15 July 2022

June 2022 Quarterly Report

The June quarter was another difficult period for investment markets rounding off a tough start to 2022. After the strong Covid 2021 economic recovery, markets became deeply pessimistic despite still reasonable global economic momentum. The US share market (S&P 500 index) experienced its worst half year run since 1970, dropping -21%.

The villain is inflation. Unexpected levels of inflation in the period (the highest in 40 years) saw central banks move aggressively to try and supress demand and reduce inflation by tightening financial conditions. This included raising interest rates in the quarter and signalling much higher rates to come. Higher mortgage rates for example leave households with less money to spend reducing overall demand.

Until the end of 2021 central banks remained confident inflation surges were temporary and attributable to the world restarting after Covid lockdowns. China then locked down on Omicron fears, suspending significant manufacturing capacity upon which the world relies. Russia's invasion of Ukraine sent energy (and grain) prices sharply higher and impacted European manufacturing. This derailed the expected improvement in global supply chain problems and increased inflation further.

The sharply higher interest rate outlook caused share, bond and property markets to all pull back. Only certain commodities moved higher. Markets have now priced in a reasonable chance of recession (30-40%) so we expect markets will bounce in the short term on any 'less bad' news. There will be more volatility (up and down) as we move into the second part of the year, and this is likely to continue until inflationary forces wane. Interestingly, in 1970, the US share market reversed all its losses in the second half of that year to eke out an overall gain for the year. With all the talk of recession it is easy to forget that sentiment can change quickly and our active fund managers are already excited about the opportunities they see to invest in high quality companies at these lower prices.

These are unnerving times for clients, but we have been through difficult periods and down market cycles many times before. Client portfolios have performed well relative to the market over the period, and they only hold high quality and well diversified assets that will recover value as economic

conditions bottom out. As investors we need to be patient through this cycle and focus on long-term objectives and strategy.

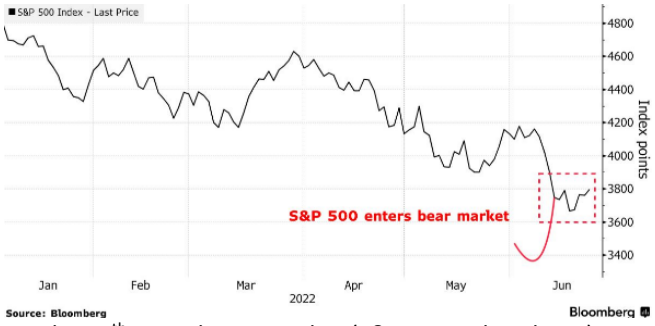
Please don't hesitate to contact us if you would like to discuss your portfolio.

Kind regards,

Wayne Ross
Director Investments

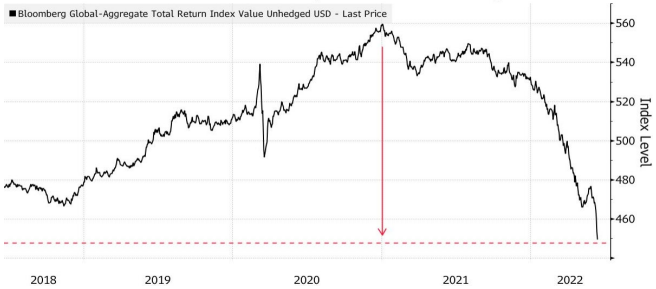
ECONOMIC AND MARKET SUMMARY

If inflation is transitory, it is certainly taking its time to pass. Consensus was for inflation to peak during the quarter and instead we saw further sharp rises in June - reaching 40-year highs in some economies. This continued rise also surprised central banks causing them to pivot and react harder and faster to tightening financial conditions by raising interest rates and providing higher future rate guidance. Markets which had been rallying in May from a tough first quarter then sold off sharply in June as investors factored in the impact of much higher inflation and interest rates.



On the 13th June the US market (S&P 500 index above) entered 'bear' territory being down more than -21% from its peak and the worst years' start for the market since 1970.

Global Bonds -20% from 2020 Record Highs



Global bond markets also fell sharply - down -20% from their peak in 2020. It is unusual to see bond and share markets fall so significantly together over a similar period. This means there has been little diversification benefit in the quarter to better protect investment portfolios. Additionally, property assets and some commodities were down while the new class of "Crypto" assets were devasted with flagship Bitcoin down more than -50%.

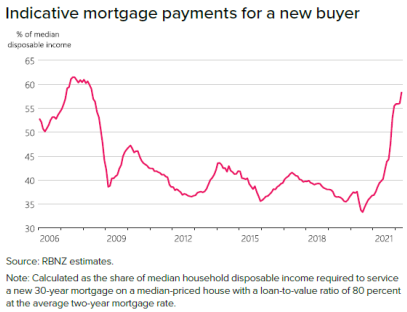
Inflation is the villain.

Economists, market commentators and fund managers have been debating ad nauseum this year whether inflation is temporary or structural. If temporary, then rates don't need to rise (market supportive). If structural central banks are compelled to raise rates (market negative). Markets are now priced for structural inflation and much higher interest rates. They are also increasingly pricing for recession and certainly for slower economic growth given the dramatic central bank action. It is ironic that central banks are trying to crush demand and slow economies by raising rates while many governments are still spending money and trying to stimulate activity back to pre-Covid levels.

A significant portion of current inflation will be proven to be transitory as global supply chain issues improve (China re-opening, stockpiling slowing). Inflation should then peak. However higher energy and labor costs will be with us for some time though labor market relief may occur as post Covid travel/migration improves.

Higher interest rates have successfully crushed business and household confidence. When mortgage rates rise so quickly and the cost of fuel and food increases so dramatically, households have limited capacity to spend on other things. At the time of writing global economic activity has followed confidence levels downwards but growth is still positive.

Additionally, bond markets are starting to rally believing central banks policies are too aggressive and they will be forced to reverse course and ease interest rates to avoid recession as economic activity slows. This flip flopping would be extraordinary but reflects the very tricky environment the world is in presently. From here we are waiting to see how company earnings are being impacted (July earnings guidance data). Markets are pricing in weaker but not negative earnings growth. While bleaker guidance may see markets move lower initially, it may also force central banks to ease policy earlier which would be supportive for markets. Uncertain times and historically big negative market movements can be unnerving for investors, but we remain confident the high-quality nature of the assets held in portfolios will prevail (as they have before) and recover value - particularly as inflation data begins to improve. Though still negative, we have added portfolio value versus market benchmarks over the period.



