Manufacturing and shipping are not coping. Prices are rising and testing the patience of central banks. Despite Covid-19 lockdown conditions, the RBNZ was one of the first central banks to raise cash rates and we expect others to also tighten their monetary policy settings this quarter.

Rising inflation is not necessarily a bad thing if it signals stronger economic growth but, unexpected and persistent inflation would be more disruptive to markets. We view the present inflation spikes as a supply side problem that will improve towards the end of the year and as we move into 2022.

Kind regards,

Wayne Ross
Director Investments

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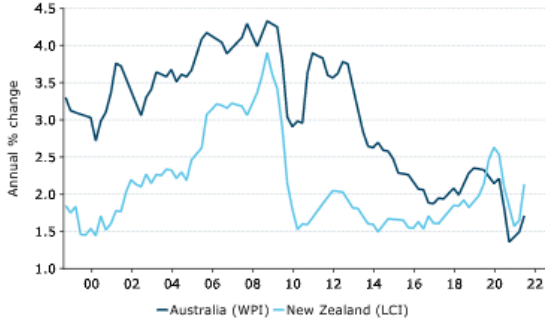
ECONOMIC AND MARKET SUMMARY

The world is still very much still in recovery phase following the 2020 Covid-19 lockdown recession. After a strong initial bounce, global activity is now starting to hit speed bumps as governments, businesses and households all embark on a spending spree which is throwing poorly recovering supply chains into chaos. Supply has not recovered as quickly as demand and can't keep up. We are all experiencing this problem whether it relates to delays in goods (and services) and or seeing higher prices. Countries are also having to deal with further rolling shutdowns to slow the Delta variant. Throw in weather impacted world crop production, trade spats, energy and critical parts shortages, together with shipping bottle necks and the supply side of things is messy. This is translating into inflation spikes which are not unexpected during a recovery phase. Central banks have been prepared to let inflation run higher to get economic growth onto a solid footing and we expect them to remain patient of recent high inflation numbers provided there is sufficient slack in labour markets. Labour supply will tighten as hospitality industries re-start, though reduced travel restrictions will assist migrant worker movement. Unlike the US and European economies, New Zealand and Australia are already suffering from labour shortages (nurses, doctors, engineers, trades, farm workers) and this is translating into rising wage costs this year as shown in the following graph.



Source: RBA, Stats NZ, Macrobond, ANZ Research

Wage inflation (in the absence of productivity improvement) is a more structural problem and part of the RBNZ decision to start lifting interest rates (house price inflation the other). This decision was also supported by our better-than-expected economic performance during this Covid lockdown. Australia too has started to tighten conditions though is unlikely to directly raise rates until 2023. Other major central banks remain more accommodating for now and will move more slowly. Meanwhile governments continue their fiscal easing, by borrowing to spend on job protection through lockdowns or embarking on more ambitious reforming economic and social programs (US, China and now EU).

On balance and in the near term, markets will remain volatile particularly as valuations are elevated on the expectation of further growth and better earnings. Investors will try to look through the inflation risks and central bank and fiscal responses while consumers and producers deal with higher prices and businesses face margin and earnings pressures. Medium term, the stage remains set for a period of very strong global demand and as the supply side improves and Covid restrictions lift (on vaccinations and new antiviral medicines), economic growth should reaccelerate and support company earnings. We also expect inflation will moderate in 2022 and for long-term disinflationary trends from technology development and convergence to re-emerge.

The positive medium term outlook may also mark the turning point for interest rates. While cash rates may not be lifted significantly in the near-term, longer-term rates are rising amid the better outlook and now forming a trend. The NZ 10-year government bond yield rose from 1.8% to 2% over the quarter while US 10-year global bonds yields rose from 1.4% to 1.53%. Term deposit rates are also rising (marginally). Rising interest rates do negatively impact the value of long-term bonds but will also increasingly provide a better opportunity for investment.

During the quarter investment markets were initially positive carrying on from the strong returns achieved over the last year. They then dipped during September on supply and inflation concerns and on US Congress intransigence (once again) in passing critical debt ceiling legislation. At the time of writing this impasse remained. Emerging sharemarkets were impacted (-6%) by Chinese government intervention into dominant tech, education and property behemoths. The certain collapse (or restructuring) of giant Chinese property developer Evergrande also has worldwide markets concerned about financial system contagion risks. Global sharemarkets ended the quarter down -1.1%, with the US market flat (albeit down -5% from its highs in early September). Our market was better over the period performing relatively well (+4.9%) while the Australian market was flat in NZ dollar terms. Growth asset (shares, property, infrastructure) valuations generally remain elevated but also well justified by higher earnings and rent prospects. Valuations are also relative to the alternative low returns available from fixed interest and cash assets which have slightly improved.

We expect markets will be volatile through the early parts of the coming quarter but improve through to the end of the year as growth prospects become clearer and some of the near-term problems resolve.

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

Market Returns	Sep. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-0.0%**	3.0%	0.8%	-0.9%
$NZ v $US	**-0.7%**	4.9%	1.6%	-0.9%
$NZ v $AUD	**2.5%**	3.4%	1.5%	0.2%
NZ Cash	**0.1%**	0.3%	1.0%	1.4%
NZ Fixed Interest	**-1.2%**	-7.1%	2.4%	2.4%
Intl Fixed Interest 100% hedged to $NZ	**-0.0%**	-2.1%	4.3%	2.7%
Australasian Equities 50/50 Indexes	**2.0%**	19.6%	10.4%	11.6%
NZ Listed Property	**3.2%**	9.6%	12.2%	9.9%
Intl Equities 50% hedged to $NZ	**-0.4%**	26.0%	11.5%	13.8%
Commodities $NZ	**8.0%**	36.3%	5.5%	5.6%

