NEWTON ROSS

PRIVATE WEALTH MANAGEMENT

Friday, 16 July 2021

June 2021 Quarterly Report

It has been another solid quarter for investment portfolio performances.

At the half-way point of the year, investment markets are locked on three key themes including: vaccination speed, economic stimulus, and rising inflation prospects. Governments remain focused on opening their economies back up and providing sufficient spending support while central banks are keeping their economies awash with cheap funding. Inflation is rising but presently viewed by authorities and markets as being transitory only and just reflecting the stresses and strains associated with re-opening.

On the present trajectory, 67% of developing countries and 91% of developed countries will be vaccinated by the end of the year. Global economic growth is currently expected to run close to +6.5% this year, with economists having to revise their expectations upwards each quarter. Several major economies are now ahead of where they were before Covid-19 hit in 2020. This high rate of growth is expected to ease later in 2021 and through 2022.

The recovery story continues to drive growth asset (property, commodities, shares) markets higher - justified by much stronger company earnings and particularly when considering the alternative is the very low to negative real returns available from cash term deposits and government bonds.

We expect investment conditions to remain favourable until central banks assess inflation as being more structural and move to tighten monetary conditions including reducing bond purchases and raising interest rates. The impact of higher rates on markets is not certain and will depend on both the speed and the size of the increases when they finally come.

The global recovery remains under the shadow of the mutating virus and a vaccination race that must now be quickly extended into the most vulnerable emerging countries.

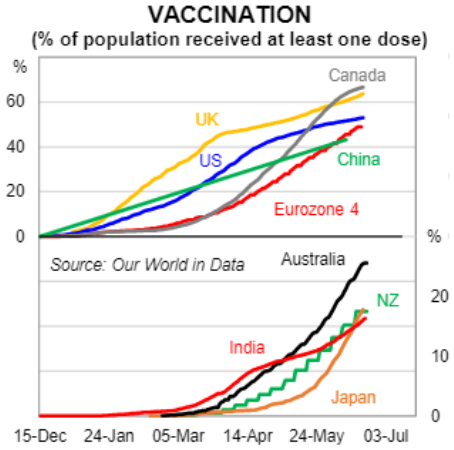
Kind regards,

Wayne Ross
Director Investments

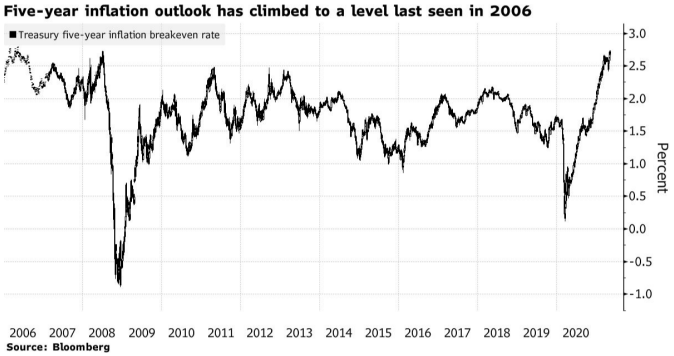
T 09 377 5777 | PO Box 2683 | Shortland Street | Auckland 1140 |www.newtonross.co.nz

ECONOMIC AND MARKET SUMMARY

After contracting -3.3% in 2020, the global economy has been accelerating hard and moving back to pre-Covid growth levels as we move into the second half of 2021. The global economy may finish +6.5% higher over the year. This is a remarkable outcome given so much of the world is still locked down and many services industries, particularly travel and hospitality are still suffering. Countries reliant on tourism remain especially affected. The combination of record government fiscal stimulus and aggressive central bank easing has allowed economies to mothball and then quickly re-open. Now as vaccination rates approach herd immunity level, countries will begin to transition from lock-down strategies to simply accepting Covid as they would any seasonal flu for health management. At the time of writing the UK with 86% of its adults having received at least 1 dose (64% fully vaccinated) is moving to fully re-open its economy. Given the UK had one of the highest Covid death rates in the world it is a phenomenal outcome. Meanwhile the many "hermit" states such as NZ, Australia, Hong Kong and Japan remain well behind on vaccination. At the time of writing a new Covid variant "Lambda" was emerging as a specific risk to existing vaccine efficacy. Clearly, Covid will be an ongoing challenge that may require regular re-vaccination programs.



The frantic pace of re-opening has created significant supply chain problems around the world exacerbated by those industries that were forced to lock-down or at least slow down during 2020 leaving inventories (some critical) at very low levels. From building materials to computer processing chips, shortages are now creating inflationary pressures across the world. Some of these may be short-lived but rising real wage costs (due to travel restrictions and higher employment rates) will lift structural inflation. US inflation expectations are now at their highest since 2006. Global central banks are presently comfortable with inflation rising (they have been trying to lift inflation for years) and content to let things "run hot" for a while to ensure economic growth is "embedded".



We therefore expect interest rates to remain lower for longer and this is how fixed interest (bonds) markets are pricing things. Markets are focused on and debating every bit of new inflation data and central bank comment. It is not obvious when and by how much rates may rise, particularly given the strong disinflationary forces that globalization and rapid technology development have driven over the last 15 years. Meanwhile technology is likely to continue to erode labour costs. Should interest rates rise slowly and steadily over a 3–5-year period we can expect markets to absorb the news relatively well as it indicates a future of continued growth. However, should inflation and hence interest rates rise sharply and unexpectantly, most investment markets and asset classes (excluding commodities) would be significantly impacted over the shorter term. Fixed interest (bonds) and equities that are similar in nature to fixed interest assets would initially be the most impacted. They would however recover over the medium term as economic growth, inflation and interest rates ebb. We are best managing inflation risks by firstly keeping the duration (average maturity) of fixed interest bonds for clients less than the market. As these shorter dated bonds mature the proceeds can be used to buy higher yielding bonds should interest rates have risen. Meanwhile, international equities (share) portfolios are spread across different styles of managers that perform differently in different parts of the cycle. For instance, Platinum is a "Value" style manager and likely to perform better in a rising interest rate market. The balance of International Equity assets are index invested meaning clients have an exposure to a very diversified range of companies in different sectors and regions. The NZ and Australian equities also have exposures to "Value" style companies that better weather rising interest rates. For perspective it is important to look at the sharply rising interest rates we had in bonds late last year (+1% rise) which saw bond markets fall sharply while our client's fixed interest investments remained largely protected. While we are confident for the future it is also important to manage client portfolio risks in an environment where investors are trying to take on more risk to generate higher short-term returns.