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	**-5.9**	-4.6	-1.3	-1.0
$NZ v $US	**-10.0**	-10.6	-2.4	-3.1
$NZ v $AUD	**-2.3**	-2.9	-1.8	-1.0
NZ Cash	**0.4**	0.8	0.6	1.1
NZ Fixed Interest	**-3.2**	-10.3	-2.9	0.6
Intl Fixed Interest 100% hedged to $NZ	**-4.5**	-8.7	-1.4	1.1
Australasian Equities 50/50 Indexes	**-10.0**	-8.9	3.4	7.8
NZ Listed Property	**-12.4**	-13.6	-1.6	6.4
Intl Equities 50% hedged to $NZ	**-10.1**	-9.7	8.0	9.0
Commodities $NZ	**5.5**	40.0	17.3	12.0

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	-8.3%
Contact Energy	Energy	-10.7%
F&P Healthcare	Healthcare	-16.7%
Fletcher Building	Building	-20.2%
Freightways	Transportation	-25.4%
Meridian Energy	Energy	-7.2%
Port of Tauranga	Ports	0.7%
Spark NZ	Telecommunications	4.6%
Precinct	Property	-12.0%
Australian Equities		
BHP Group	Resources & Energy	-7.9%
CSL	Healthcare	3.2%
IAG	Financials	1.9%
James Hardie	Building	-19.1%
Macquarie Group	Financials	-15.1%

- Contact Energy announced the retirement of their gas-fuelled Te Rapa power station which provides steam and electricity to the Fonterra dairy factory. The plant's boiler will be sold and still used by Fonterra, but the gas turbine will be retired resulting in an expected 20% reduction in Contact's long term direct emissions. Contact will replace the lost capacity with new renewable generation and staff will be re-deployed. Contact is one of NZ's largest generators and retailers of electricity - predominately from renewable hydro and geothermal sources. The company are seeking to reduce total emissions by 45% by 2026.
- BHP completed the merger of their Petroleum business with Woodside. The merged business is owned 52% by existing Woodside shareholders and 48% by BHP shareholders who each received 1 Woodside share for every 5.534 BHP shares held. Key drivers for the merger include achieving scale as an independent energy company (the combined Woodside has a high margin oil portfolio and long-life LNG assets), and BHP moving to focus their business on copper/iron ore/nickel/potash and metallurgical coal which are considered essential in the global energy transition to a lower carbon world. Following a review of the new merged Woodside business we sold the shares and reinvested sale proceeds in our core Australasian holdings which we believe represent better investment opportunities.
- CSL earnings are forecast to grow by 20% next year as plasma collections return to pre-covid levels with donors happier to return to centres and a slowing US growth outlook creating an incentive to collect the donation fee. The recent Vifor acquisition is expected to receive regulatory approval soon which will allow integration of Vifor's kidney business into CSL's highly prospective kidney transplant and heart attack treatments.
- Ramsay Healthcare was the standout performer over the quarter after receiving an unsolicited bid for the company from private equity firm KKR.

Goodman Group	Property	-19.6%
Ramsay Healthcare	Healthcare	14.6%
Sonic Healthcare	Healthcare	-4.8%
Westpac	Financials	-15.3%
Wesfarmers	Diversified Industrial	-14.9%
Woolworths	Consumer Staples	-2.6%

- Goodman Group's share price fell despite a very positive earnings result in May with +23% growth expected for the full year. Property company share prices typically fall during periods of rising interest rates as investors factor in lower property valuations. However, within the overall property sector, high quality industrial premises typically remain in demand and there is less pressure on yields. GMG manages one of the best industrial property portfolios in the world with global clients such as Amazon requiring high quality and well-located premises to support their online e-commerce supply chain. GMG has a very strong balance sheet and a pipeline of property development activity which should see fee producing assets under management grow to A$100b over the next 5 years.
- Gentailers Contact Energy and Meridian Energy's share prices fell as rising interest rates lower their relative attractiveness for investors who invest for income. At the same time their business fundamentals have improved with strong retail and wholesale demand growth, favourable climate change regulatory tailwinds, the lower risk of a forced Tiwai smelter exit and a growing consensus that short term rates are too high and may fall back closer to levels forecast by the RBNZ.
- Auckland Airport announced it will start building a new transport centre in front of the international terminal and introduce a new smart baggage system. The $300m project are the first step in the construction of a combined domestic and international terminal which will have a total cost over $1bn.

The indicative bid price of A$88 was significantly more than the market $64.39 prior to the announcement. However, after jumping higher, the current share price has pulled back slightly due to the general market downturn and an extended due diligence process. RHC has attracted investor attention due to the strong demand for private hospital services across Australia and Europe as the population ages and demand for elective surgery outstrips supply.

- Freight forwarding courier company Freightways saw a sharp drop in share price as concern mounted about lower volumes due to slowing domestic economic growth. While courier operations remain core to the company's profitability, they have done an excellent job of diversifying and building revenue from refrigerated transport, document storage/destruction and medical waste treatment. Freightways main competitor is government owned NZ Post who is a perennial underperformer.
- James Hardie shares were lower on a weaker outlook for housing in the US and Australasia. Rising mortgage rates are curtailing the large price rises we have seen over recent years. A closer look at their US market shows most US mortgage holders have 30-year mortgages set at less than 3% and JHX is well positioned in the replacement and renovation market where their fibre cement products hold a 22% share of the sidings market. Some uncertainty is understandable given new builds make up a third of their core US business and this market is more sensitive to rising interest rates.
- As expected, after quarter end Spark announced the sale of 70% of its newly established "TowerCo" to the Canadian pension fund giant, Ontario Teachers' Pension Plan Board. TowerCo currently has 1,263 cell phone tower sites and Spark has entered into a 15-year agreement to secure access and build a further 670 sites. Spark continues to own all the network technology including its radio equipment and spectrum which provides a competitive advantage. The $900m sale proceeds will be used by Spark to further invest in high growth digital services.

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AUSTRALASIAN EQUITIES

The Australian market followed global markets lower with large cap stocks finishing down -11.9%. Smaller companies fared even worse, falling -20%. Only two defensive sectors, Utilities (+1.7%) and Energy (+1.5%), recorded positive returns over the quarter. Hardest hit sectors were Information Technology (-27.2%), Real Estate (-17.8%), Materials (-16.1%), Consumer Discretionary (-14.9%) and Financials (-13.7%). June is financial year end for most Australians and tax loss selling was also a factor in driving down prices. These sharp share price declines were despite the Australian economy retaining considerable momentum during 2022 with 4% GDP growth expected this year and still high business and consumer confidence. The labour market is extremely tight (3.5% unemployment), household balance sheets are in good shape and consumer spending is expected to lift by at least 6% before higher interest rates start to bite later this year.

In NZ it was similar story over the quarter with the S&P/NZX 50 index -10.2% lower. In fact, only 5 of the top 50 stocks generated a positive return over the quarter. Defensive stocks with high earnings certainty did well while financials and cyclical industrials were weakest. A key difference in NZ however is that consumer confidence is already plummeting, along with house prices and business confidence, and there is already very low to no growth in the local economy unless you are involved in the Government sector or exporting certain commodities.