SECURITIES RETURNS FOR THE QUARTER

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

AUSTRALASIAN EQUITIES

Company	Sector	Quarterly Performance In NZ$ terms
New Zealand Equities		
Auckland Airport	Ports	7.6%
Contact Energy	Energy	5.3%
F&P Healthcare	Healthcare	2.8%
Fletcher Building	Building	-1.9%
Freightways	Transportation	3.3%
Meridian Energy	Energy	-4.7%
Port of Tauranga	Ports	2.5%
Spark NZ	Telecommunications	3.2%
Stride Property	Property	3.3%
Australian Equities		
BHP Group	Resources & Energy	-19.1%
CSL	Healthcare	0.9%
IAG	Financials	-4.6%
James Hardie	Building	8.3%
Macquarie Group	Financials	12.9%
Goodman Group	Property	-0.1%
Ramsay Healthcare	Healthcare	10.1%

- Ramsey Healthcare had a strong quarter as investors sought companies who will benefit as countries re-open post lockdown. For RHC that means more elective surgery which is extremely profitable. The company is seeing a back log of surgeries which will provide a strong tailwind for earnings over the next 2-3 years. Ramsay failed in a bid to buy Spire Healthcare in the UK. The deal was recommended by the Spire Board, but only 70% of shareholders agreed to the deal (75% required) even after RHC increased their offer to 30% above the traded share price. RHC operate 47 hospitals and 37 clinics across the UK and were hoping to add Spire's 39 Hospitals and 8 clinics to become the largest private hospital group. Ramsey now provide healthcare services from over 500 locations across 10 countries and admit over 8.5 million patients every year.
- Macquarie Group share price continues to push higher as progressively more analysts believe that the company will beat 2022 consensus earnings expectations. Macquarie recently purchased US asset management businesses that benefited from higher energy prices and boosted profits in the near term while Macquarie's increasing investment in alternative/green energy and sustainable infrastructure assets will also help underpin longer term growth.
- BHP announced its intention to create a global top 10 energy production company by merging their petroleum business with Woodside. The merged entity will have significant scale with current production of around 200m barrels of oil equivalent a year (46% LNG) and a portfolio of assets diversified by product, geography and end market. BHP will focus its portfolio on metals such as iron ore and copper and invest more in potash as it looks to diversify away from fossil fuels. BHP aims to become net zero operational emissions by 2050. The merged entity will be owned 52% by Woodside shareholders and 48% by BHP shareholders who are then free to weight their exposure to the different investment propositions.

Sonic Healthcare	Healthcare	4.7%
Westpac	Financials	-1.8%
Wesfarmers	Diversified Industrial	-5.9%
Woolworths	Consumer Staples	2.7%

- Over the quarter we sold down Endeavour Group (EDV) shares which had been allocated to clients. EDV was created when Woolworths spun out their retail liquor, gaming and hotel operations into a joint venture with ALH Group. This demerger was agreed prior to Covid and allows both businesses to focus on their core business and brand. Woolworths was particularly keen to reduce their exposure to the gaming industry as part of an ESG revamp however they still retain a 14% shareholding in the new company. Based on a recommendation from Devon we sold all allocated shares and reinvested funds across the remaining portfolio companies which offer better long-term opportunities.
- Westpac agreed to sell its Australian life insurance unit to Japan's Dai-ichi Life for A$900m. This is another example of the rapid exit of the large Australian lenders from operations outside their core banking operations following increased regulatory scrutiny. As part of the deal the bank agreed to a 20-year exclusive deal with Dai-ichi to sell life insurance products to its customers.
- The BHP share price was negatively impacted by a plunge in the iron ore price due to the Chinese Government placing a cap on steel output and the likely collapse of property developer Evergrande. Iron ore prices have fallen from a record high of US$233 per tonne in May to around US$112 at the end of the quarter, a large pull back but still significantly above the marginal cost of production which is around US$14-30 a tonne).
- Electricity generators Meridian Energy and Contact Energy will be impacted by decisions around the Tiwai smelter and research by Jarden suggests that due to record aluminium prices, the leaving date may be extended another 4 years to at least 2028. While this could delay wholesale prices moving towards more economic long-term levels, it would allow more time for additional demand to build particularly with the closure of large electricity user Tasman paper mill and with NZ Refining closing refining operations. Contact Energy has the most renewable production assets and would likely be the first to increase its dividend pay-out subject to any regulatory moves to limit prices or adopt a more aggressive timetable for moving NZ to 100% renewable energy.

AUSTRALASIAN EQUITIES

The Australian market was up for the period (+1.7%) and ahead of global markets with the best performing sectors Energy, Industrials and Utilities. Resource stocks, in particular the large miners, were very weak down -9% which reflected the sharp drop in iron ore prices. The reporting season in both Australia and NZ was solid and although it is evident that the environment for positive earnings surprises has largely passed, forecast profit growth of +3.5% in NZ and +8% in Australia still provide good investment opportunities. Particularly in Australia as they move to reopen states with high vaccination rates and unleash pent-up consumer demand from households who have built up savings over lockdown.

The NZ market performed well over the period (+4.9%) after lagging both Australian and global markets over 12 months. Relative to bond yields NZ equities are moderately priced but after years of outperformance NZ equities remain expensive versus offshore market opportunities. Energy was the strongest sector over the quarter with materials the weakest. In the near term the NZ economy is clearly constrained due to rising interest rates and ongoing lockdown restrictions, as yet with no clear plan to end restrictions.