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

Market Returns	Jun. Qtr.	1yr p.a.	3yr p.a.	5yr p.a.
$NZ v TWI	**-0.2%**	3.3%	0.6%	-0.6%
$NZ v $US	**0.0%**	8.2%	1.1%	-0.4%
$NZ v $AUD	**1.3%**	-0.4%	0.6%	-0.5%
NZ Cash	**0.1%**	0.3%	0.9%	1.3%
NZ Fixed Interest	**0.2%**	-3.6%	3.3%	2.9%
Intl Fixed Interest 100% hedged to $NZ	**0.8%**	-1.4%	4.1%	2.8%
Australasian Equities 50/50 Indexes	**3.8%**	19.3%	10.8%	12.5%
NZ Listed Property	**2.2%**	20.4%	13.1%	9.7%
Intl Equities 50% hedged to $NZ	**7.0%**	34.3%	13.7%	14.9%
Commodities $NZ	**13.6%**	34.2%	2.8%	2.8%

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	-7.3%
Contact Energy	Energy	17.7%
F&P Healthcare	Healthcare	-2.1%
Fletcher Building	Building	6.2%
Freightways	Transportation	11.3%
Meridian Energy	Energy	-1.1%
Port of Tauranga	Ports	-8.8%
Spark NZ	Telecommunications	6.9%
Stride Property	Property	6.3%
Australian Equities		
BHP Group	Resources & Energy	5.8%
CSL	Healthcare	6.3%
IAG	Financials	8.7%
James Hardie	Building	6.5%
Macquarie Group	Financials	3.5%
Goodman Group	Property	16.1%
Ramsay Healthcare	Healthcare	-7.5%

- F&P Healthcare net profit was up +82% on last year, driven by huge growth in Hospital hardware and consumables used to deliver nasal high flow therapy to Covid patients worldwide. Revenue for the Hospital product group was $1.6 billion, an increase of +87% over last year and making up 76% of the company's operating revenue. Dividends are +38% higher however the company was unable to provide any profit guidance for the year ahead citing the ongoing uncertainties of vaccinations, lockdowns, Covid-19 variants, localised waves and hospitalisation rates.
- Contact Energy posted a strong profit result and has benefited from the NZ wide drought conditions forcing wholesale electricity prices higher. The company also presented to investors on how they plan to meet future demand growth and decarbonise their asset base, targeting new South Island commercial and industrial demand to replace the aluminium smelter at Tiwai Point. Opportunities being explored (or underway already) include an IT data centre, hydrogen production, transport and alternative heat processing operations. Some of these will require technology enhancements or the price of carbon to rise in order to become feasible. CEN has an excellent pipeline of renewable developments including NZ's only material geothermal resource and a partnership with Roaring 40s Wind Power to identify new wind generation opportunities.
- Stride Property has been very active in repositioning its office portfolio with the purchase of 3 new office buildings during the last year. The company intends to spin out its $580m office portfolio by listing a new entity in late 2022. They would likely retain 20-30% and use the process to raise new capital. That would leave the company with additional cash, a $310m retail portfolio, property management contracts and stakes in 3 key funds – a new Office vehicle, Investore (supermarkets and large format retail) and Industre (industrial properties).

Sonic Healthcare	Healthcare	8.0%
Westpac	Financials	7.0%
Wesfarmers	Diversified Industrial	8.5%
Woolworths	Consumer Staples	5.3%

- Goodman Property benefited from a rise in industrial property prices as investors chased the relatively higher yields from these assets. GMG have considerable property development expertise and the sector strength has allowed them to earn better development margins as well as higher fees from the properties they manage.
- The on again, off again nature of the Trans-Tasman travel bubble has led to uncertainty about the near-term outlook for Auckland Airport passenger numbers and therefore short term profits. Over the longer term AIA remains a high quality infrastructure asset which is incredibly difficult to replace, a fact not lost on institutional investors. Sydney Airport is in a similar position and early in July received a cash takeover offer which was 40% above their market price.
- James Hardie has benefited from the global lift in construction material prices as production supply chains remain challenging due to imbalances in demand and capacity. JHX is well positioned due to new production facilities and has been able to make the most of government fiscal spending on infrastructure and a household renovation spree. Media reports during the quarter highlighted the company still faces legal action relating to weathertight claims from products used in building construction between 1998 and 2004. JHX are vigorously defending their position and the $200m claimed represents less than 1% of the company's value.
- Ramsay Healthcare announced a $2b debt funded acquisition of UK hospital operator Spire Healthcare. The deal will add significant scale to RHC footprint in the UK, becoming the largest private hospital operator with 73 hospitals, 11 clinics and 217 operating theatres. Profit margins in the UK market are not as large as Australia but RHC is targeting at least GBP26m of cost savings over the next 2 years.
- Reducing Covid cases had led to an increase in the number of people looking to donate plasma to CSL. It is from human plasma that CSL derives immunoglobulin which is then used in the treatment of numerous auto immune conditions.

Changes to the Australasian Portfolio

During the quarter we made changes to enhance the portfolio by adding Wesfarmers Limited (WES.AU) and James Hardie Industries (JHX.AU). We funded these purchases by selling Brambles (BXB.AU) and Woodside (WPL.AU). Wesfarmers and James Hardie provide a high return on invested capital, generate positive cashflows and are well positioned to benefit from pent-up consumer demand as economies move out of lockdown.

Wesfarmers is a holding company comprised of several Australian companies. The key business for the group is home improvement retailer Bunnings which is currently 60% of operating earnings. Bunnings is a strong business franchise with very high returns on invested capital and is expected to continue to benefit from re-directed travel spending and stronger housing turnover. Renovation activity in Australia and NZ has been supported by higher house prices, low interest rates and a high savings rate which has improved household balance sheets. The rest of the group includes Kmart, Officeworks, Target and a number of smaller operations such as Catch Group which is an online marketplace business that has seen strong growth during the pandemic and now has 2.9 million active customers. Wesfarmers management have a long track record of effectively allocating capital to a portfolio of well-positioned businesses and value-accretive transactions.

James Hardie is the world's largest manufacturer and marketer of fibre cement and fibre gypsum. The company turns paper pulp and cement into a high-quality, high margin product that competes with other cladding options primarily in the United States. New house construction and alterations and additions are both key drivers of

demand and sales growth. The building materials sector has benefited during COVID as Governments have lowered interest rates to support economic recovery which has led to inflated house prices and consumers feeling wealthier. Governments have also raised huge amounts of debt which has mostly gone to consumers as transfer payments (as many have been unable to work due to lockdown) and as a result the savings rate has jumped to all-time highs. Working from home has become more acceptable and there may be a permanent shift in preference towards homes with more space. At the very least people have been making the most of what they have via alterations and additions, leading to supply shortages of durable products. James Hardie has managed this sharp increase in demand very well through good inventory management and having available manufacturing capacity.