Fund	Quarterly Performance In NZ$ terms	Commentary
Devon Trans-Tasman Fund	-6.6%	The fund outperformed the market benchmark over the quarter. BHPs share price was volatile over the quarter in line with volatility in iron ore forward prices as investors tried to gauge how quickly China would emerge from Covid lockdowns and roll out additional stimulus. The largest detractor however was ANZ with the valuation of financial stocks heading lower as interest rates rise and the potential for mortgage defaults increases. However, stress testing by rating agency Fitch shows that Australasian banks are extremely well positioned and even in the extreme case of -30% house price declines and 5% mortgage default rates there is very little impact on overall bank profitability. Positive contributions came from Ramsay Healthcare (takeover offer) and infrastructure managers Ventia while AMP announced the sale price of its fund management business well ahead of market estimates. ResMed is one of the largest overweight positions in the portfolio and their share price rose sharply in June. The company continues to gain market share from its key competitor Phillips Respironics (who have voluntarily recalled certain ventilators, bi-level positive airway pressure machines (BPAP) and continuous positive airway pressure machines (CPAP). As a result, ResMed now has a large order backlog for CPAP machines which should help earnings growth of +20% over the next couple of years regardless of wider macro conditions.
Harbour Australasian Equity Focus Fund	-13.4%	The fund underperformed the market benchmark over the quarter. Key detractors to performance were Macquarie Group and Mainfreight (slowing economic growth), Xero (margin compression) and Summerset (lower residential property volumes). While returns were positive from Serko and Vista – both of which indicated better trading conditions - the portfolio has a 'growth' company style bias, and several holdings were caught up in the global sell down as investors shifted to 'value' companies or cash. Volpara (a project with Microsoft to detect cardiovascular issues) is an example of a biotech company which announced positive news in the period but saw its share price fall. Pacific Edge (strong demand for cancer detection tech) and Aroa (increased order book) also fell. Company AGMs attended by the manager were positive albeit with a cautious outlook. Earnings are better than expected and some are even taking the opportunity of lower share prices to engage in corporate share buybacks or industry merger & acquisition activity. Despite the positive tone the manager remains cautious about the upcoming reporting period which is likely to be more volatile than usual as future profit expectations are managed lower due to elevated input costs from labour, energy, regulation, sustainability programs and the cost of borrowing. Cost out and efficiency programs are also likely to feature. The focus is therefore on investing in companies which have pricing power and less dependence on cyclical activity such as healthcare.

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INTERNATIONAL EQUITIES

International equity markets were sharply down again in the June quarter. Markets are now down around -20% since the start of year and the tech laden Nasdaq (-30%) particularly impacted. Our NZ market is -18.2% lower from its highs while the Australian market with its mining and financial stocks performed slightly better down -14% from its highs. While this may have been the worst start to the year for the US stock market since 1970, it is also worthwhile remembering that since then the S&P500 has earned 10.5% p.a. despite the downturns and has had positive return for the year for 8 out of every 10 years.

US Forward Earnings Lower

Valuations at the end of 2021 were generally high for most markets but were supported by strong company earnings and a high growth environment outlook post covid lockdowns. Subsequent sharply higher interest rates have driven valuations lower for all shares but especially for low earnings or 'growth' stocks where some major names have fallen as much as -70%. In fact, the outperformance of value over growth stocks in the last 6 months has been extreme (97th percentile) and not seen since the end of the technology bubble nearly 20 years ago.

The sharp turnaround in fortunes is largely due to the shift in approach by central banks who have gone from believing inflation would be temporary to suddenly fighting against inflation levels not seen for decades, even if this was brought about by the unique combination of war and a global pandemic. Historically the S&P 500 has pulled back from a median of -24% during recessions which makes the current decline, in the absence of a recession, look particularly deep. The global share market Price/Earnings ratio is now at 15.3x forward earnings, while the S&P500 P/E has fallen from 24x to 15x, and the Nasdaq index now trades on a P/E of 22x (down from 33x). The de-rating for share valuations has largely been a function of higher interest rates and the key issue looking forward is whether earnings will fall as trading conditions get harder. Central banks will be keen to avoid a stagflation situation with slow growth and still rising inflation. Thankfully household and corporate balance sheets are in good shape due to 2 years of covid induced monetary and fiscal stimulus. Company earnings which generally correlate with nominal GDP growth should still be positive (+2% for 2022) but certainly lower than recent periods. A weaker outlook is partially factored into current valuations with Q2 yoy earnings expected to be +5.6% (or -2.45% when the energy sector is excluded), but all eyes will be on the Jul/Aug US earnings season for signs of further decline and any particularly weak forward guidance from company management. The market may yet have further to fall unless long term interest rates decline quickly and support valuations.

Fund	Quarterly Performance In NZ$ terms	Commentary
Active Fund Managers		
Platinum International Fund	4.8%	The fund was up 2.5% in AU$ terms for the quarter. This year the manager has positioned the portfolio to benefit from what they saw as alarming fundamentals and/or extreme valuations in technology and consumer companies. Short selling those sectors added +7% to the portfolio return over the quarter. Despite the market sell-off these short positions remain in place to protect the portfolio while there is still risk of further step down in prices. In contrast to these overvalued sectors, the manager sees compelling value and opportunity in semiconductors, travel, Chinese consumers, European financial, growth industrials and companies focused on decarbonisation.