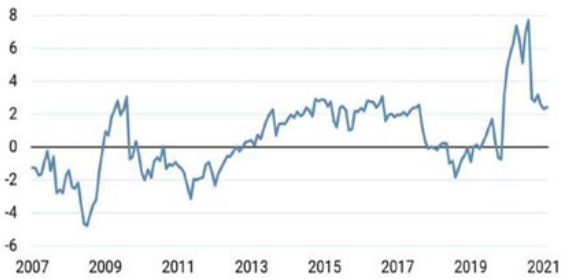
NZ became the first country to legislate mandatory climate related disclosures which will come into effect in 2023 and apply to around 200 NZ companies. So rather than the current system of voluntary disclosure (which varies in depth, quality and usefulness), companies will disclose in line with global best practice guidelines (TCFD) which cover Governance, Strategy, Risk Management and Metrics/Targets. Currently, only 16 of the top 50 NZ companies report sufficient information to be compliant under the new regime. Climate change has very real consequences for businesses and improved disclosure will no doubt help focus the attention of all stakeholders. Certainly, it will be an important resource for investors.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	2.5%	The fund outperformed the market benchmark over the quarter. Outperformance was due to holdings in South32, Vista Group, Macquarie and Oil Search which rallied strongly as investors focused on their merger with Santos and the extreme tightness of gas and oil markets as the global economy reopens. Transurban (TCL) was added to the portfolio. The company operates 17 toll roads in Sydney, Melbourne and Brisbane and the recent selloff due to weak traffic volumes provided an opportunity to buy a high-quality business at an attractive price. Devon was recently recognised by the Responsible Investment Association Australasia as a top three Responsible Investment leader in NZ. Devon is involved in a number of local and global sustainable investment initiatives and last year launched the Climate Related Financial Disclosure Survey of all companies in the S&P/NZX50.
Harbour Australasian Equity Focus Fund	8.9%	The fund outperformed the market benchmark over the quarter. Despite rising bond yields impacting some shares, overweight investments in idiosyncratic growth stocks Mainfreight, Pacific Edge, IDP Education and Macquarie boosted returns. These growth companies have pricing power or are expected to benefit from structural change. The largest detractors were Fortescue Metals, Aroa Biosurgery, Kathmandu and a2 Milk. The portfolio has no exposure to the communication or energy sectors which are expected to face increased competition. The manager participated in the $80m capital raise of bladder cancer detection company Pacific Edge (+24% over the qtr). There is growing acceptance of the company's technology as the gold standard for detection and as well as listing on the ASX they intend to use the extra capital to grow the US sales team and build out the Southeast Asia business. IDP Education share price benefited from boarders re-opening in the UK, US and Canada for international students. Kathmandu shares bounced back 17% in September, benefiting from post lockdown euphoria and signs people were able to get back outdoors (even if just for a picnic). In-store retail revenue in NZ and Australia has suffered but online sales of Rip Curl clothing and Oboz hiking shoes have kept sales buoyant.

INTERNATIONAL EQUITIES

More open economies enabled companies to produce some very strong earnings results in the period with 92% of S&P 500 companies beating earnings expectations and 78% raising their profit guidance. The broad US market actually posted 19 new highs before falling almost -5% to end the quarter largely unchanged. It was a similar story for international equities with markets down -3.7% in September and down -1.1% for the full period. The reversal came as investors became increasingly concerned for future earnings prospects amid sharply rising input costs and supply chain woes. The potential collapse of Chinese property giant Evergrande also contributed to negative sentiment. Valuations have also become stretched and increasingly reliant on better earnings prospects. With better earnings, S&P 500 P/E ratios are back to pre-pandemic levels of approximately 20 times and lower than they were in September last year.

Global Equities P/E Ratio Relative to 5 year average



Strong order books, low inventory levels, healthy balance sheets and trillions in additional global household savings mean pent-up consumer demand should provide the base for continuing earnings improvements providing input costs can be contained. Rising inflation and steeper bond yields are not necessarily bad for equities as long as central banks are not forced to play catch-up. Above trend GDP growth and low cash rates will provide further support for equity markets, particularly over the medium term. The 'overvalued' US market should still deliver earnings improvements of around +7% in 2022 with dividends on top of this and despite increasing margin pressures. Elsewhere European and Japanese markets are trading at more attractive levels (about 75%-80% of US valuations), while the Chinese market represents a bargain at present, at valuation levels not seen since 2013 and driven even lower by severe regulatory interference during the quarter. Investors will remain wary of China as central government continues its "Common Prosperity" campaign.

Changes to the International Equities Portfolio

During the quarter we completed a switch into the Vanguard Ethically Conscious International Shares Index Fund (NZD Hedged). This fund provides exposure to many of the world's largest companies listed in major developed countries. It offers low-cost access to a broadly diversified range of securities that excludes companies with significant business activities involving fossil fuels, nuclear power, alcohol, tobacco, gambling, weapons, adult entertainment, and a conduct related screen based on severe controversies (based in UNPRI Principles). The fund replaces our existing holding in the Vangaurd Select Exclusions Fund which we introduced in 2015 and provided similar market coverage with less exclusions. The key difference between the funds is the removal of an exposure to fossil fuels considering the global move to reduce carbon emissions and seek green energy alternatives. Energy is currently only 3.3% of the total market (and fossil fuels a portion of that) so the impact of the additional exclusions relative to the total market will vary over time and will often be more about the overweight investment into other sectors such as technology.