AUSTRALASIAN EQUITIES

Australia was one of the better performing markets over the quarter, up +8.3% after improved bank earnings (a big part of their market), solid domestic activity and a better outlook for returns from resource companies. Large companies dominated market performance with the top 20 companies by market size up +9% on average. Nine out of 11 industry sectors, rose with the best performers being growth companies in areas such as Information Technology +12%, Consumer Discretionary +11% and Telecommunications +10%. The laggards were value orientated companies in sectors such as Utilities down -4%, Energy -2% and Consumer Staples +5%. Over the year, NZ has performed better than Australia but underperformed during the quarter up +0.8% on weaker results from Ryman Healthcare, a2 Milk, F&P Healthcare and Auckland Airport. In line with global markets June saw better returns from NZ shares (+2.7%) as investors moved back into both growth and bond proxy companies as global interest rates fell.

The successful deployment of Covid vaccinations in most western economies has essentially broken the cycle between case, hospitalisation and fatalities however this is not yet the case in Australia and NZ where only 4.7% and 7.9% of the population respectively have received two doses of the Pfizer vaccine. The potential short term negative implications of this delay have been evident in recent weeks with the extended lockdown in Australia now impacting growth forecasts (despite more people being employed that prior to the start of the pandemic) and a nervous wait for NZ during a short Wellington lockdown to see if a Trans-Tasman visitor had introduced the Delta variant here.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	4.2%	The fund outperformed the market benchmark over the quarter. Positive contributions came from investments in iron ore producers as prices touched a record US$195 per tonne due to strong demand, robust steel prices and supply concerns due to pollution-based production controls in key producing regions across China. Other holdings to do well included clothing retailer Kathmandu which benefited from the opening of the Trans-Tasman travel bubble and ahead of the key winter trading period. Retirement village operator Summerset has 32 villages, 6200 residents and 1800 staff across NZ. The company has done an excellent job managing the operational aspects of Covid and the business value has risen due to price increases across its substantial land bank and housing portfolio. The portfolio holds more value rather than growth

		orientated companies and has outperformed the market over the past year. While Australasian markets are trading in excess of historical multiples, the expansion of profits is contributing to more acceptable valuations. Consistent with this and the availability of cheap funding is an increase in corporate merger and acquisition activity, a theme that is likely to continue over the next 1-2 years. These factors will support portfolios with a valuation bias.
Harbour Australasian Equity Focus Fund	5.7%	The fund outperformed the market benchmark over the quarter. Key positive contributors included Mainfreight, Summerset Group, Pacific Edge and Charter Hall Group. Pacific Edge confirmed Kaiser, their large US private healthcare provider client intends to start commercial use of the company's new triage product. Australian real estate investment manager Charter Hall beat market expectations with assets under management growing 28% in the last year to A$52bn. Detractors included a2 Milk, My Food Bag, Pushpay and Volpara Health Technologies. The manager believes that the market has priced in a lot of good news – effective vaccines, extraordinary stimulus and policy responses and much better economic data – but not necessarily the fact that we are at the beginning of an expansion phase when equity markets can still perform well but become more volatile. While the path of vaccinations and interest rates will create challenges for investors, so will picking the winners and losers from decarbonisation, innovation in digital platforms, AI, mRNA technology and new immunotherapies to tackle endemic diseases. The opportunities are many with more new businesses starting in the US, France, UK, Australia and NZ than in any other 12-month period in history.

INTERNATIONAL EQUITIES

S&P 500 Y/Y Earnings Growth Rate 2021

With global uncertainty receding and economic activity rising, company earnings are accelerating with results coming in ahead of expectations. The solid swing to value stocks over the past year has also seen previously unloved energy, financials, materials, and industrials rise strongly while re-opening strategies are starting to support the still struggling leisure, travel and hospitality sectors.

Massive central bank support (US$30 trillion in the G5 alone) and an estimated US$17 trillion of government fiscal stimulus continues to support equity markets. Global equities were up +8% over the quarter with the US market hitting record highs with 87% of companies beating their earnings expectations. Globally bank stocks have performed well as they start to reduce loss provisions. Earnings of US companies in the first quarter were up +23% and a massive +53% over the year on the back of the covid recovery. 2021 earnings for the S&P 500 are expected to be +13% higher than anticipated at the start of the year. With share market returns strongly positive the (inevitable) chasing of past returns is evident with annualised inflows into global equity funds hitting US$1.3 trillion in March.

Looking forward earnings per share growth for 2022 is now forecast at +12% of the US market and almost 15% for Europe which has a higher exposure to financials and cyclically sensitive sectors such as industrials, materials and energy. China is travelling well despite the recent regulatory attempts to slow credit growth in their economy. The Global Risk Appetite index is at its highest since 2006 as investors remain confident for the future.