		While the Chinese economy has been under extreme pressure due to ongoing Covid lockdowns this did not stop Chinese companies Trip.com (online travel +19%), ZTO Express (parcel delivery +10%) and property developer China Overseas Land & Investment (+6%) all contributing positively to the fund return. Elsewhere in the world, energy company Saras (+99%), Suncor Energy (+11%) and insurance player Beazley (+19%) also helped performance. Key detractors were Allfunds (-30%) and St James Place (-24%) which both face lower revenue due to reduced assets levels under management. The fund is currently only 56% net invested with long share positions at 76%, short sale positions totalling 20% and cash 24%. Notably cash levels have risen sharply over the quarter (up from 10% in March) - reflecting profits banked from trading activity and a cautious outlook on market prospects in the short term, with the manager preferring to wait and take advantage of opportunities as they arise during the impending volatility expected over the coming months.
Magellan High Conviction Fund	-12.2%	The fund was down -14.2% in AU$ terms for the quarter. The largest detractors were Netflix (200k less subscribers), Amazon (first qtrly loss since 2015 due to rising costs and write down of investment in electric car maker Rivian) and Alphabet (Google 1st qtr revenue growth of +20% disappointed due to poorer ad sales in Europe and on Youtube). Magellan continue to evolve their business structure following the departure of founder Hamish Douglas (he retains a consulting role) and a very experienced CEO has been appointed. As part of the changes Magellan have added Michael Poulsen as co-portfolio manager for the fund alongside Chris Wheldon, with CIO Chris Mackay remaining in an oversight role. Michael has been a key part of the Magellan investment team since 2012. The refreshed investment team have taken the opportunity to increase the portfolio flexibility by amending the fund guidelines to allow 10-20 company holdings (up slightly from the previous 8-10). This fund remains highly concentrated (which is part of its attraction for investors) but will now have more opportunity to hold a meaningful allocation in slightly smaller companies (min US$3bn+ market cap) and the greater diversification should help improve overall risk management.
Monks Investment Trust	-14.1%	The fund was down -13.4% in GBP terms for the quarter. The two principal drivers of underperformance have been investments in early-stage growth companies and Chinese businesses. One the largest detractors was Farfetch, an online luxury goods marketplace which has seen volumes and revenue double in the past 2 years but faced a collapse in its share price. The role of the manager during such volatile market periods it to reassess all holdings and make sure they remain confident in the long-term success of the business. For example, Farfetch continues to provide a significant opportunity while home fitness company Peleton is now on watch. Peleton has significantly over invested in production of its hardware (bikes) at the expense of its more scalable and profitable software solutions which has placed future profitability under pressure. It remains to be seen whether the appointment of a very experienced CEO, formerly of Netflix and Spotify, will be sufficient to turn things around. Among their Chinese holdings the manager has reduced exposure to companies which face new regulatory constraints on private company profitability (Ping An Healthcare and Meituan), while retaining companies which are better aligned with the Chinese State view of a more sustainable and fairer society. In aggregate across the portfolio, company revenue growth is accelerating, and sales are forecast to grow at 17% vs 10% for the broad market. Even if we have a period of sustained high inflation and interest rates (traditionally a difficult time for growth companies), the portfolio is skewed towards companies with strong pricing power, flexible business models and typically low capital requirements. On a positive note, market volatility has created the opportunity to add to existing holdings (Martin Marietta, Anthem, Farfetch) and buy into 11 new high-quality businesses such as Certara (bio simulation software, Chewy (online pet consumables), Analog Devices (semiconductors), Adobe (digital software) and Royalty Pharma (life sciences). New purchases have been funded by taking profits in better performing stocks and outright sales where the investment case had changed. For example, ride sharing company Lyft was sold in the belief that company management have become too focused on reacting to short term market signals rather than operating the business in the best long-term interests of shareholders.

Passive/Index Funds		
Vanguard Ethically Conscious International Shares Index Fund Hedged to NZD	-16.1%	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. The key US market (which makes up 70% of the benchmark) was down -16%, one of their worst quarters for performance and the worst start to a year since 1970. European markets fell -9.4% with the ECB recently signally rate rises and that it is winding down quantitative easy despite signs of debt risk in regions such Italy. In comparison Japan was down -5% (the Bank of Japan will be very hesitant to raise rates) and the UK which was -3.7% lower due mainly to the market composition (UK companies earn much of their revenue outside of the UK while there is a relatively high market exposure to commodity prices and financial stocks, but low exposure to tech stocks).
iShares Russell 2000 Index Fund	-8.0%	These funds provide passive exposure to smaller companies in the USA and around the world and are valued in USD. The NZ dollar was lower against the US dollar over the quarter which assisted returns by just under +9.5%. The US small cap Russell 2000 index was down -17% in local terms, its 11th worst quarter on record, but more importantly, when combined with the poor March quarter this was the worst start to a year since the index began in 1979. What is also striking, is that at the same time as share prices were falling, small cap company profits grew by +53.5% over the year to 30 June.
Vanguard FTSE All-World ex US Small Cap Index Fund	-7.1%	
Vanguard FTSE Emerging Market Index Fund	1.1%	The fund provides passive exposure to companies listed in emerging markets and is valued in USD. Despite higher interest rates and a very strong US dollar (typically problematic conditions) emerging markets fared relatively well over the quarter, led by China after the promise of additional government stimulus and Middle East countries who export energy. Conversely, many markets in East Asia, Latin America and Eastern Europe are suffering the effects of imported inflation due to ongoing covid supply chain issues and rising energy and food costs from shortages created by the Russia/Ukraine war.

COMMODITIES

The broad CRB commodity index is up over +24% YTD driven by sharply higher energy and crop prices, although this includes the recent sharp drop of -12.5% in June as oil prices abated and industrial metals (an activity indicator) fell on the prospects for a weaker global economy. Copper fell sharply hitting a 16-month low and is on track to have its biggest monthly loss in 30 years, while tin has more than halved from its March peak and metals from aluminium to zinc have also plunged. The Bloomberg Industrial Metals Spot Subindex is down -26% this quarter and headed for its biggest drop since the end of 2008.

CRB Commodity Index +24.3% YTD

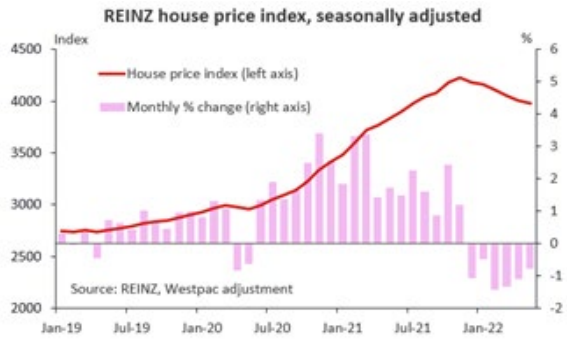
Meanwhile, energy and grain prices continue to be elevated following the Russian invasion of Ukraine. Conversely, the prospect of lower global demand has seen energy prices continue to fall and wheat has also dropped over the month (-18%). Ironically for Ukraine, Russia is on track for a bumper crop harvest (Trading Economics). NZ commodities prices were

generally lower over the quarter almost across the board, although our weak NZ dollar in the period provided some assistance for exporters.

PROPERTY

Buyers have certainly stepped back from the property market on weaker economic prospects, sharply higher mortgage costs and negative net migration pressures that look set only to accelerate while we have record new consent levels with the increasing housing supply adding to the pricing pressures. REINZ data shows NZ residential property sales have plummeted (-38.1% y/y), while NZ house prices are down -6.7% from their peak and Auckland prices are down -10%. Recent month on month data shows the fall in prices is accelerating and bank forecasts see residential property falling -15% over 2022/2023.