This switch was made as part of our NZ DIMS Sustainable Investment Policy. Across every client portfolio we incorporate a range of sustainable investment strategies which we broadly classify as evolution, engagement, and exclusion. Over recent years the increased global commitment to Sustainable Development Goals, alliances such as the Paris Agreement and the adoption of guiding principles such as the UN Global Compact has led to greater transparency and communication of processes, more defined policies, product innovation, increased regulation, higher capital flows and greater opportunities to reduce investment risk and improve return. This is driving a positive change in corporate policies and ultimately alignment with a more sustainable future. If you would like more details of our sustainable investment approach, please ask your adviser for a copy of our policy.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	-3.1%	The fund was down -0.7% in AU$ terms for the quarter. The fund has significant exposure to the Chinese economy and despite the dire headlines, Chinese stocks in the portfolio only had a -1% impact on returns over the quarter (still positive over the year). China's reform program which is built around the idea of common prosperity is making foreign investors nervous, particularly in the big tech, education and property sectors which have seen sharp sell offs on regulatory interference. In contrast the manager has taken the opportunity to increase their exposure to the world's largest physical economy. In addition to having Chinese consumer investment themes in the fund there is a focus on travel, semiconductors, 'growth industrials', electric vehicles and broader decarbonisation. The portfolio is weighted towards cyclical/ value companies rather than growth companies which provides a different exposure when compared to our other active fund managers and it is well positioned should interest rates move higher and faster than expected. This risk is also managed by holding relatively high cash levels (13%) and short stock exposures which mean the fund is currently 68% net invested.
Monks Investment Trust	-0.2%	The fund was down -1.4% in GBP terms for the quarter. Key positive contributors over the past year have been Tesla (structural move to electric cars globally, building lower cost factories ahead of schedule, advances in autonomous driving); SEA the Southeast Asian ecommerce, gaming and online payments company (Covid lockdown spending, mobile phone digital payments); Moderna (Covid vaccine, MRNA technology) and pet insurance company Trupanion. Key negative contributors have all come from China based businesses (Alibaba, Ping An Insurance, Naspers, Ping An Health) impacted by regulatory pressures. While painful in the short term the manager sees a lot of the enforced changes as creating more sustainable and healthy companies and economy in the longer term (lower cost education, cleaner environment, reduced online gaming by children). In a recent interview Spencer Adair, one of the co-managers of the trust, spoke about some of the often-overlooked key fund statistics since the start of the Covid outbreak. While portfolio returns have been more than twice that of the index, he reiterated that this was a very short time frame to assess performance which is much better viewed over 5-10 years. Rather he was heartened by the lower-than-average turnover (buying and selling) of 16% in the trust which implies they were not panicked into reactionary trading, held good quality businesses and were focused on growth over the long term. Low gearing (currently only 0.8% vs max 10%) suggests they did not chase markets and still had capacity to buy when markets falter, and lastly strong FUM growth has allowed fees to come down making Monks one of the lowest cost global trusts in the UK.
Magellan High Conviction Fund	-1.2%	The fund was up +1.3% in AU$ terms for the quarter. The portfolio is highly concentrated and holds only 10-12 stocks which represent the managers highest conviction picks. During the quarter a change was made by selling Tencent and buying Amazon. The view was taken that while Tencent is an incredible company, there was too many unknowns as to the future given regulatory, social and political tail risks with its large gaming, social media and content businesses. Amazon offers better risk adjusted returns and there was an opportunity to buy at a good price when the share price dropped after the company posted a weak quarterly result. This leaves the portfolio invested in 10 companies (Microsoft, Alphabet, Facebook, Netflix, SAP, ICE, Amazon, Visa,

		Starbucks, Alibaba) and across 7 key investment themes (digital payments, cloud computing, digital advertising, mobile and ecommerce, digital financial networks, digital media and the Chinese consumer).
Passive/Index Funds		
Vanguard Ethically Conscious International Shares Index Fund Hedged to NZD	0.5%	This fund provides passive exposure to all major developed share markets and is hedged back to the NZ dollar, so returns are not influenced by movements in the currency. As noted above we switched investment into this fund during the quarter so returns have been adjusted to reflect the combined return over the period. All developed markets globally followed a similar pattern, rising to (often record) highs in the first part of the period before reversing sharply in September due to rising interest rates, increased regulation, supply constraints and building inflation concerns. The US market was up +0.6%, UK +2.0%, Japan +3.0% while China fell -1% and Europe -0.1%.
iShares Russell 2000 Index Fund	-3.1%	These funds provide passive exposure to smaller companies in the USA and around the world and are valued in USD. The NZ dollar was slightly lower against the US dollar over the quarter which assisted returns. Small company shares fared worse than larger companies as investors took some risk off the table. Small companies tend to be domestic companies which are more susceptible to the stop/start nature of lockdowns, supply chain bottlenecks and skilled labour shortages. Blackrock, the world's largest asset manager (including the iShares range), recently announced they will allow big investors in their funds the ability to vote on shareholder proposals. Vanguard already allows sub-advisers to vote their shares separately to how the manager acts. Large index managers such as Blackrock and Vanguard have previously been criticized for regularly voting with management so these developments have been welcomed by investors who believe it will lead to less 'rubber stamping' of more controversial decisions.
Vanguard FTSE All-World ex US Small Cap Index Fund	-0.3%	
Vanguard FTSE Emerging Market Index Fund	-5.9%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets were under pressure over the quarter due to a rising US dollar and the sharp fall in Chinese stocks, electricity shortages and the potential collapse of property developer Evergrande. Across regions, EMEA (Europe, Middle east & Africa) rose +4.2%, Asia fell -9.6% and Latin America dropped -13.3%. Consumer discretionary, real estate, communication services and health care sectors all performed poorly while energy and utilities rose. Further action by the Chinese government remains a risk as they look to clamp down on monopolistic behaviour and address income inequality. According to Credit Suisse the richest 1% of Chinese households own 30.6% of the nation's wealth. The outlook for stronger global growth in 2022 is positive for emerging markets which generally do better when demand for commodities and exported goods in strong.

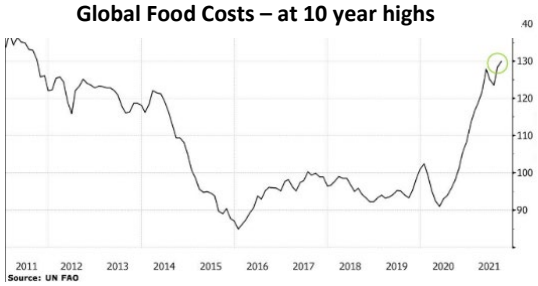
COMMODITIES

Broad commodity prices have jumped as global activity bounced and peaked in Q2 (chart opposite) before pulling back over the recent period. This suggests the inflation impulse from higher commodity levels should start to abate over the rest of the year. The story has been mixed with surging energy prices in Europe and China in particular impacting production and causing outages.

Thermal coal, natural gas prices and oil have all been much higher (cold winter, low inventories, low hydro, trade tiffs and re-opening demand). Materials prices have weakened on production stoppages and as inventories, particularly in China are rebuilt. Aluminum prices hit a 10-year peak on Guinea supply problems while iron ore prices fell -40% to a 7-month low due to likely lower demand for steel from the Chinese property sector.