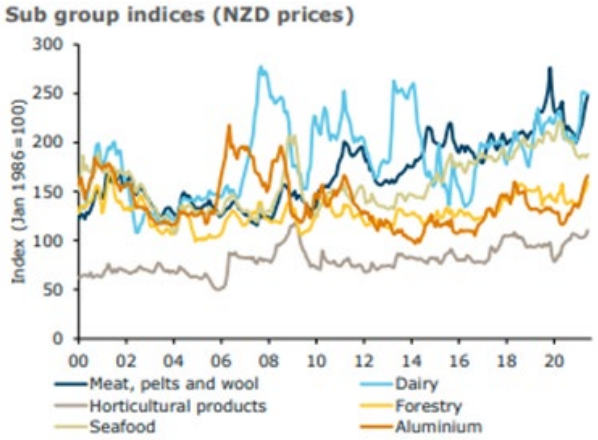
The economic growth outlook is currently supportive of this confidence and rather than markets becoming more expensive on a P/E ratio expansion they are rising in price on earnings growth. Conversely, some market P/E ratios are higher than they were before the great financial crises although these are being skewed by the very high, mega-growth companies. With earnings revisions likely to remain supportive, bond yields low and excess liquidity high, the outlook for equities remains positive though vulnerable to inflation risks.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	0.3%	The fund was up +1.6% in AU$ terms for the quarter. Key positive contributors during the quarter were commodity stocks such as copper plays Glencore (+9%) and First Quantum Minerals (+19%), and speciality paper company UPM-Kymmene Oyj as supply shortages increased prices. Chinas decision to rein in the use of credit across its economy impacted on Chinese financial and real estate holdings, notably Ping An Insurance (-18%) and China Vanke (-20%). The investment case for these companies remains sound and the price dip provided a buying opportunity. The portfolio is dominated by cyclical assets with examples being the semi-conductor companies purchased during the trade war between the US and China, resource stocks and travel related companies picked up during Covid related sell downs. Some of these have done very well in the market rebound and the manager has been taking profits. As global inflation pushes interest rates away from zero these are the type of companies which can provide resilience in the portfolio. The continued search for sustainable investment opportunities has seen the manger build a position in Showa Denko, a Japanese speciality materials and chemical company which produces graphite electrodes used in the production of steel in electric arc furnaces. This production method reuses scrap metal and significantly reduces carbon emissions.
Monks Investment Trust	1.8%	The fund was up +1.5% in GBP terms for the quarter. Lead portfolio manager Charles Plowden formally retired after a 38-year career with Baillie Gifford and former deputy manager Spencer Adair has taken up the role with Malcom MacColl continuing as deputy. These two have worked together for 15 years and have managed portfolios using the same investment philosophy since 2005. Monks is an active stock picker with a bias towards growth companies they deem are rapid innovators. That does not preclude them from holding more cyclical companies who they believe will create long term wealth and they can invest in any size company, across all markets. The portfolio managers take input from the wider Baillie Gifford team, including monthly meetings with their regional analysts where part of their process involves asking each person to name 5 stocks they would sell and 5 stocks they would buy if they were to become portfolio manager tomorrow. The manager was recently asked what business models they thought are next in line for (or still to see the full impact of) disruption using tools such as artificial intelligence, quantum computing and data management. Industries highlighted include energy, banks and insurance, online education, law enforcement, telemedicine and healthcare. The pandemic has accelerated some of these structural shifts with an example being Moderna who used technology to analyse the Covid-19 virus and develop a prototype vaccine in just 48hrs.

Magellan High Conviction Fund	8.4%	The fund was up +9.8% in AU$ terms for the quarter. The biggest contributors to performance were Alphabet, Microsoft and Facebook. Alphabet rallied after the parent of Google reported that rising spending on digital ads boosted 1st qtr sales by 34% to US$55.3bn. Microsoft rose following a 19% rise in sales to US$41.7bn with PCs, gaming consoles and digital services delivered over the cloud all enjoying strong demand. The company also agreed to buy speech recognition firm Nuance Communications to expand services to business customers. Facebook surged after 1st qtr sales rose 48% due to higher advertising revenue (the platform has 2.9bn users) and a US judge unexpectedly dismissed complaints against the company from the US regulator which the judge said failed to prove the company was a monopoly. Hamish Douglass and Chris Weldon are the portfolio manager for this highly concentrated portfolio of 8-12 stocks and they recently added ICE (digital exchange for energy) and Netflix (content streaming services). Netflix in particular is considered to be incredibly well positioned with viewership moving from pay-tv providers to streaming services. Netflix currently has 200m subscribers (expected to double over the next 10 years), early mover status in a number of markets, and is building an industry leading content library which is highly scalable and profitable. The company's highly successful programs include Ozark, The Crown, The Queen's Gambit and Stranger Things for which it achieved an industry leading 160 Emmy nominations in 2020 and 37 Oscar nominations in 2021.
Passive/Index Funds		
Vanguard Intl Shares Select Exclusions Index Fund Hedged to NZD	7.2%	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. Over the quarter returns were strongly positive as investors gained comfort with central bank 'steady as she goes' messaging (reducing the likelihood of sharp short term interest rate rises) and as political momentum gathered for additional fiscal stimulus packages. As investor confidence grew, longer term bond yields (surprisingly) reduced and growth stocks again outperformed value stocks. The US market was up +8.6%, UK +5.7%, China +5.4%, Europe +5.3% and Japan -1.2%.
iShares Russell 2000 Index Fund	4.0%	These funds provide passive exposure to smaller companies in the USA and around the world and are valued in USD. The NZ dollar was volatile over the quarter, moving sharply both up and down before ending the quarter with its value little changed against the US dollar. Small cap stocks performed well albeit lagging slightly the returns from larger companies. In the US, communication services make up only a small component of the Russell 2000 but it was by far the best performing sector, boosted by 'meme' stocks which saw rapid price increases largely due to social media activity. For the first time in over a year global small caps outperformed the US market despite the fact that European and Asian economies are lagging the US in vaccination rates and economic recovery. Perhaps this is the beginning of global investors seeking better value in international markets which have underperformed the US by -4.5% p.a. over the past 5 years.
Vanguard FTSE All-World ex US Small Cap Index Fund	6.7%	
Vanguard Emerging Market Index Fund	5.0%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Emerging markets registered a strong return over the quarter despite a sell-off in May after higher-than-expected US inflation renewed concerns over the timing of global monetary policy tightening. Brazil was the best performing market as their currency recovered while higher crude oil prices supported Russia and Saudi Arabia. Once global central banks had calmed investor nerves over the pace of interest rate increases, markets in Poland, Hungary and the Czech Republic outperformed due to their improved economic outlook but political uncertainty continued to weigh on several countries including Chile and Peru.

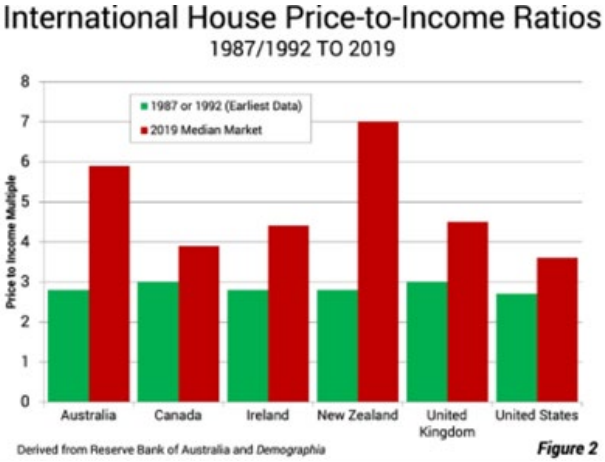
COMMODITIES

Global commodity prices lifted sharply from a low base, up +13.7% for the quarter and +34% over the year (Bloomberg Commodity Index NZD). Energy, metals, materials and agriculture prices have been supported by the demand surge but also as a result of stock-piling behaviour with global supplies struggling to re-boot from the 2020 lockdown. Global transport bottlenecks are exacerbating the problem with shipping costs soaring and backlogs only recently showing signs of easing. The demand for NZ exports firmed up further over the quarter with most prices at or above pre-Covid levels in $NZ terms. Comparatively, dairy prices were slightly easier in June but still up +35% yoy. More recently, global lumber and copper prices have eased as supply has caught up, while energy prices have moved higher on OPEC supply restrictions and iron ore continues to rise on infrastructure activity - specifically Chinese inventory building. At the time of writing softer Chinese growth data was emerging and correspondingly impacting some prices.