REINZ House Price Index Lower

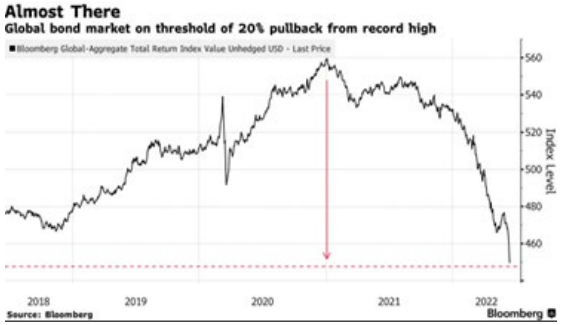


While retail spending is strong, Covid restricted staffing and rising wage and interest costs are hampering retail property assets. Office attendance has been improving - despite high recurring Covid numbers and demand for high quality office space is picking up. According to Colliers, industrial property remains the standout sector due to limited supply and strong rental pricing (+3-4% expected). Industrial property consents were the third highest on record in Q1 2022 although labour and materials restrictions are likely to hamper delivery. Meanwhile soaring farm produce prices has underpinned farm sales which are at their second highest level since 2008. Offshore property markets are also weaker everywhere with Australian capital city house prices falling.

FIXED INTEREST

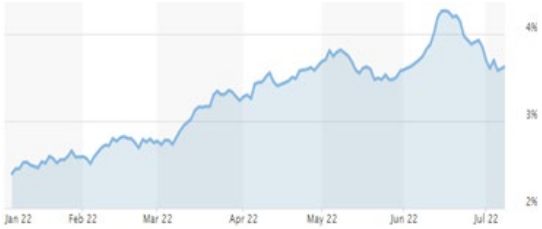
Central banks have responded to rampant inflation by aggressively raising short term interest rates and reducing stimulatory monetary policy in an all-out effort to slow economic growth. The US Federal Reserve lifted rates by 0.75% and is expected to raise them a further 1.8% by year end to 3.5%. The European Central Bank is about to start the same process (despite facing a war driven recession) and the Reserve Bank of Australia surprised markets with a 0.5% raise on the way to 2.0% by year end. The tighter monetary conditions, the ongoing war in Ukraine and China's zero-tolerance approach to Covid are all expected to slow global economic growth despite tight labour markets and households sitting on cash savings built up during covid support periods.

Global Bonds -20% from 2020 Highs



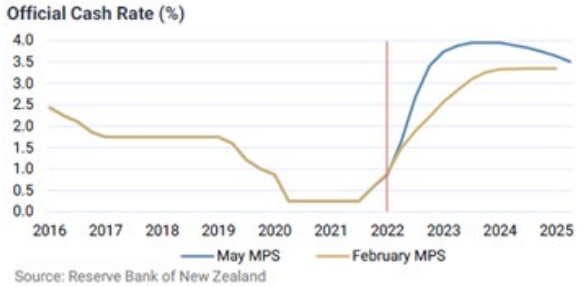
The sharp rise in rates has meant global bonds have fallen -20% from their highs in 2020 with -16% of that in 2022 so far alone. This is more than three times the size of the next biggest annual loss from bonds in 1990 and the worst bond rout ever recorded. The selloff has been immense in tandem with equity market falls, severely impacting balanced portfolios. After moving sharply higher through most of the quarter, the long end of the curve fell away in June in most markets reflecting greater concerns for recession. Credit spreads have also moved wider as investors price in greater challenges for lower quality issuers. This has been particularly dramatic in Europe where peripheral state issuers saw their debt sharply repriced - triggering an emergency ECB meeting to put measures in place to close the gap. Italy's 10-year bond went through 4% after trading at 0.54% in August 2020.

NZ 10 Year Govt Bond Yield



Although clearly behind the curve in taming inflation the Reserve Bank of NZ has been ahead of offshore central banks in lifting rates. After a series of 0.5% increases they had lifted the overnight cash rate (OCR) to 2% by the end of the quarter. Market rates have followed with cash rates rising 1.26% and 10-year bond yields up 0.64% to 3.86% (although they reached as high as 4.3% in mid-June). The RBNZ has again lifted the OCR by 0.5% to 2.5% in early July, making them the first central bank to lift rates above their widely accepted neutral interest rate (2.0% in NZ's case) as they fight to lower inflation by slowing the economy. While the official forecast is for the OCR to peak at 3.95% there is some doubt whether it will get this high.

RBNZ May MPS OCR Outlook



The NZ economy is rapidly responding to tighter monetary conditions; consumption is down despite the strong labour market, business and consumer confidence are rock bottom, house prices are falling, and higher mortgage rates are weighing on sentiment. The only bright spots at present are increased government spending and the export commodity sector. Through the period we have continued to maintain a shorter duration than the market which has added significant value to portfolios (approximately half of the market fall). With portfolio yields now at or above 4.5% p.a. bond funds are again looking more attractive, and we will seek to lengthen the duration of the overall portfolio when inflation data supports the decision.

Security	Quarterly Performance In NZ$ terms	Commentary
Macquarie NZ Fixed Interest Fund	-2.2%	The manager outperformed over the quarter. The portfolio has been moved back to market duration in longer dated bonds over the quarter as yields rose higher. The portfolio holds a small overweight position in 1-5yr bond maturities believing that the RBNZ is underestimating the negative impact of rising rates on the housing market and that consumer confidence will quickly deteriorate. Longer maturity NZ bonds tend to broadly follow offshore markets and the expectation is that US 10-year rates will stay at around 3% this year so longer-term bonds will be range bound. Looking ahead to November when NZ government bonds will be added to the world government bond index, even at the mere 0.2% allocation; the size of the global markets means as much as $2bn will need to be purchased by passive global bond funds. Global credit spreads have worsened in the face of tougher trading conditions for corporates - however this has yet to fully play out in NZ, so credit exposure has been reduced and focused on high grade.
Macquarie NZ Short Duration Fund	-0.5%	
Harbour Wholesale NZ Core Fixed Interest Fund	-2.7%	The manager outperformed over the quarter. Additional longer maturity bonds were purchased during the quarter as the manager took advantage of the sharp rise in yields which are now at levels considered fair value. Yields were pushed sharply higher as central banks moved to correct rampant inflation however the expectation is that inflation will start to ease during 2023, or possibly earlier and that the economy will slow which will allow the RBNZ to cease rate hikes at or before the OCR reaches 4%. Investment grade new 5-year corporate bond issues from ASB (5.52%) and BNZ (4.99%) were sought after by all investors and 10-year govt bonds rates at 4.3% attracted some institutional attention. With the yield curve having moved down again over recent weeks, the manager is positioning the portfolio expecting further gains in the 0–5-year part of the curve as the RBNZ begins to get on top of inflation. Exposure to lower rated corporate bonds is limited given these companies may come under pressure as economic growth slows.
Harbour Enhanced Cash Fund	0.2%	

OVERVIEW

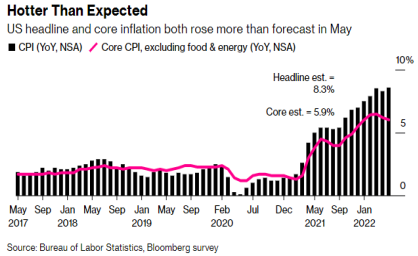
How did the world get into this position and what is the route out?

