

DYNAMIC TREE ASSET MANAGEMENT REVIEW & OUTLOOK Q3 2017



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Autumn has arrived, and the equity bull market which began in 2009 continues on its 2017 uptrend, pushing aside events like the current crisis surrounding North Korea. Usually, such events would serve as a trigger for a larger correction, but this time, equity indexes are ignoring all potentially bad news and are climbing from one all time high to the next. In the process, they are thus also climbing the so-called 'wall of worry'. As just one example, the Dow Jones has already had more than 60 new all-time highs since Trump was elected. The reasons remain the same, as solid global growth led by developed economies and increasing momentum also in emerging countries are coupled with inflation pressures being absent in both the US and the eurozone – a dream scenario for stock markets.

On the political front, the only significant event in Q3 was the recent German federal election, which saw the return of Angela Merkel's party as the holder of the largest number of seats, while the main surprises were the loss of her previous coalition partner SPD (which has announced that it prefers to be in opposition now) and the surge in popularity of the nationalist AfD party. Despite all this, there will probably be no major impact on equity markets, where we will continue to see additional upside for the eurozone. The new coalition with the FDP is perhaps not the best news for the euro as a currency, however, and the recent euphoria should cool off and might even lead to a comeback of the USD.

The crisis in Catalonia carries a message for the entire region. Questions of political freedom, identity and sovereignty are not a relic of the past. It is the nature of political risk that is changing. The risk is less systemic, more local, and not mainly financial in character. The rather paradoxical conclusion is that Europe is becoming more complex for the international investor.

ANOTHER STRONG QUARTER FOR OUR DT 15

The DT Top 15 had another very good run in the second quarter, advancing by +6.2% in USD terms.

Year-to-date the strategy is up +26.57% in USD terms.

The stage is nevertheless set for the global economy to power ahead over the coming months. Most leading indicators suggest that growth remains strong. Unusually for such a strong economy, however, inflation has remained subdued recently but is expected to pick up, at least in the US, as wage pressure and the further absorption of excess capacity have finally led to higher prices. After a long period of stubbornly slow growth, the economic recovery of the eurozone has also gained additional momentum in 2017, and has broadened significantly.

Stock Markets

Equity markets enjoyed another strong quarter extending their already powerful performance so far this year. Most markets once again reached new all-time highs (S&P 500, Dow Jones, MSCI World), with notable exceptions being Switzerland and Japan (the Nikkei 225 is still far below its all-time high of 38,950 at the end of 1989). The following table shows the Q3 2017 and the 2017 year-to-date performance of equity indexes in local currency terms (total return including dividends):

	Q3 2017 (%)	2017 YTD (%)
S&P 500	+3.96	+13.21
Toronto TSX	+2.98	+2.88
Euro Stoxx 50	+4.44	+9.41
SMI Swiss Market Index	+2.81	+12.88
Japanese Nikkei 225	+1.61	+7.91
MSCI World	+4.38	+14.75

Source: Bloomberg

The strongest market in the third quarter was the Euro Stoxx 50. In combination with the strong euro, non-euro based investors were able to make solid gains in the last few months when investing in Europe. That does not change the fact that European markets are still not among the best performers in 2017. The Canadian TSX remains a laggard and has not been following world markets so far in 2017, but at least it is no longer in negative territory. US markets are still leading the crowd, and Asian markets have started to outperform with the exception of Japan.

Going forward we expect the recent outperformance of European and Asian markets to continue. In terms of earnings growth, eurozone companies look set to continue to trump their US peers. In terms of valuation, the eurozone offers lower relative price/earnings ratios, which are often substantially below their historical average compared to

the US. A normalization of this ratio alone offers significant upside potential for eurozone equities. Asian equities should profit from the higher growth rates of most Asian economies compared to the West.

As a side note, the S&P500 has now reached the 2,550 range. We should remember that, at the beginning of the year, the consensus forecast of major American brokers was projecting that this benchmark would hardly rise to more than 2,350 this year. The lesson here is that consensus thinking is often worthless to an investor, and is merely walking backwards into the future. For otherwise, one might also conclude that markets have gone up too much!

Economics & Politics

Central bank meetings set the agenda in September, with five meetings taking place within two weeks. They all had one common theme: the ‘normalization’ of monetary policy. The Bank of Canada was the only one to subsequently raise interest rates, immediately resulting in an uptick trend for the ‘loonie’, which we believe was undervalued anyway. The Federal Reserve announced the start of a reduction on its balance sheet in order to return to a normally functioning money market, and is almost certain to announce a rate increase during its December 12 meeting (73.3% consensus rating according to Bloomberg). The European Central Bank, on the other hand, will continue to purchase assets until inflation solidifies, despite some speculation concerning a tapering.

Most economists are cautious that when central bankers talk of ‘normalization’, they do not mean a return to the old model of higher interest rate levels. Up to now, we have only had a modest change in rhetoric, and markets neither expect a monetary overkill nor massively higher interest rates anytime soon. Receding commodity-driven base ef-



“Building wealth is a process of managing risk, not ignoring it.”