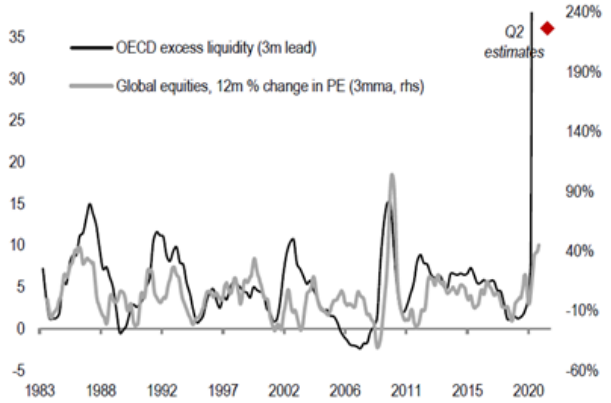
PROPERTY

Despite record building consent numbers, tougher landlord rules, changes to taxation of rental properties and further Reserve Bank restrictions, house prices continue to rise. Prices were up +9.3% (REINZ) over the quarter on very low stock levels (-33% yoy). April recorded the largest year on year (low base) mortgage lending, up +11% or $31bn and the fastest rate since the GFC. At the same time, home ownership rates have fallen to 65% which is the lowest level since the 1950s. Consequently, New Zealand ranks as one of the most expensive in the OECD. According to Demographia, Auckland has become the 4th least affordable city in the world. With lower net migration numbers and record levels of consents granted, supply constraints should be easing but construction bottlenecks (land supply, materials, skilled labour shortages, infrastructure capacity and overloaded council resources) is keeping supply well behind the demand curve. The situation will only get worse should net migration numbers return to pre-pandemic levels. Investor demand for yield continues to drive industrial property prices with significant interest for logistics and specialist distribution premises (e-commerce) on the back of strengthening manufacturing activity. Large format retail, healthcare and data centres are also doing well. The commercial office sector is seeing some cautious interest but demand for desk space remains unknown in a post pandemic world and non-premium property vacancy rates remain elevated in Auckland.



FIXED INTEREST

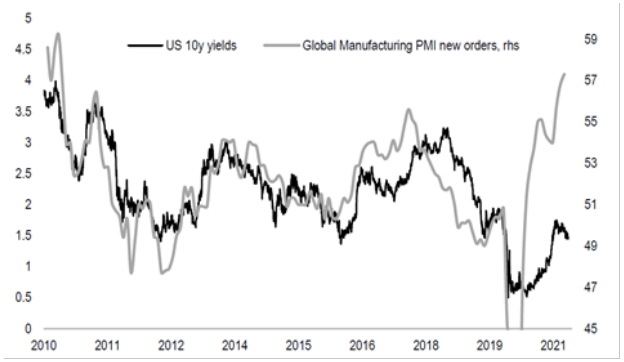
Excess Liquidity Supportive
(M1 over nominal GDP)



Ultra-easy monetary conditions continue globally for the time being, supporting activity everywhere and continuing to under-pin markets. Market debate rages around transitional versus structural inflation pressures with headline numbers either at or beginning to exceed central bank target ranges in most advanced economies. For now, markets are leaning towards temporary price rises and that central banks will let inflation run hot for some time pending more embedded growth. So, the "recovery trade" remains in full swing despite valuations in many markets reaching historical levels but also being supported by the prospect of an even better earnings environment ahead. Nonetheless, there is increasing consensus that central banks will need to start take the foot off the gas earlier than was expected at the beginning of the year. Rate rise guidance is moving closer, and investors are starting to drag forward their expectations of rate rises.

After selling off early in the quarter, global bond markets rallied with the US 10-year bond yield dropping to 1.3% from 1.7% in May and the NZ 10-year bond moving down to 1.55% from 1.9%. This was largely due to central banks signalling they believe the worst is behind us but importantly they are prepared to wait until target conditions have been achieved rather than act pre-emptively to raise rates. Global bonds remain very expensive and the recent move lower in yields has been surprising given central banks are considering winding back their bond purchase programmes.

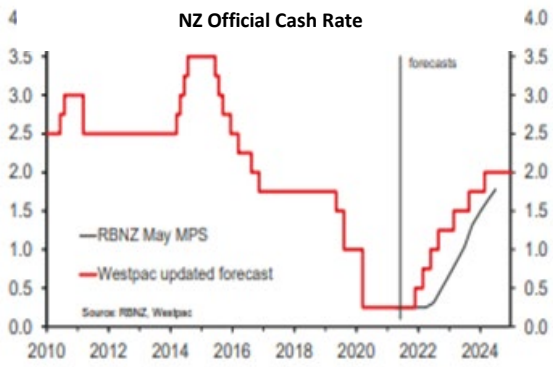
Global PMIs imply higher Bond Yields



The chart opposite bottom shows global PMIs (proxy for economic activity) on the grey line and US 10-year yields on the black line. These is a clear disconnect between growth and yields. Some of this can be attributable to Federal Reserve (and other central banks) bond buying but unless the world tips back into a much slower growth environment and a return to longer term disinflationary trends, it would seem bond yields should give way at some point and rise further. Credit Suisse expect 10-year bond rates to rise from 1.35% to 1.80% by the end of the year.

Bond market yield curves also flattened over the quarter suggesting some near-term need for rate rises but a longer-term view that inflation and presumably growth will be more constrained. We think the risk of higher bond yields is skewed to the upside from here and continue to position portfolios shorter than market duration and remain in high-quality bond issues only.