During the Covid lockdowns in 2020 and 2021 governments borrowed extensively to protect household and to a lesser extent business balance sheets. The objective was to hibernate and best preserve economies so they could re-open effectively once the peak of the pandemic passed. A good strategy though never tried before. As lockdowns eased around the world in 2021, pent up demand was unshackled. Globally, households that had accumulated more than US$5.5trn in additional savings and businesses with more than US$3.trn in additional cash reserves re-engaged with their economies. The subsequent demand pressures overwhelmed global supply chains that were still gearing up or mothballed (Air NZ for example).

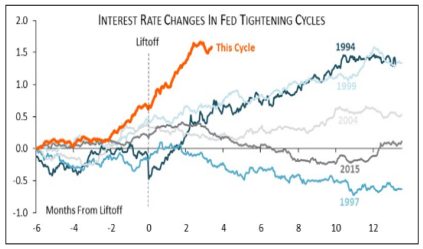
In late 2021, inflationary pressures popped due to weak supply exacerbated by businesses excessively stockpiling inventory in response. The accepted wisdom was that the 'bottlenecks' would resolve over time and inflation would abate. Central banks were wary but maintained a watching brief despite monthly inflation numbers rising. Meanwhile investment markets became increasingly convinced that central banks were wrong and 'behind the curve'. Long term bond yields subsequently jumped quickly (they had already been rising through 2021 on hot economic growth) on the expectation that central banks would be forced to raise interest rates to quell demand. Meanwhile the prospects of higher and stickier interest rates drove revaluation assumptions (down) for companies. China then locked down with Omicron adding to the global supply chain chaos and Russia invaded Ukraine, impacting European manufacturing, and sending energy costs soaring. Inflation risks consequently became more imbedded - particularly rising wage costs. Central banks then moved aggressively to catch-up and get ahead of market sentiment. The result has been dramatic. Global share, bond, property and now commodity markets have all fallen. This meant that portfolios diversified across traditional asset classes saw all these asset classes, except for some commodities markets, negatively impacted at the same time. The chart top opposite shows the values of US 10-year bonds and the US share market moving down together since the start of the year. Some investment managers hold illiquid or non-mark to market assets (direct property, private debt, and equity) that have masked some of the impact for now. Some other managers have held hedge funds with counter market properties or timed a move to larger holdings of cash that have moderated falls. Overall, bond and global share markets have now fallen more than -20% from their peaks officially entering a "Bear" market 6 months ago.

Despite these sharp falls it is possible that markets have not found their bottoms yet, particularly if economic activity slows so sharply that broader global company earnings growth goes negative. The worst economic outcome would be a stagflation environment where inflation remains rampant, but we enter a deep recession as well. A deep recession isn't anticipated although a minor "technical" recession is possible given very weak consumer and business confidence. Governments need to work hard to restore confidence and central banks be prepared to reverse their course if required. The recent rallies in bond markets suggests that investors are starting to price in an easier future for interest rates already. Any sign of peaking inflation or softer central bank signaling would be supportive for markets.

Inflation Sharply Higher

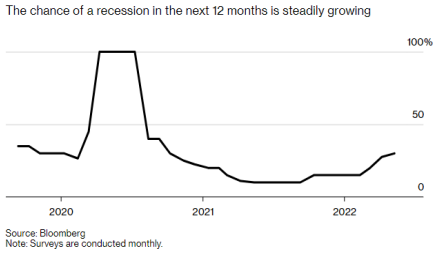


Interest Rates Rise the Steepest



US Bonds and Shares Falling Together

Recession Risk rises to 30% Chance



New Zealand

We had a negative first quarter for GDP (-0.2%) following Omicron restrictions. While the Reserve Bank remains confident our economy can avoid a hard landing (i.e., a recession) it looks like an increasingly hard challenge given household and business confidence plummeted during the quarter given higher inflationary pressures (30 year high of +6.9%) and higher interest rate settings. Survey data released in June shows consumer confidence is now at its lowest level since the early 1990s with retail spending stalling in June due to the growing pressure on household budgets. ANZ's business outlook showed a sharp drop in May (-4.7%), consistent with an economy slowing at a rate of -2%. Fifty-six percent of firms now expect economic and trading conditions to be weaker over the coming year and the lowest since the April 2020 lockdown period. This shift in confidence is remarkable given how busy firms have been as restrictions ease and given the significant backlog in orders.

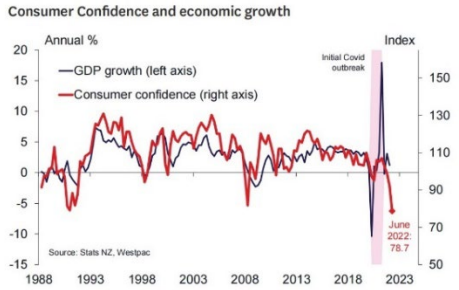
Elsewhere, supply chain problems, higher input costs and labour shortages are impacting margins and businesses are starting to pass on costs where they can. Construction and retail sectors are the most pessimistic with residential construction intentions (see graph opposite) dropping quickly. The unemployment rate is still at a record low (3.3%) and with a net outflow of workers in the last year (opening borders) employers cannot find staff. Present estimates are that up to 100,000 kiwis may leave this year. The jump in interest rates is starting to impact household finances, with all mortgage terms now over 5%, with standard 5-year fixed rates at 7%. Add in rising fuel and food costs and falling house prices (largest 3 month drop since 2010) and it is easy to see why consumers are suddenly wary. There are recent signs inflationary pressures may be starting to ease but the RBNZ will be worried about rising expectations for inflation and increasing claims for higher wages. Our official cash rate (now 2%) is forecast to be 3.5% by year end and priced in by markets. The RBNZ presently expects the cash rate to top out near 4% by the end of 2023 though this view may moderate.

On the positive side we have full employment and households still have significant accumulated savings from the lockdown periods. Additionally, our terms of trade remain strong (forecast farmgate milk prices at $9.25/kg) and NZ exported $3.9bn worth of goods to the EU in 2021 (6.4% of all exports). Furthermore, the recent NZ/EU trade deal will save exporters $100m p.a. in tariffs when it comes into force. Lastly, the Government continues to borrow to spend which will be stimulatory although the quality of their recent budget is questionable and at odds with the RBNZ's tightening. Declining tax revenues may also rain on their financial forecasts. Although the RBNZ will need to be nimble and better focused on its core responsibilities, given low unemployment and healthy average household balance sheets the outlook for growth in 2022 is still positive albeit slower (+2.7%).

