DYNAMIC TREE ASSET MANAGEMENT

REVIEW & OUTLOOK Q2 2018

AGENDA

ANOTHER SOLID QUARTER FOR OUR DT 15

The DT Top 15 had another good run in the second quarter, advancing by +2.92% in USD terms.

Year-to-date the strategy is up +3.33% in USD terms.

We are already halfway through 2018, and 'halftime' is always a good opportunity both to share what has happened, and to assess what might be the best steps for rest of the year. In short, the economies as a whole are still in good shape but politics continue to deliver conflicting and unsettling news. This has resulted in mixed markets, which on some days tried to continue their old uptrend, but were invariably held back by negative events or news of a non-economic nature. For the remainder of 2018, however, we expect fundamentals to prevail over politics and expect to see the year close in positive numbers as far as equities are concerned.

Headline news continue to grab the attention of markets and market participants alike. The US / China trade issue is still not resolved, and there are increasing signs that the old geopolitical order is falling apart. The confrontational tone of the last G7 summit held in Canada at the start of June demonstrated how fragile the situation truly is. The Trump administration continues to beat the drum of protectionism ahead of the November 2018 US mid-term elections. The US / North Korea situation is by no means settled, which is a setback not only for Asian markets. In Europe the political situation is also still fragile in its leading economy in Germany, as well as in Italy, and there is still no more clarity on Brexit than there was back in 2016.

Nevertheless, the global economy has been at cruising speed and turned in a solid performance for the first half of 2018. Growth in economic output was up over 6% in China, almost 3% in the US, and around 2% in Europe, which left overall global growth at almost 4%, which is far better than any growth rate seen in the past five years. At the same time, inflation was still relatively tame, remaining below 3%, however, rising energy prices could become an issue. All in all though, economists have branded the current state of the global economy as 'Goldilocks' – not too hot, not too cold.

Stock Markets

Last year's synchronized global rally is being increasingly replaced by regional differences in growth trends. Whereas US economic indicators signal sustained strength in manufacturing and private domestic demand, leading indicators in the eurozone and Japan point to a slight drop in the pace of economic growth. Among emerging markets, we are also seeing a growing gap between some solid Asian economies and more politically and economically unstable countries – a trend which is mirrored in Latin America. This has resulted in mixed performance among the respective markets, as can be seen below.

The following table shows the Q2 2018 and the 2018 year-to-date performance of equity indexes in local currency terms (total return including dividends):

	Q2 2018 (%)	2018 YTD (%)
S&P 500	3.40	2.64
NASDAQ 100	6.61	9.38
Toronto TSX	6.77	1.94
Euro Stoxx 50	3.37	-0.46
SMI Swiss Market Index	0.40	-5.16
Japanese Nikkei 225	4.07	-1.05
MSCI World	1.88	0.71

Source: Bloomberg

Most equity markets managed to deliver a positive performance in Q2 2018, to the extent that the 2018 year-to-date performance turned from minus to positive in many cases. However, a closer look reveals that it was primarily US technology stocks that were the main driver behind the markets, and within that sector, the so-called FANG stocks (Facebook, Amazon, Netflix, Google). They pushed the NASDAQ up to almost 10% this year, and were the main reason for the relatively strong performance of the S&P 500 (US IT stocks now represent 25% of that index). Europe's lack of technology stocks (IT only accounts for 5% in Europe) was one reason for its negative performance so far this year, and the situation was even worse in Switzerland, with its defensive stock mix of pharmaceutical, food and financial stocks.

"Sell in May and go away" has continued not to be a good strategy so far in 2018, and going forward, we expect positive fundamentals to prevail and think it is best to stay invested in equities all the way. The key will be to invest in the right sectors rather than regions. Stocks in information technology and those tied to the global growth cycle, such as oil firms and industrials, should continue to outperform.

Economics & Politics

As has often been seen in recent years, the weakness experienced by the US economy during the first quarter turned out only to be a temporary phenomenon. Since then, both sentiment indicators and hard macroeconomic data have picked up again across the board, signalling an annualized pace of growth in Q2 that could even exceed 4%. With the unemployment rate being at a historic low of 3.8%, inflation rates above 2%, and an expansive fiscal policy being pursued by the Trump administration – which could support the economic cycle well into 2019 – further interest rate hikes by the Fed are a logical consequence.

From that position of strength, the US administration is pushing ahead with its renegotiations of existing trade agreements. Meanwhile, punitive US tariffs are leading to retaliatory measures by its major trading partners, suggesting the whole situation could end up in an international trade war. There are never any winners in

"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.

such disputes, however, at least not economic ones. Nevertheless, the political advantages could outweigh the economic costs for the US, because foreign trade accounts for a low share of its GDP. In addition, given the increasingly protectionist thinking of voters in the run-up to the mid-term elections, it would not be surprising if the current US administration chooses to exploit the situation and goes ahead with its trade tariff plans.