The Reserve Bank of NZ maintained the Overnight Cash Rate (OCR) at 0.25% at their most recent meeting but is likely to lead other central banks in the move to increase cash rates. Their forecasts in May indicated a total 1.5% rise in OCR starting next year. However, since then, domestic growth for the March quarter was much stronger than forecast, increasing by +1.6% versus an expected -0.3% contraction. Most NZ economists expect our labour market to tighten further over the coming quarters and all major trading banks are now picking the first rate rise to be brought forward by the RBNZ, potentially as early as August or November this year with 3 further rate rises in 2022. Supporting the possibility of an earlier move was the latest NZIER Quarterly Survey of Business Opinion which indicated a net 39% of firms had raised prices in the last 3 months and a net 52% plan rises in the next quarter. These levels are significantly above the average over the past 20 years and intentions are widespread across merchants, building, manufacturing and service sectors. Post the end of the quarter, the RBNZ surprised the market by calling an abrupt end to its bond buying program but kept cash rates at 0.25% for now at least.

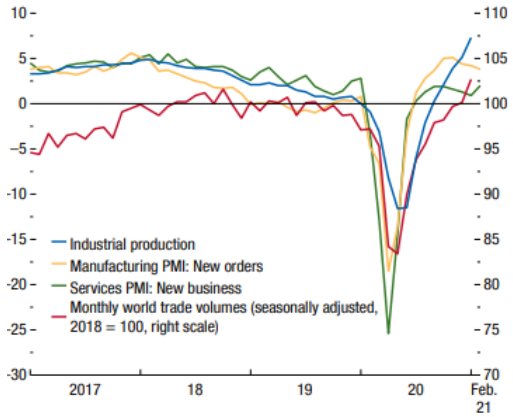


Security	Quarterly Performance In NZ$ terms	Commentary
AMP Capital NZ Fixed Interest Fund	0.0%	The manager has shifted the short duration position in the portfolio from longer dated bonds to those maturing in 5-10 years. This strategy is expected to perform better if domestic economic growth, inflation and unemployment statistics lead the RBNZ to move ahead of their current plan to begin 1.5% of cash rate hikes in August 2022. NZ long term rates will likely follow US rates and the bias is for these to move higher (prices fall) ahead of better unemployment data and Fed tapering. The fund has a small overweight to high quality credit in order to boost yield however the manager remains cautious in this space given NZ credit spreads are just above cycle lows due to central bank liquidity and there is expected to be more subordinated trading bank debt issued over the coming year.
AMP Capital NZ Short Duration Fund	0.3%	
Harbour Wholesale NZ Core Fixed Interest Fund	0.2%	The manager believes the NZ economic recovery is well advanced and therefore they expect the RBNZ to begin hiking rates in the first half of 2022 - and by more than what markets currently expect. Strong domestic growth, rising costs and acute capacity constraints are a recipe for higher inflation and if this proves to be more than transitory a move back to a neutral 2% cash rate is expected to be quicker than anticipated by current market pricing. This has led to some longer-term bonds being sold as yields drift lower and the purchase of more inflation linked bonds at prices which appear cheap if inflation heads above 1.5%. As we saw last year, during times of market stress liquidity in some parts of the NZ market can quickly deteriorate quickly and therefore it is worthwhile being cautious across certain sectors.
Harbour Enhanced Cash Fund	0.2%	

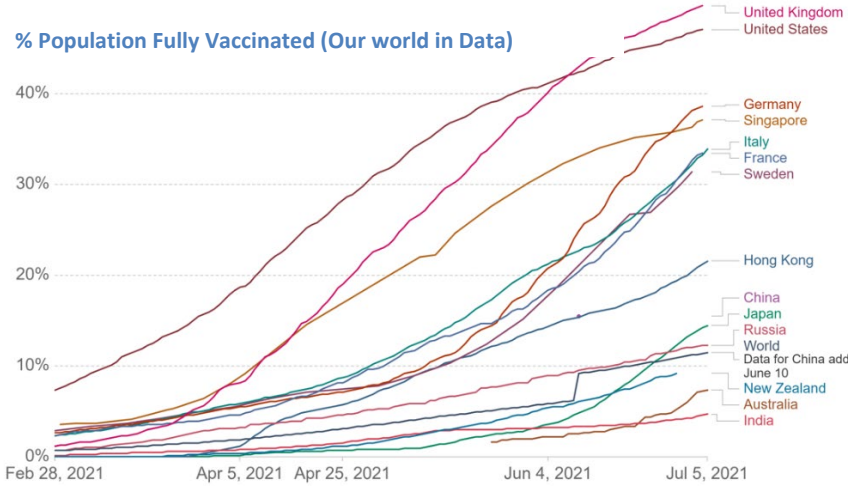
OVERVIEW

At the yearly halfway mark, vaccination programs are on track for major western economies but lagging (as expected) in developing countries where infection rates and deaths are at record levels. The US and UK are commencing to move out of all restrictions with Europe not far behind. The second half of 2021 will still be dependent on the speed of global vaccination, but also about how vaccinated economies can open and reintegrate with unvaccinated populations. When herd immunity is reached or close to being reached, countries will need to adopt a different mindset, accepting Covid-19 as just another flu season that needs to be managed each year. This means being prepared to accept rising infections, hospitalization rates and deaths as part of the cost of normalizing economies. This will be a particular challenge for those countries that have managed the virus through isolation, lockdowns and other significant social restrictions. These "hermit" countries (including NZ and Australia) need to prepare health systems and quarantine facilities while establishing testing and border protocols appropriate for re-engaging with the world. There will also be significant political ramifications as governments and state institutions struggle to let go of the power they assumed to manage the pandemic over the last 2 years and in most cases increasingly used to justify wider political agendas. This includes winding back massive spending activity and counting the cost effectiveness of record non-war government borrowing programs. The pandemic may be passing but likely represents a pivo point in history given the structural shift in geo-politics, the enhanced role of the state and central banks and the social and economic re-engineering taking place. All the fiscal and monetary stimulus and now the unleashing of record house-hold savings will drive consumer demand higher over the balance of the year. This will continue to lift company earnings and provide further support for asset prices. Global activity will now be uneven and favour the vaccinated while supply constraints of materials and energy and labour shortages will create and lift headline inflation rates. How output gaps trend over the coming quarters will reveal either transitory or more permanent structural inflation. This will incur central bank interest rate guidance over Q3. Investment markets are meanwhile viewing inflation as a passing thing with recent reductions in some global supply bottlenecks and some relief in commodity prices supporting this view.