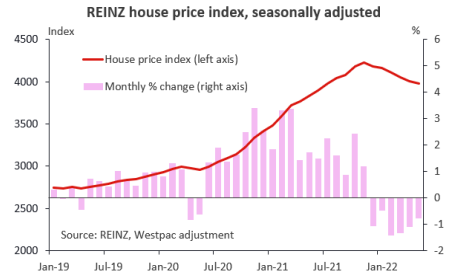
Australia

The Australian economy is faring better than NZ though will also slow this year and into 2023. A +9.5% jump in exports in May saw a record trade surplus of A$16bn. Consumer confidence like that in NZ, is being impacted by lower house prices, higher mortgage costs and rising expenses. Conversely, household spending is presently holding up well, supported by $265bn in excess Covid savings. Retail spending data was still strong in May and up +10.4% on the past year, while business confidence has also been more resilient than in NZ with business investment slowing but still positive at around +4%

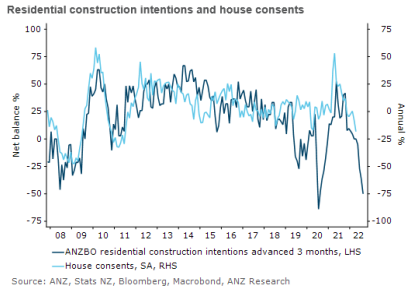
NZ Confidence leads Economic Growth Lower



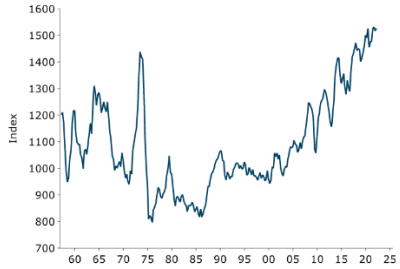
House Prices Lower



Residential Construction Intentions

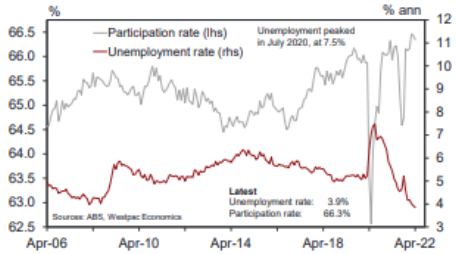


NZ Terms of Trade

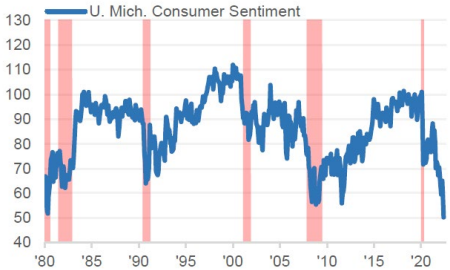


forecast. Federal and State government infrastructure spending plans will help offset the slowdown in residential construction intentions while the opening of their borders will bring net migration levels up through the year and be supportive into 2023 (alleviating wage pressures). The RBA recently surprised markets by lifting the cash rate higher than expected (0.5% vs 0.25% expected) to 1.35% and signaling its intention to get on top of inflationary pressures at the same time stressing the importance of patience. Unlike other banks (e.g., the US Fed), the RBA is clearly not taking a crush inflation at any costs approach. Markets have priced in further rate rises this year, expecting to be around 2% by year end. Economic growth is forecast to slow but still come in at a respectable +4% for 2022 (down from +4.5% estimates). Meanwhile the Australian Labor Party won the Federal election but may require the support of the Greens and Independents to govern which will see a greater focus on climate action policy.

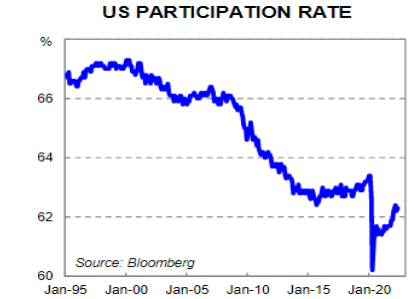
Australian Unemployment at 48year low



US Consumer Sentiment Slumps



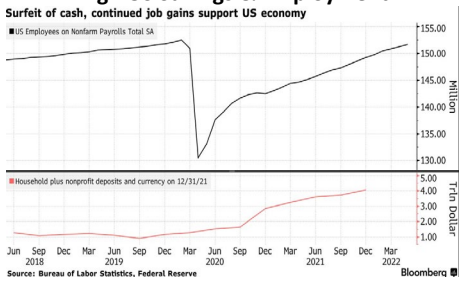
More Americans are Working



US

After contracting -1.5% in the first quarter the US economy is performing better this quarter and it should avoid a technical recession. Jerome Powell said the US is in "strong shape" and more than one Federal Reserve member says the fears of a recession are overblown. The Fed raised interest rates in the quarter up to 1.5% and signalled further rises this year. Markets are expecting cash rates to end at 3.4% this year and peak at 3.75% in 2023. The recent +0.75% rate increase was the largest since 1994 as the Fed tries to catch up and curb inflation. The speed at which they are tightening financial conditions is now having the expected impact on confidence and activity. The Fed is forecasting 2022 growth at +1.7% - down from +2.8% forecast last quarter. Consumer sentiment (opposite chart) dropped from 58.4 to a record low 50. Recent inflation expectations are fortunately starting to moderate, and households remain in a strong position with around $3.5 trillion of additional savings accumulated during Covid now available to spend. US businesses are also continuing to invest, reflecting decent underlying demand for goods and particularly services. The US services PMI index ticked up to 52.7 in the period and orders for durable goods rose +0.7% in May and up +10.5% over the year. Though manufacturing activity slipped in June it remains positive and accounts for 12% of their economy. New home sales were up +10.7% last month when a fall had been forecast. US 30-year mortgage rates are closing in on 6% but for now the property market is holding up well with median prices up +15% year on year (to US$449,000) though new property starts are down (-7% year on year) and sales are falling. Total US mortgage debt is less than 43% of current home values and the lowest on record, while the mortgage delinquency rate (3%) is at a record low. The labour market is tight with job openings close to record highs, showing the US economy effectively at full employment. US wages jumped in May by 6.1% on a year ago, the biggest annual increase in more than 25 years. Logically, this should be positive for consumer spending, and its ability to withstand a rising cost-of-living. There are also more participating in the workforce (see opposite) today as the many who opted (or were forced) out during Covid return to the market. The chances of recession are greater, and the Fed has stated they are focused on inflation over growth. Markets have priced in a 30% -40% chance of recession but presently this seems at odds with the strength of the US economy and the resilient shape of household and business finances.