In contrast to the USA, the current pace of economic growth in Europe is disappointing and has even slowed in 2018 due to weaker exports, with the appreciation of the euro possibly also acting as a drag. Since Europe is more open to trade, it may also be more vulnerable to the potentially negative consequences of a trade war. Russian sanctions also play a more important role in Europe, as do the volatile situations in Turkey and Iran, in addition to the fact that Brexit remains yet another unsolved problem. Despite all this, however, the ECB has announced its intention to wind down bond purchases to zero in Q4, preparing the ground for an initial interest rate hike sometime in 2019.

Impact by Asset Class

Liquidity / Fixed Income

The magnitude of future rate hikes by the FED, and the US government's refinancing needs, currently dominate the fixed income landscape. Against the backdrop of solid private consumption, rising capital spending, and mounting inflationary pressure, we expect three more rate hikes in 2018, which should lead to lower bond prices. In spite of this, we have still invested some USD cash into two-year corporate bonds with an 'A' rating and yielding around 3%, rather than just sitting on the cash. Any bonds with a duration of more than two years are not attractive in

the above scenario, however. Other possible instruments continue to be Floating Rate Bonds and Treasury Inflation Protected Securities (TIPS).

In the eurozone, the ECB has expressed disappointment regarding the lack of growth momentum in Europe, and is thus unlikely to significantly change its policy stance anytime soon. With EUR and CHF bond yields still in negative territory, we are keeping high cash positions for such accounts, Floating Rate Notes, and are keeping away from 30-year bonds yielding below 1%.

Equities

Equity markets nearly kept their value in 2018 – so far in the USA at least – but are currently undergoing a paradigm shift. They are no longer 'liquidity driven' (with rising interest rates as seen in the US, and the resulting reduction on the balance sheets of central banks), but 'earnings-driven', and with solid company earnings so far in Q1 2018, they have sustained that trend. It remains to be seen, however, what the upcoming earnings season will bring to the table in the second half of July 2018, as expectations are high with regard to some IT stocks. One continued positive is that equity valuations are still attractive compared to bond yields, but the strong momentum and bull market sentiment of the last few years all but disappeared during the first few months of 2018, which is clearly a negative.

We have kept our equity allocation at 46% for balanced accounts as we feel comfortable with this fairly conservative stance, and intend to keep it for the time being. We think that equities in cyclical regions such as the eurozone, Japan, and some Asian emerging markets will be stronger going forward, also taking into account that they are currently lagging behind and thus have much cheaper valuations. Such countries typically perform well in late-cycle growth periods, and since about September 2017, gross domestic product (GDP) growth in emerging markets has been higher than in developed markets. Commodity prices on the uptrend are another positive factor for emerging markets. As far as sectors are concerned, we prefer cyclical sectors and those with low indebtedness, as rising interest rates will lead to higher refinancing costs. Based on that metric, the areas to invest in are information technology, financials and industrials. In consideration of the above, we have added ABB (an industrial stock) and Samsung Electronics (both an information technology and emerging market stock) to our portfolios.

Currency Impact

In 2018, the USD stopped its downtrend against the euro, which had been going on since March 2015, and reached a peak of 1.255 on February 18, 2018, having lost 19.56% in value against the euro during the last three years. The interest-rate advantage has finally kicked in for the US dollar, with potentially more to follow, as dollar sentiment is improving while euro optimism has all but gone for now. In fact, the euro's strength has become somewhat of a headwind for the eurozone, and as recent economic data in Europe has been disappointing, growth seems soft in 2018, which makes rate hikes in the eurozone unlikely this year. On the other hand, the US FED intends to increase interest rates at least two more times, which will widen the interest rate gap even more. All this points to a stronger dollar for the rest of the year, but looking farther into the future, the USD remains fundamentally overvalued and could weaken again once interest rates start to rise in the eurozone.

Commodities have presented a mixed picture so far in 2018. Gold was disappointing in the first half of 2018, dropping 3.9% despite financial market jitters and geopolitical tensions, but followed the rise in the USD (gold and the USD tend to follow each other, but in opposite directions). We think that any additional downside will be limited, however, and view gold as 'neutral'. Other metals have also shown weakness overall. Oil was an entirely different story, however, with Brent Crude rising by an unexpected 18.7% in the first half of 2018 due to strong demand, Venezuela's supply collapse, and production restrictions in petro-nations such as Russia and Saudi Arabia. The oil market remains under the spell of politics and its future direction is highly uncertain.

DT Top 15

Our DT Top 15 stock portfolio rose by 2.92% in the second quarter of 2018, making a solid plus of 3.33% for the first half of 2018 overall, following an increase of 30.86% in 2017 (all figures in USD terms). With this result, we have outperformed most major equity markets in the first half of 2018 – which had very different outcomes ranging from -5.16% (Switzerland's SMI) to +9.16% (NASDAQ 100) – and we have also beaten our main benchmark, the MSCI World, which came in at plus 0.71% (see above table). It is of great significance to us, and we expect also to our valued clients, that we were able to outperform markets not only in bull market situations like the one we had in 2017, but that our portfolio is also doing well in bear markets such as the one in Q1 2018, thanks to our solid mix of growth and value stocks.