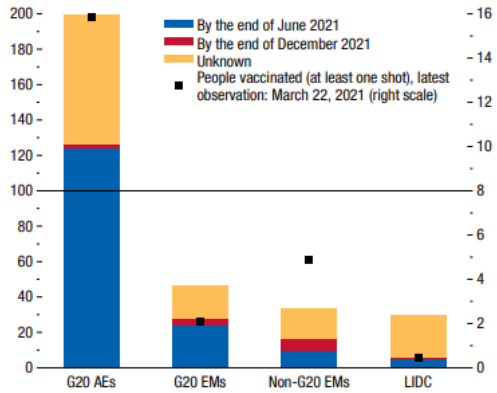
Global Activity Back to Pre-pandemic Levels (IMF)



% Population Fully Vaccinated (Our world in Data)



Confirmed Vaccine Procurement (% of Population) IMF Emerging and Undeveloped Countries Lagging

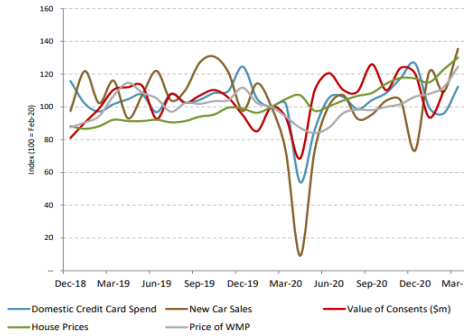


NEWTON ROSS
PRIVATE WEALTH MANAGEMENT

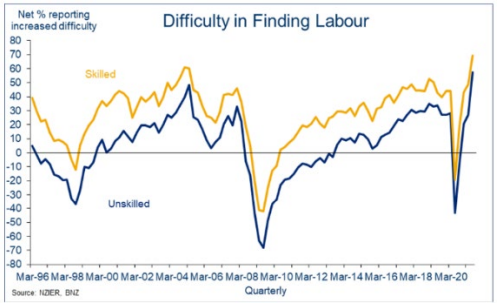
New Zealand

Following a negative (-1%) December quarter for GDP growth, NZ reported a surprisingly much higher growth rate of +1.5% in the March quarter despite predictions for a decline. NZ remains on target for a 4.2% growth rate in 2021. The sharp March rise reflects stronger general business confidence and accelerating activity - particularly in the booming construction sector (43,466 new dwelling consents last 12 months). Strong household spending, record vehicle sales and rising dairy, beef and lamb prices have all assisted. The jump in GDP growth is even more surprising given near zero international tourism. With unemployment levels back down to 4.7% severe labor shortages are being experienced everywhere but particularly in construction, healthcare, agriculture and specialist software and civil engineering sectors. Some argue we are now beyond full employment. New Zealand's net population gain from migration was just 6,327 in the 12 months to the end of April, compared to 90,038 in the 12 months to April 2020 (Stats NZ). We have run out of labor supply and working visa restrictions are now hampering recovery. The government remains focused on creating jobs for New Zealanders, which is a well-intentioned policy, but the reality is t there may be limited unemployed that want to work or who don't have the skills for the jobs available. Demand for employees is now impossible to fill and may get worse as Australia opens the borders and entices kiwis across the ditch. Global supply constraints (possibly temporary) and tight labour conditions means business pricing intentions are lifting with inflation potentially rising to the top of the RBNZ's management range. They will need to assess whether the inflation is transitory or longer term but given recent additional wage pressures (with no corresponding rise in productivity) and higher energy prices they will likely bring their rate rise guidance forward again from 2022 (May Statement) to sometime this year. They will also be carefully balancing the risks of a higher NZ dollar and an increased net migration impact as our border opens.

NZ Activity Still Rising (UBS)



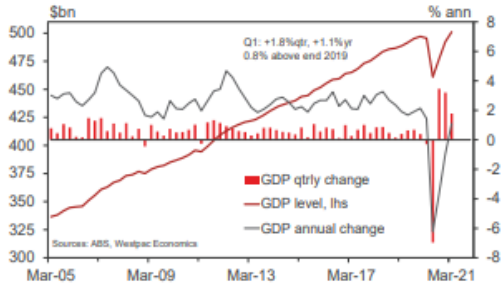
NZ Labour Shortages



Australia

Despite the rolling lock-down across states, the Australian economy is also charging ahead driven by similarly high levels of fiscal stimulus and accommodative monetary policy settings. This is supporting business investment (tax breaks) and construction activity while lifting house prices and domestic spending. Resurgent Chinese demand for iron ore (despite having politically shunned many non-critical Australian exports) and stronger global demand for metals and energy has also boosted activity. The Australian economy grew by 1.8% in Q1 (0.8% above pre-covid levels) as it transitioned from recovery to expansion. The Government's budget deficit looks like it will come in around 7.8% of GDP for 21/22 year – significantly better than the 10% forecast at the beginning of the year. This week the RBA acknowledged the recovery is stronger and earlier than expected which lays the foundations for an earlier reduction in their bond purchase program and a closer timeframe for rate hikes. Like NZ, Australia is also experiencing a tight labour market and rising wages, with the cost of hiring skilled software developers, security specialists and data experts up about +30% in 12 months, while the unemployment rate that has fallen back to 5.1%. Property prices are also rising strongly after weak prices in 2018 and 2019 with Sydney the standout up +11.2% year on year.

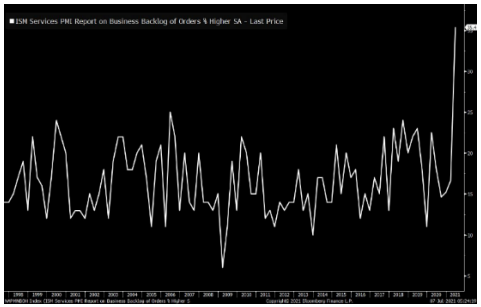
Australian Economy
Above pre-Covid Levels