Commodity Price Index (CRB Index 5 years)

Global Food Costs – at 10 year highs

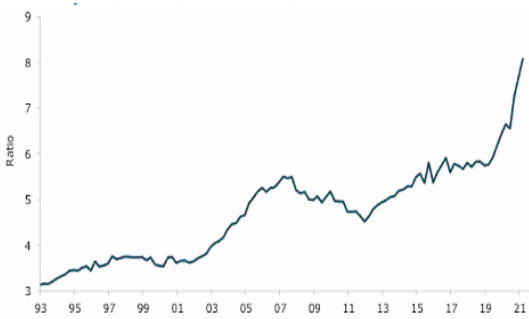


After dropping sharply in July, agricultural commodities and food prices have recovered and touched a 10 year high (chart opposite) due to weather induced supply problems and global shipping challenges. ANZ's commodities report confirmed better prices in September with strong meat and aluminum prices while forestry and dairy prices also recovered some ground. ANZ points out that the shipping congestion continues to increase transport costs for our producers.

PROPERTY

Global property prices have surged in re-opening economies. US house prices hit a record in the period up +24% over the year and the largest increase in 30 years. Prices are now more extended (versus rents) than at the peak of the credit boom and has led to a sharp rise in rents. New York landlords have raised rents sharply as people flood back to the city with offices and entertainment re-opening. Like NZ, the US remains vulnerable to rising mortgage rates and the pricing out of first-home buyers. Despite rolling lockdowns, very low net migration for the last 2 years and record building consent issuance, REINZ data in September shows NZ median residential property prices rose +25.5% over the last 12 months with Auckland up +26.4% to $1.2m. Recent monthly data suggest prices are slowing. Median house prices are now 9x median household income (chart opposite) and over 10.5x median disposable income.

NZ House Price to Income Ratio since 1993



The government has tried to address the demand side for housing by introducing a raft of tax changes (still to be clearly defined!) and generally making life harder for landlords while the RBNZ has been granted the ability to implement debt to income ratio limits on housing lending in addition to LVR limits. The recent OCR lift and expected further rises has seen mortgage rates already backing up. With the proverbial 'kitchen sink' being thrown at the demand side the additional marginal supply now coming on should finally tip the market here. BCA research wonders if the collapse of China's second largest property developer Evergrande, could be the "canary in the coalmine" warning on the vulnerability of record priced global real-estate.

FIXED INTEREST

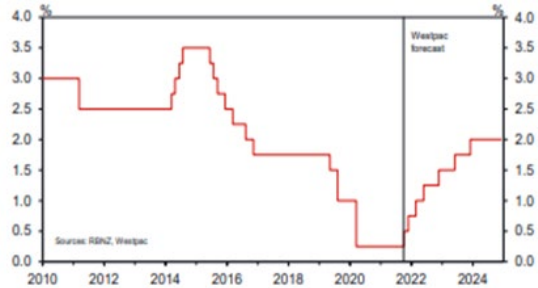
Global bond yields rose further over the period on improving global activity and sharply higher inflation data although bond pricing suggests these spikes are still expected to be short lived. US 10-year Treasury yields moved up over the quarter to 1.53% (close to pre-pandemic levels), while at home NZ 10-year yields rose from 1.8% to 2.0% with strong offshore demand for new issuance. The New Zealand Debt Management Office successfully issued the first $3bn 30-year bond which was massively oversubscribed. The rise in long term yields means bond prices have fallen and the benchmark NZ Govt Bond Index was down -1.2% over the quarter and -7.1% for the year.

10 Year Govt. Yields since Jan 2020. NZ in Red

As economies further re-open, yield curves are expected to steepen further with some forecasters picking 10-year US bond yields to reach 2% by year end. Despite the increased volatility in offshore credit markets (Chinese property debt distress) record global liquidity and the strong demand for yield has kept credit spreads contained for now and below pre-pandemic levels.

Despite the economic drag of our Covid lockdown, the RBNZ is betting on a strong bounce back, implementing a long-signaled OCR rise from 0.25% to 0.5%. The NZ central bank remains particularly focused on our very tight labour market, unstainable house prices and rising inflation rate which could well print above 4% due to higher oil prices, transport costs and supply shortfalls. Commentators expect a further 0.25% hike in November and more next year to take rates to 1.5%. This compares to the Reserve Bank of Australia which kept their cash rates at 0.1% and indicated no rise until 2024.

RBNZ OCR Westpac Forecast



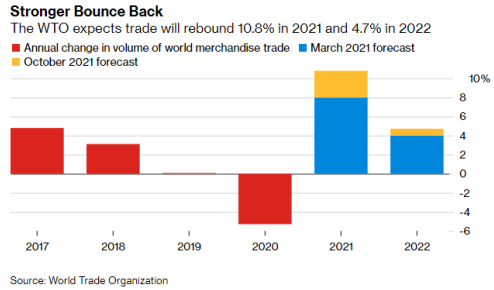
The RBNZ believes the NZ economy's long term neutral interest rate is at least 2% so until we reach at least that level monetary policy settings are considered stimulatory. Our positive yield differentials versus global rates are expected to move the NZ dollar higher and will worry exporters although it is presently trading below pre-OCR announcement levels.

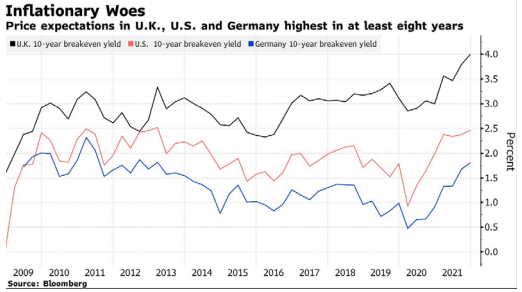
Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	-1.1%	Local money markets are pricing in a further four x 0.25% cash rate hikes over coming months to take the OCR to 1.5%. The manager assesses this as fair priced so has taken profits and taken a short position in longer dated bonds where prices are expected to fall as global yields grind higher due to growing inflation risks and central bank tapering. Corporate bond valuations are stretched, and major bank spreads have underperformed as a result of new issuances. However, any downside risk is expected to be limited as the RBNZ is still an active (if reduced) buyer of bonds (maturing in 3-5 years range) and these corporate bonds offer a pickup in yield. One interesting issue to consider for bond investors is the move away from income assets for the KiwiSaver default funds as part of the transfer between providers in December possibly creating some selling pressure.
AMP Capital NZ Short Duration Fund	-0.6%	