Jon Duncan

International diversification helps to spread and diminish risks globally while exposing the portfolio to additional opportunities.

facts have delayed the recovery of global inflation outside the US, and the backdrop for reflation on a global scale needs more time to unfold.

The US economy is running at cruising speed – despite the lack of fiscal stimulus expected to be generated by Trump – and even the recovery seen in the eurozone is genuine, outpacing expectations. Brexit negotiations are creating headwinds for the UK, which will add to data disappointment. The Bank of England will probably sit through the inflation overshoot and wait for further visibility.

China's growth is slowing somewhat structurally, as the economy transforms from investment-led to consumption-led growth. During this fragile phase, the country's Achilles' heels are its overheated property sector, capital flight, and its ever-increasing debt burden. The 6.5% average yearly growth envisioned by the government during the

years 2015-2020 appears to be within reach, but may come at the cost of an even higher debt burden.



Impact by Asset Class

Liquidity / Fixed Income

We continue to hold a relatively high cash allocation to safeguard portfolios from expected losses in bond markets in the future. Fixed income remains one of the most unattractive asset classes in decades, as there is almost zero reward to the upside but a significant amount of potential loss ahead if interest rates start to rise. Lately, the trend of higher long-term interest rates in USD has come to an end for the time being, and the core inflation rate in the eurozone declined from 1.2% to 1.1% in September. This means that despite solid economic data, there is only slight pressure on the ECB to raise interest rates before 2019.

The yield levels will rise only slightly over the coming months without any inflationary pressures on either side of the Atlantic. Our approach in this scenario is to buy only short-term bonds, bonds with an inflation hedge, or a certain percentage of high-yield bonds, but again only of short duration.

Equities

US equity indexes are currently at all-time highs, and the main European markets are also scaling lofty heights. This can be attributed to consistently solid sentiment data and a synchronised upturn in the global economic cycle, coupled with an inflation rate and outlook which is stubbornly low.

Other factors include the lack of alternatives to equities, and the fact that companies are still delivering strong results. All in all, the sun is shining for equities and everybody wonders what will eventually spoil the party.

We have had a positive view on equity markets throughout the year, and have decided to increase our equity weighting in balanced portfolios from 44% to 46%. During Q3 we bought the ETF Global Robotics & Automation (ticker symbol: ROBO). Automation is a secular trend that is only in its early stages. This security invests in the rapidly growing robotics and automation industry, with companies in 15 different countries around the world, of which only 39% are domiciled in the USA, thereby offering true international diversification. We have sold ATT instead, which has been lagging behind the markets for quite some time, and will only suffer from increased competition. As we see high growth potential in Asia, we have also increased our position in the iShares MSCI ASIA ex-Japan from 2% to 4%.

Currency Impact

During the third quarter of 2017, the USD continued to soften against the euro by losing another 3.4%, bringing the yearly decline to 12.32%. This downtrend of the USD, and in particular also the size and magnitude of the move, surprised markets, and even us to some extent. Nevertheless, we believe the tides will slowly turn as market participants realise that the interest rate differentials are likely to expand further, which is typically negative for the value of a currency. Consequently, we expect the euro to weaken slightly over the coming months. The situation in Catalonia is not helping the euro either. Its economic impact is very limited outside of Spain, but it shows the world once again what a fragile construction the EU really is, and it adds uncertainty – an element markets hate. The Swiss franc was unchanged more or less to the USD in Q3, and lost ground against the CAD.

The CAD gained another 3.9% to the USD in Q3, thereby advancing 7.5% overall so far in 2017. The main reason for the increase Q3 was the rate hike in Canada, but more importantly, the increase came without any major support from rising oil prices. During the last quarter, gold was able to break through its 1,300 resistance level, moving as high as 1,357.61, but was unable to sustain the rally, and at the present time is below 1,300 again. We are holding on to our gold position, however, as we think gold will advance to above 1,400 in 2018, but will consider selling at that level.

DT Top 15

The DT Top 15 continued its excellent performance in 2017 by advancing 6.2% in Q3, equating to an increase of 26.57% in 2017 YTD, both figures in USD terms. With this result, we have outperformed most equity markets in 2017, and have simultaneously also beaten our main benchmark, the MSCI World, which is at plus 16.53% YTD. Some part of the strong performance is currency related, however, as 11 out of the 15 stocks are not denominated in USD, and the USD lost 12.32% against the euro, and 5.28% against the Swiss franc.

During the last quarter, we added the American ADR of Sony to our portfolio, the reasoning behind which is outlined below. In contrast, we sold Shiseido and took profits, as the stock had gone up by more than 44.6% in 2017 alone. We think that the stock has already priced in all potentially good news for the time being, and is overpriced at current levels.