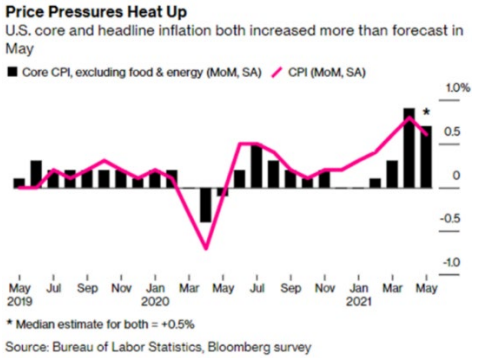
US

The US economy is powering out of Covid with an annualised 6.4% GDP growth rate as vaccinations unleash a wave of activity driven by all areas of their economy, including hospitality and leisure. Manufacturing expanded at its fastest pace since records began in 2007. The US ISM Services index hit an all-time, 24-year high and house prices are up +24% over 12 months. Rising home prices, record household savings rates and rapidly improving employment conditions (including new minimum wages) are expected to drive consumption and deliver a +7% growth rate for 2021, before easing to +3.5% in 2022. The rush of activity is creating some severe supply constraints with backlogs (see opposite) at their highest level in decades. Inflation is rising too - core personal consumption expenditure in the US (Federal Reserve's preferred measure of inflation) rose +3.4% in the 12 months to May, its largest annual increase since 1992. Despite the general supply constraints, unemployment at 5.8% remains above the Fed's expectations (4.5%), while wages' growth is also limited, providing justification for the ultra-accommodative monetary policy settings to stay in place for now. Likewise, the Fed has indicated that it is prepared to let inflation run higher than target until labour market recovery progresses. Elsewhere, President Biden continues his dream run on vaccination success and is about to undertake the largest spending spree since WW2. He continues to negotiate his multi trillion-dollar American Families and Jobs Plans packages. Biden has also successfully re-engaged key western democracy leaders to start countering the increasingly aggressive actions coming from both China and Russia and recommitted the US to climate change policies. Biden's first summit was a virtual one in March and strategically, was with the leaders of the Quad — the US, Japan, India and Australia.

US Supply Backlog Levels - Highest in Decades



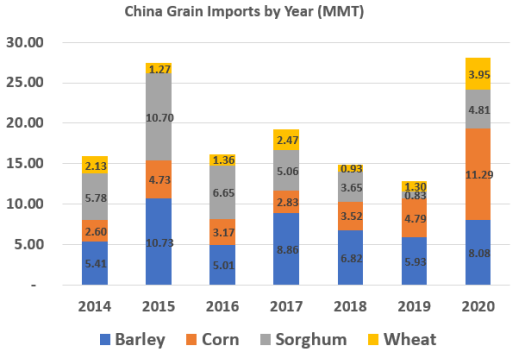
US Price Pressures



China

With a few Covid hotspots appearing during the quarter, China is now pushing ahead much faster with its vaccination program. After making a complete economic recovery and recording an 18.3% yoy growth rate in the first quarter, officials are slowing things down and focusing on realignment polices designed to make China more self-sufficient with (greater internal demand growth) and less reliant on imports. This includes reining in credit growth through greater banking and non-banking regulatory measures (witness the regulatory backlash to non-banking payment systems) and general de-leveraging including in construction activity. 100 years of Communist Party rule heralds an era of resurgent nationalism and self-belief with much of the quarter having been dominated by increasing diplomatic and trade spats with every major trading block. The most dangerous of China's ambitions are Taiwan re-integration (after the success in Hong Kong), greater military mobilization and clashes on India's border (and a threat to India's critical head waters). Elsewhere, growing global condemnation of China's human rights abuses is undermining important trade relationships with Europe, the US and Australia. In response, China will likely pivot to Asia for its exports and work hard to limit its reliance on imports from the west where relations have soured. This includes stockpiling critical supplies (iron ore, zinc, copper, grains) while at the same time blocking non-essential imports from countries such as Australia and the US. This has driven up world commodity prices and the fastest rate of inflation in China since the GFC. China also announced a new 3-child policy during the quarter and commenced new programs to encourage larger families as

China Grain Imports Rising By Year (MMT)



demographic pressures build. Finally, China is expected to be making over eight million electric cars a year by 2028, compared to Europe (5.7m a year) and America at just 1.4m electric cars a year by 2028 (NYT).

Europe

Europe has lagged the UK and US in vaccination speeds after baulking at Astra Zeneca clotting concerns and delaying their roll out in the first quarter. Europe remains below pre-covid economic levels, but the second quarter has been better although still impacted by lockdowns. Economic growth will correspondingly lag but is expected to accelerate through the rest of 2021 and forecast to reach + 4.4% for the year before dropping to +3.8% in 2022. The manufacturing sector has performed well, and exports have made a complete recovery (German exports up +47.7% yoy), although post-Brexit trade with the UK remains difficult and falling -5.8% yoy (see opposite). Following last year's pandemic drop, services activities are now improving as household spending rises using elevated lockdown savings. With import price inflation the highest in nearly 40 years, core inflation is likely running above ECB targets with no tightening expected until well into 2022.

UK

In contrast to Europe, the UK with one of the highest adult vaccination rates in the world is well positioned to resume all activity and fully re-open in July. The June UK services index was well above expectations and GDP growth is forecast at +5.3% for 2021 - again driven by pent up household consumption and potentially better post Brexit trading conditions. On the negative side, the Covid workers support scheme is due to finish in September which may impact household spending and consumer confidence. The BOE will keep conditions easy through to 2023, retaining current policy settings (cash 0.1%) and maintaining their bond buying programme through to the end of the year.

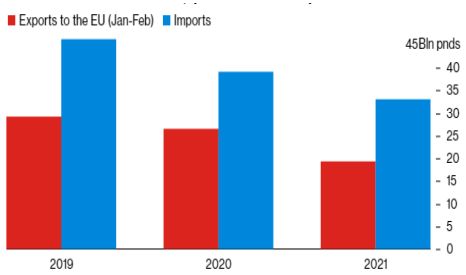
Japan

After managing the pandemic so well, Japan has been enduring outbreaks and subsequent lock downs in local areas. They are now working hard on increasing vaccination rates which will allow their economy to begin a more significant domestic recovery over the second half of year, although a spectator free Olympics will be significant disappointment. They will also be concerned that the concentrated arrival of global athletes may bring significant re-infection risks. Manufacturing and exports are doing well and expected to rise further as global capital expenditure builds through the rest of year. Inflation remains depressed and further fiscal support is expected before new elections in October.

Emerging Economies

According to the IMF, the pandemic has globally driven more than 95 million people back below the extreme poverty line, reversing a 20-yeartrend in the reduction of poverty in emerging and developing economies. As worldwide vaccine production accelerates and more vaccine options become available, the onus is increasingly on advanced countries to provide more support. This includes ramping up funding for the W.H.O led COVAX programme and providing debt deferment or restructuring programs to prevent the most vulnerable states from collapse. Particularly hard hit are countries that rely on tourism and foreign worker income receipts while commodity export economies are faring better on stronger global demand. The chart opposite shows that for Low Income Countries (the last column) the medium-term impact of Covid is likely to be worse than during the GFC.

EU/ UK Trade Hit



Source: Office for National Statistics
Note: Figures exclude non-monetary gold and other precious metals

UK Growth on Household Spending