Harbour Wholesale NZ Core Fixed Interest Fund	-0.6%	Since the start of the year the manager has held the view that inflation risks were rising in NZ and that the RBNZ would need to start raising rates. Since Nov 2020 the 2-year swap rate has risen from 0% to 1.4% and now prices in the OCR at being at 1.5% by the end of 2022 which appears a reasonable expectation. The portfolio has benefited by being positioned for higher rates and the manager has continued with this strategy given they do not believe long term interest rates fully reflect the expected rise from here in bond yields. This means they hold an overweight allocation to short term bonds are underweight long-term bonds and remain invested in inflation indexed bonds. Risks remain with tight global labour markets, strong consumer demand, surging energy prices and supply chain pressure forcing central banks to accept inflation is more persistent. The situation is even more complicated for the RBNZ with the potential for slower domestic growth as they raise rates ahead of others. As central banks reduce liquidity and hike interest rates the pressure will increase on corporates, many of whom are now rushing to issue new debt, and credit quality will again become a focus for prudent investors. New corporate issues purchased include Transpower, Oceania and TR Group.
Harbour Enhanced Cash Fund	0.2%	

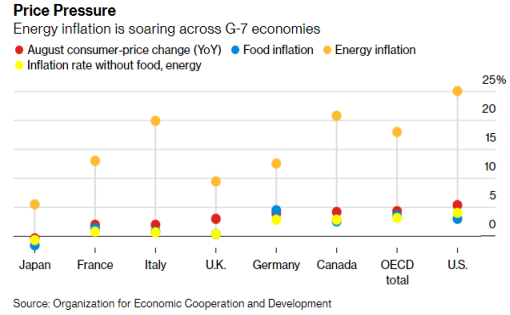
OVERVIEW

As the global economy bounced out of the 2020 recession so have investment markets sharply recovered. The re-opening phase of economies has been swifter than expected with government and central bank stimulus and rising vaccination rates underpinning consumer and business confidence. The WTO is still forecasting global trade to rise just under 11% this year (chart opposite) and nearly 5% in 2022. But we are now starting to get some speed wobbles. The frantic pace of re-opening has been so great that surging demand is creating global shortages and supply bottlenecks. The natural outcome is higher prices and expectations of rising inflation (chart opposite). A significant contributor to the inflation outlook is sharply higher energy - especially natural gas and coal where shortages have triggered blackouts in China and factory shutdowns in Europe. Lack of investment in production and storage, a cold past winter, reduced hydro production and trade spats (China not buying Australian coal, reduced Russian pipeline supplies) have seen prices soar and the largest contributor to spiking inflation (chart opposite). Other supply bottlenecks include critical component shortages such as semi-conductor chips affecting the production of everything from consumer electronics, motor vehicles and manufacturing equipment. Meanwhile shipping back-logs and reprioritizing needs have created a logistical challenge and negative feed-back loop. For now, the major central banks are maintaining a watching brief (particularly on labour scarcity) and prepared to let headline inflation move above target averages in the expectation that the global demand/supply imbalance will self-correct. Monetary settings remain easy although the extraordinary stimulus activity (such as bond buying) seen to date, is being signaled to wind back.

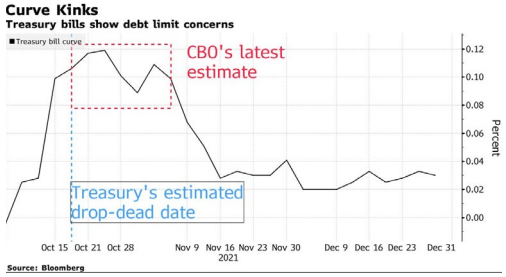




Investment markets are also uneasy over the US budget debt ceiling debate. This ridiculous issue seems to pop up every few years as Congress plays brinkmanship to partisan interests. This time round, Biden's $3.5trn fiscal stimulus package is linked to a budget debt ceiling lift creating an impasse even within his own party. Treasury bill rates have leapt (see bottom chart) as market concerns rise. A recent time extension to December has assuaged markets but the problem still needs resolution to avoid default and a US credit downgrade (like that in 2011 that led to the European debt crises). Finally, China is facing its own financial system challenges as their second largest property developer, Evergrande and now Shenzhen-based property developer Fantasia have defaulted on recent debt obligations. Evergrande's total liabilities are about 1.8% of Chinese GDP or 0.6% of the total assets in China's banking system. China's over leveraged property sector represents around 30% of their GDP. Authorities are intervening to prevent wider financial system contagion but are not in a hurry to bail out bond holders.



Despite the recent headwinds and uncertainty, the foundations for strong medium term (3-5 years) global growth remain intact. Supply side problems do need to be addressed, countries need to open further and inflation pressures to subside. Central banks need to remain patient and support activity to avoid a stagflation trap. Business and consumer confidence is high and while supply issues and rising costs may impact currently very strong business earnings the outlook is positive and economic recovery is still underway.