Below is an overview of some of our holdings and latest additions:

Sony – In September we bought shares in this Japanese technology and consumer goods conglomerate, which is still a powerhouse with a strong global brand and a dominant position in the fields of gaming as well as home entertainment/audio. It is also the world's largest vendor of video cameras. This year, its PS4 sales were stronger than those of its gaming console competitors. The last quarter saw better than expected results, as its sales rose by 15% year on year overall (7% above consensus), and its semiconductor sales even rose by 41% year on year. The stock is only trading at a price/earnings ratio of 18.20, which is the lowest seen in many years, and its price/sales ratio is at a very moderate 0.69x. We believe the stock is undervalued, and does not yet fully reflect the company's strong market position and growth momentum.

Microsoft – Since we bought the stock in March this year, it has risen by more than 16%. We will continue to hold on to the stock for the same reasons we bought it. While Microsoft enjoys a near monopoly in personal computer operating systems and office productivity software with a global distribution network and presence, the company is also showing strong momentum in its cloud offerings (such as Office 365 and Azure), and is on track with its intended transition into a cloud-based software company. During the last quarter, its revenues increased by 9% year on year, ahead of consensus, and more importantly, its Office 365 software registered revenue growth of 21%, offsetting a small decline in its personal computing revenues (its legacy business). LinkedIn also added USD 1.1 billion to segment revenues.

Vinci – This is one of two stocks we have held since the beginning of the DT Top 15, and it is up again more than 24% this year, making it one of the ten best stocks of the French CAC40 Index. Its combination of the stable concessions business and the more cyclical construction activities is an attractive mix. Being the largest toll-road operator in France, it generates cash flows of approximately EUR 2 billion annually, which adds resilience to its revenues. On top, Vinci has pursued a prudent financial policy focused on maintaining a robust balance sheet. We like the defensive character of Vinci, and its modest but steady growth.

Dufry (up 22.28% YTD by end of Q3) – The Swiss company is the world's largest, most diversified duty-free retailer, operating 2,200 duty-free shops (as of July 2017) mainly in airports, railway stations and seaports. While other retailers suffer from ever increasing competition from online shopping, duty-free shopping is still in an uptrend, as worldwide travel continues to rise and people have enough time to shop while waiting for their next flight. Its 2017 results have so far been strong, with sales growth of 8.9% year on year in Q2 2017, and the company expects its organic growth to continue throughout the remainder of the year. The unlisted Chinese group HNA's acquisition of a 20.9% stake could strengthen the group's exposure in Asia (still underdeveloped), but also leaves room for the possibility of a complete takeover by HNA.

Allianz (up 26.27% YTD by end of Q3) – The German company is one of the leading non-life insurers in the world. In an environment where size matters, we believe that the market underestimates the potential of Allianz to leverage its scale advantage, which should amount to EPS growth of 5% per annum. It has a moderate price/earnings ratio of only 10.6x, which is at the lower end of the pan-European insurance sector, and its current valuation does not properly reflect its best-in-class standing within the industry. It has a high dividend yield of 4.02%, and the ability to increase its dividend payout even further. During the last quarter, its operating profit grew by 22.9% year on year, which was 10% above consensus. Net profits were even up 83.4%, which was also well above consensus. Even after the recent surge, the stock is still trading at less than 50% of its all-time high of 402.66 in the year 2000.

Outlook

In recent weeks, we have seen a number of increasingly cautious comments regarding the current equity bull market. After eight years of continuously rising prices, this is understandable. Equity valuations continue to rise in particular in the US, although we also see elevated levels in Europe, albeit to a lesser extent. While we are aware of the downside risk, we nevertheless also want to highlight once again the factors that could make equities rise further. The macroeconomic environment still looks robust, corporate earnings are rising and, last but not least, other assets classes do not provide a clear investment alternative. The upcoming earnings season in the second half of October will provide some answers, but we expect no negative surprises for the market as a whole, although individual stocks might suffer as expectations are often very high.

In the US, renewed hopes about Donald Trump's political agenda concerning taxation ("the most wonderful tax reform ever seen") are also expected to materialize in the near future. Even so, the financing for that program has not yet been secured, and no details have yet been published. This is not a major cause for concern, however, given earlier disappointments already experienced by investors during the first months of Trump's presidency.

Consequently, we remain invested in equities with a 46% allocation in Balanced Portfolios, although we also want to reiterate that total return might remain relatively modest for the

remainder of the year. We remain positive on eurozone and Asian equities, and cautious on US and UK equities.

Fixed income remains an unrewarding asset class, and as a result, we remain underweight in it. We are keeping durations short, and with upcoming redemptions we are only buying papers with maturities of two years at the most, and/or floating rate instruments. We expect the yield levels in most currencies to rise slightly over the coming months.

We will hold on to our gold position as outlined above, but might sell the position if gold surpasses the 1,400 level. We remain positive on real estate instruments, and will hold on to existing positions, predominantly as a hedge against inflation. We expect the euro to weaken slightly over the coming months, and will take this into consideration when buying new securities.

For the remainder of 2017, we expect markets to rise further and our portfolios to do well. At the same time, however, we are increasingly cautious and will continue to watch all sentiment readings and other early warning signs of a possible correction.



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**“Games are won by players who focus on the playing field –
not by those whose eyes are glued to the scoreboard.”**

— Warren Buffet —

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