High US Savings & Employment

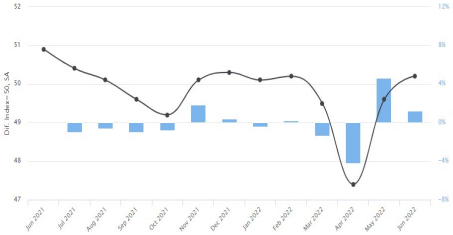


China

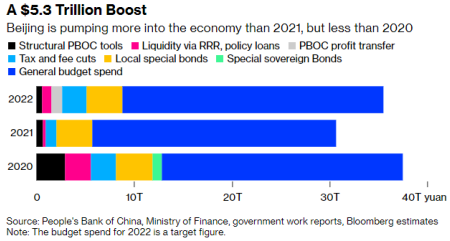
China's hard-line zero Covid policy has been severe on their people and economy. The lockdowns in Shanghai, Beijing and other cities in the quarter saw the economy contract sharply and throw transport and logistics into chaos. Trade was heavily impacted and threw global supply chains back into disarray. Both manufacturing and services activities were badly affected and contracted. Shanghai has now declared victory over Covid after the city reported zero cases for the first time in two months and all major cities are loosening restrictions. President Xi called on his government to "strike a balance" between a Covid-zero policy and overcoming economic difficulties as China's growth this year threatens to be de-railed. More recently, Covid cases have appeared as the more infectious BA.5 variant takes hold so it will be interesting to see how they respond. Factories have been re-opening since May and Chinese production levels are ramping back up with PMI data (see opposite) jumping in June. With the 20th Party Congress later this year Xi will be focussed on getting their economy back towards its 5.5% GDP growth target. While manufacturing and exports are increasing, China's GDP growth target is looking increasingly difficult to achieve unless household spending (confidence) responds and lifts sharply. A wide range of both monetary and fiscal stimulus ($5.3 trillion as calculated by Bloomberg opposite) equivalent to a 1/3rd of their GDP is now being applied. International travel remains highly restricted (Covid) while consumers are increasingly encouraged to buy local over imported goods. Interestingly some are forecasting that the US may outgrow China this year for the first time since 1976. Meanwhile China's foreign policy settings may drive further geo-political clashes with the west. The US Secretary of State Antony Blinken said *"We can't rely on Beijing to change its trajectory, so we will shape the strategic environment around Beijing to advance our vision for an open and inclusive international system. The U.S. will form coalitions with other nations to limit the Chinese Communist Party's influence"*. A potential cut in US tariffs on Chinese imports may provide a near term olive branch.

China Covid Cases to Zero

China PMI Jumps



China Boosts Stimulus



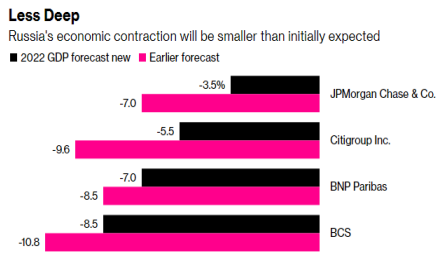
Europe

Clearly the Russian-Ukraine invasion remains the biggest risk to Europe. European inflation rose again sharply (+8.9%) in May, with German PPI up +33.6% year on year (food and energy and the highest since the 1940s). About half was made up by energy costs though inflationary pressures are broadening. Gas prices are up +240% and electricity prices +90% year on year. Soaring energy import prices have created Germany's first trade deficit result since 1991. The days of cheap Russian energy have passed, and supply constraints are putting significant pressure on German manufacturing profitability and threatening exports. Overall, inflationary pressures have forced the ECB to deliver a tighter policy stance and they will raise rates 0.25% in July with a 0.50% hike is possible if inflation data deteriorates. Further rate rises of 1.25% are expected through to year end with the ECB's long term neutral interest rate range of 1% to 2%. Presently, the ECB thinks a recession can be avoided given the record strong labour market, government support, the post covid reopening of their economy and significant household savings that were built up during the pandemic. However, falling confidence and economic expectation levels (opposite chart) may suggest otherwise. Recently structural financial pressures have emerged in the EU with peripheral states seeing their bond yields rise sharply (spreads rising) relative to core member states, forcing the ECB into maintaining and using its asset purchase programmes keep the disparity of EU yields in check. High global energy prices mean Russia is weathering the western economic blockade far better than expected and is on track for a much shallower recession this year. Russia is still supplying Europe with critical and

European Confidence Falling

expensive energy while expanding its exports to China, India, and other eastern states. The western sanctions will over time continue to degrade the Russian economy but not at a rate fast enough to dissuade Putin.

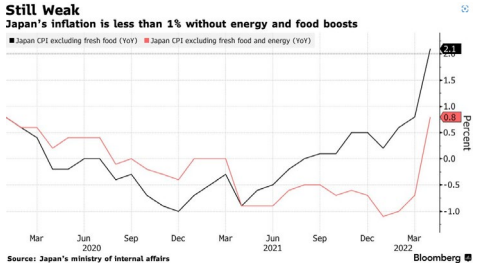
Shallower Russian Recession



UK

At the time of writing Boris Johnson had finally resigned under no-confidence pressure by his MPs following a series of gaffes and scandals that occurred under his leadership. He will stay on in a caretaker role until October when a new leader will be decided. The UK may be the first major economy to enter recession - and possibly this year - with the slowest growth rate (Russia aside) of any G20 economy. With import costs soaring and a disastrous post Brexit trade performance, the UK economy contracted in April while headline inflation has reached a staggering 9%. Despite the contraction in activity, the BOE lifted interest rates in June by 0.25% to 1.25% and signalled further rises will be required to head off inflation. On the positive side UK unemployment rate hit a 48-year low (3.7%) and again household and business finances are healthy.

Japanese Inflation Still Weak



Japan

Ex- Prime Minister Shinzo Abe was shockingly killed by a lone gunman in the city of Nara, while delivering a campaign speech for the Liberal Democratic Party (LDP) ahead of their general elections. A nationalist, he was a divisive but also a highly devoted public figure. The ruling LDP were re-elected just after Abe's death and may achieve the super majority in parliament needed to overturn Japan's highly restrictive defense force policy. Japan is the only major economy which continues with zero interest rate policies as it still grapples with structural deflationary forces. This zero-rate policy has led to significant weakness in the Yen which has fallen to a 20-year low and, surprisingly, the subsequent increase in the cost of imports is not translating through to core inflation. If energy and food costs are tripped out, Japan's inflation rate is still less than 1% (see chart opposite). The BoJ has pledged to continue stimulus measures to bolster Japan's economy.

Emerging Economies

Commodity producing economies continue to perform well on with rampant energy and food prices. This includes many Latin American countries, the oil producing Middle East and some Asian countries. The strong US dollar is hurting $US dollar indebted economies and those reliant on imported energy and food prices face rampant inflation. Without Ukraine's wheat and other crop production (said to feed 400 million people), Middle Eastern and Central and North African countries that are reliant on their exports face almost certain hardship and famine. Putin's invasion is badly impacting food supply to poorer nations and as a result may be responsible for far more deaths and a wider spread humanitarian crisis than that in Ukraine. The flow on effect from the loss of Ukraine exports has much further to run - India recently announced a restriction on its grain exports to ensure it can feed its own people.