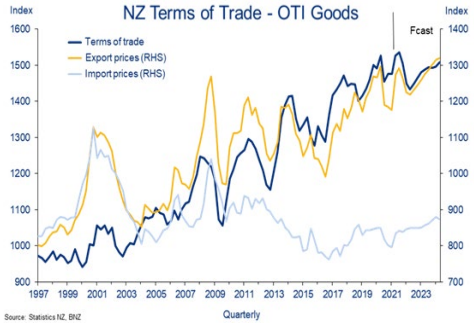
New Zealand

We were really tracking well after a much stronger than expected 2.8% economic growth rate in the 2nd quarter and the RBNZ was itching to lift the cash rate to address house price inflation. Delta got in the way driving us back into lockdown and seeing us underwhelmingly prepared for its management. Remarkably, and despite the ongoing restrictions, economic activity this time around has been much more resilient and business conditions have been firm across most industries. The recent NZIER quarterly business survey showed an expected drop in confidence but suggests the economy has solid momentum and should bounce back quickly as lockdown measures ease. Hiring intentions remain strong and company balance sheets and orders are in generally good shape except for our devasted hospitality, tourism and retail industries. Our exporters continue to do well on strong global demand and our terms of trade keep improving (opposite chart). Further covid wages and business support from the Covid relief fund (government borrowing) should again assist recovery. The RBNZ is so confident of our growth momentum that they lifted the official cash rate for the first time in 7 years, albeit off historically low levels but signaling further rises which are likely in November and February. Unlike overseas economies, our inflation pressures may be more structural given how tight our labour market is (see opposite), currently at the "maximum sustainable level" having recovered remarkably quickly from the 2020 recession. This is creating wage pressures especially as blunt migration restrictions have limited critical skills resources. Inflation expectations are now sitting at 3% and above the RBNZ's target band and house price inflation continues to get worse despite low net migration and record house consents. Rising mortgage rates will be the catalyst that finally depresses house demand. From here, the focus is all about getting sufficiently high levels of vaccination (and hopefully quick access to new anti-viral medicines) while preparing our hospitals and learning to live with Delta.

Remarkable NZ Jobs Recovery

Source: BLS, Stats NZ, ABS, Bloomberg, Macrobond, ANZ Research

NZ Terms of Trade

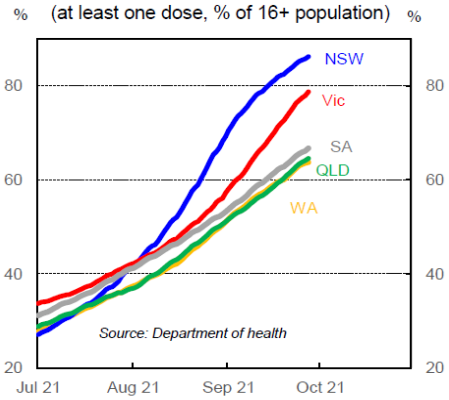


Source: Statistics NZ, BNZ

Australia

After a very strong 2nd quarter, Delta conditions also impacted Australian activity during the 3rd quarter though at differing levels for each State and in line with the severity level of their restrictions. GDP is expected to contract -4% annualized over the 3rd quarter, as the powerhouse states of NSW and Victoria remain in full lockdown while GDP for 2021 is now forecast at 2.4% (down from 3.2%). Australia has set vaccination targets for leaving lockdown (November) and reopening international borders (early 2022) and NSW in particular is well on track (opposite chart). Even with the lockdown restrictions, Australia produced a record trade surplus in August - well above all expectations as demand for cereal grain, LNG and coal (despite China blocking imports) drove export earnings higher, though weaker Chinese demand is impacting iron ore prices. Government wages and business support schemes and continued accommodative monetary policy from the RBA will enable the economy to press ahead through to year end. Though inflationary conditions are also rising in Australia, their labour market is not as tight as ours providing room for the RBA to leave rate settings for now. Their housing market has also been on a tear as business and household confidence remains high leading to strong credit growth. We expect wider macro-prudential rules to be introduced (as in NZ) to restrict lending rather than risk raising interest rates. Meanwhile Australia's move to a trilateral defense pact with the UK and US (AUKUS) marks an historical geo-political pivot point for the Asia / Pacific region and fundamental relationship change with China.

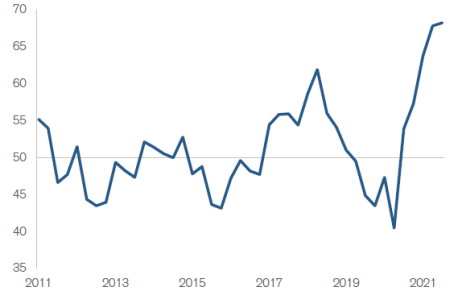
Australian Covid-19 Vaccinations



US

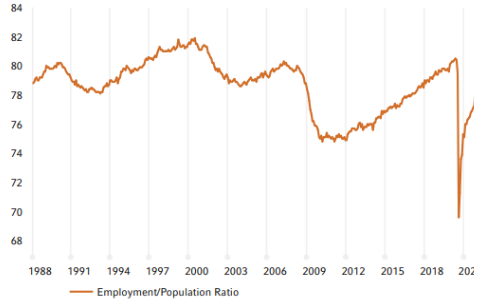
The US opened fully from Covid restrictions in the 2nd quarter allowing business activity to accelerate through the recent period, although Covid infections, hospitalisations and death rates jumped as Delta sorted out the unvaccinated. America has now chosen to live with the health consequences of keeping their economy open. The rise in infection rates and the end of benefit payments in September saw consumer confidence dip in the quarter but encouragingly, Covid deaths have recently started to fade and the outlook improving. Both manufacturing and services indexes were much stronger than expected in August, while inflation numbers printed slightly lower over the month. House prices rose nearly 20% year on year which is the largest increase in more than 30 years. Household savings are high with sizeable pent-up demand (cars, hospitality, leisure and travel) remaining. Businesses have a record backlog of orders (chart opposite) and strong balance sheets required to make necessary capital expenditures. Business investment intentions are strong and reflected in the recent record US trade deficit. US unemployment levels fell to 5.2% in the quarter although the Federal Reserve judges that there is sufficient slack in labour markets (chart opposite) for now to keep monetary conditions easy – albeit monitoring this closely. They have indicated they may soon start tapering their bond purchase programmes and bond yields are starting to rise. Biden's $3.5trillion spending packages remain embroiled in Congressional dispute. Even some Democrats are questioning the need for more stimuluses given the more than $5 trillion in emergency spending undertaken over the last 2 years and already strong economic activity. The Federal Reserve reduced its GDP forecasts back to 5.9% for 2021 while also raising its inflation forecast to 4.2% indicating it is prepared to let inflation overshoot and expecting it to moderate.

ISM Manufacturing: Backlog of Orders Index



Source: ISM, Haver Analytics®, Credit Suisse

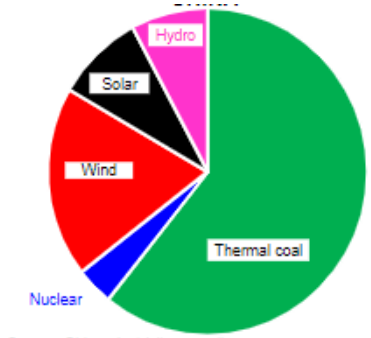
US Unemployment
(Population Raito for Prime-Age Workers)



China

Thermal coal is still a critical energy source for China particularly in its Northeast Region (chart opposite) but they are working hard on replacement alternatives as they pursue self-sufficiency for their economy. This pursuit has led to recent power cuts and rationing with thermal coal shortages over the quarter leading to factory shutdowns and slowing industrial activity. It could be argued that China's ban on Australian coal imports may be hurting China more. Their manufacturing PMI moved below 50 for the first time since the pandemic began (implying China's GDP is presently contracting) but should achieve a still fast 8% for 2021, particularly if currently harsh Covid lockdowns are eased and consumer spending resumes. China is still pursuing a zero Covid policy while frantically vaccinating. China will step up monetary easing measures (liquidity support and likely rate cuts) this quarter to support growth but also to assist with ringfencing measures they are taking with their embattled property developers and to prevent financial system contagion risk. BCA research commented that 'Beijing believes it can maintain central control, harness technology, enhance its manufacturing prowess, and grow at a reasonable rate, all while bulking up its national security. The challenge is to maintain social stability and supply security through the transition'. Meanwhile, geo-political pressures continue to rise with the US 'formally adopting a policy of confrontation rather than engagement with China that seemed all too inevitable. At the time of writing China was also piling on 're-unification' pressure and threats on Taiwan.

Power Supply in Northeast China

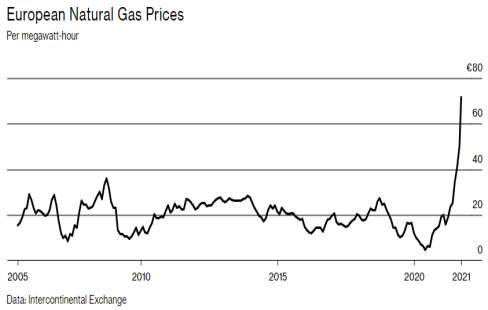


Source: China electricity council

Europe

After a slow vaccination roll out earlier this year, Europe is now leading the way with 75% of its eligible population fully vaccinated. Denmark and Ireland lead at 95%; while the major states are averaging 80%. Smaller satellite states are lagging. Europe, like NZ and the UK introduced furlough schemes that underwrote more than thirty-two million workers at the height of the pandemic. This has enabled Europe to retain productive capacity and achieve a strong economic recovery. Europe's five largest economies Germany, U.K., France, Italy and Spain spent around $230bn (approximately 1.8% of GDP) to protect their workers. The ECB remains dovish, keeping monetary conditions highly accommodative despite recently very sharp inflation rises (energy); and their bond buying programmes will remain in place until at least next March. The EU is yet to disburse fiscal support through its pandemic recovery fund which should particularly support its southern members (Italy). A new German leadership is also likely to be more fiscally expansive. Global supply constraints are now hampering burgeoning European factory orders while critical energy shortages (natural gas) are likely to curb activity and point to a more worrying winter period ahead although Russia has indicated it will improve critical natural gas supplies. EU GDP growth is now forecast lower at 3.7% for 2021.

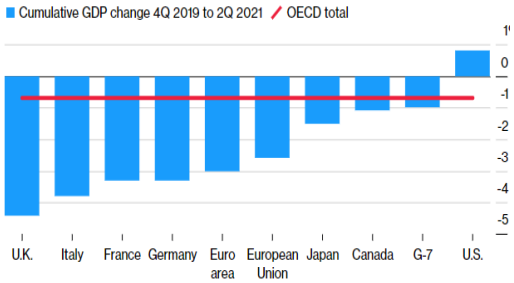
European Natural Gas Prices Spike



UK

Following an aggressive vaccination programme the UK also threw off its Covid shackles and recommenced normal activities (infection rates have soared but serious illness low) in the quarter. It also ended its successful job furlough programme in the period that reduced forecast 12% unemployment rates for March 2020 to only 5%. By July however, UK GDP was still well below its pre-pandemic level and lagged G-7 countries (chart opposite). Brexit is now really impacting and costing them. EU workers are leaving and creating significant skilled worker shortages across all areas of their economy (truck drivers) while border paperwork and customs controls are impeding trade activity which was 63% of the UK GDP in 2019 and now only 55% in 2020 (World Bank). The energy crises and lack of storage facilities is exposing critical supply links the UK had/has with the EU. Previously strong 7% GDP growth forecasts for the UK this year may come in closer to 5.3%.

UK lags G-7 Pandemic Recovery

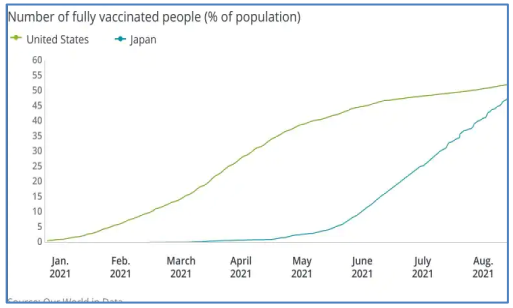


Source: Organization for Economic Cooperation and Development

Japan

Following the post Olympics Covid-19 surge, Japan accelerated (chart opposite) its vaccination roll-out and completed its fourth State of Emergency in September. They now have 63% of their eligible population fully vaccinated. Pent up consumer demand will lift domestic spending while strong factory orders are bringing manufacturing activity up to the highest level since 2018 (Tankan survey). Like elsewhere, supply-chain issues and associated cost pressures will hinder activity this coming quarter.

Japan Accelerates Vaccination



Emerging Economies

S&P research indicates that the pace of vaccine rollouts has accelerated in core emerging markets (EMs) in the past few months. Europe, the Middle East, Africa and Latin America are generally ahead of countries in Asia but still significantly lag advanced country rollouts. Manufacturing economies have strong order books but now face increasing energy and materials supply problems. Pakistan and Bangladesh could simply grind to a halt. Rampant Covid infection rates are crushing domestic consumption and tourism based economies.