During the last quarter, we added the Swiss robotics and automation company ABB to our portfolio, the reasoning behind which is outlined below. We took profits in Swatch, the Swiss watchmakers, which had risen by 25.24% in 2018 until we sold it, making it by far the best performer on the Swiss Market Index up to that date (the index itself was down 7.9% during the same period, making the outperformance of Swatch even more significant). We took that strong performance as a good opportunity to lock in the profit generated in 2018, as we also thought the stock had priced in all possible good news ahead, and was starting to become expensive.

Below is an overview of some of our continued holdings and latest additions.

ABB (new addition, replacement for Swatch) - This Swiss/ Swedish company is a global leader in power and automation technologies, with a well-balanced global geographic presence, as well as a healthy balance sheet and cash generation abilities, which give it financial flexibility. It should profit from ongoing secular trends such as urbanization, energy efficiency, clean energy and rapid industrialization in emerging markets. Its robotics and motion division is growing quickly (+11% in order intake year-on-year) and already makes up 23% of the company's overall turnover. 2017 was a transition year by the company's own definition, and it expects to return to solid growth numbers in 2018. Q1 profits have already grown 12% year-on-year, which is 5% above market consensus, and sales were also up 10% (3% above consensus). The stock valuation is moderate with a price/earnings ratio of 15.8 (2018E), a price/sales ratio of 1.4x, and an attractive dividend yield of 3.6%. As a result, we see more upside potential in this 'robotics' stock.

Merck KGAA (purchased in March 2018 and already up 8.1% by the end of Q2 2018) – We bought shares in this German pharmaceutical and chemical company at a weak point in March 2018, and the stock has recovered nicely since our purchase. Merck operates mainly in the field of oncology (cancer treatment) and autoimmune and inflammatory diseases. It continues to have a strong pipeline of drugs in the second phase of development, which in our view is underappreciated by the market. The company is also the world's largest supplier of liquid crystals, with its flagship technology being organic light-emitting diodes (OLEDs), which are used in the manufacturing of liquid-crystal displays (for notebooks, tablets, mobile phones, etc.). Its Q1 earnings came in at 21.7% below the previous quarter (which was one of the reasons for its earlier decline), but were still above consensus. Sales also declined, by 4.4%, but still grew in its important healthcare division. We think the company's current weakness will be offset in the long term by its strong pipeline of multiple oncology drugs, causing the stock to resume its former uptrend.

Novartis (down 5.29% during the first half of 2018) – At the end of June, the Swiss pharmaceutical giant announced its intention to spin off its Alcon eye care business unit into a separately traded, stand-alone company during the first half of 2019. Novartis shareholders will receive one Alcon share for each Novartis share, and the transaction is expected to be tax-neutral for the company (although for shareholders perhaps not in some cases). It is expected that the new med-tech company will become a member of the Swiss Market Index SMI and will perform well post-spin – owing to the fact that spin-offs from large-cap pharma have performed well in the past. While this is all still one year away and further details have yet to be given, the markets' immediate reaction was positive, and the stock was up 4.21% on the day of the announcement and has been trading higher ever since. Otherwise, Novartis generally trades in line with its global large-cap pharma peer group average, but toward the bottom of the historical trading range. We will follow future events closely, and intend to hold on to Novartis for the time being.

Royal Dutch Shell (up 10.19% during the first half of 2018, including dividends) – This globally leading, independent oil and gas company has had a good run so far in 2018, in line with rising oil prices. It has repositioned and streamlined itself in recent years to accommodate a long-term low oil price environment by cutting operating expenses to a base scenario of USD 62 per barrel Brent, which is well below current prices. It is now perfectly situated to harvest cash flows from investments made earlier in the decade, as well as from its acquisition of British BG Group. Furthermore, it intends to resume its share buyback program during the second half of 2018, and its dividends will now be paid fully in cash. The stock is trading at moderate multiples with a discount to its US peers, and offers a dividend yield of 5.20%. In Q1 2018, its adjusted earnings surged by 42% year-on-year, driven by better performance in integrated gas and upstream operations. As with all other oil stocks, however, the stock would suffer if oil prices were to decline to their 2017 level or even further.

Sonova (up 18.59% during the first half of 2018) – This Swiss hearing healthcare company provides wireless communication systems for audio applications and cochlear implant systems, and has a dominant market position owing to its strong brand image.

It will continue to benefit from underlying global trends such as aging demographics, increasing noise pollution, and growth in emerging markets where its business still has a fairly low penetration rate. Sonova has a reputation for having superior technological know-how and a high level of investment in R&D. Its latest results were very convincing, with sales up 10.5% and EPS even increasing by 14.5% year-on-year, both above consensus expectations. However, its recent strong performance has pushed its valuation to the upper limit, and further upside seems unlikely at the moment. Nevertheless, we will keep the stock for the time being regardless of its recent run, partly owing to the fact that following the death of its long-time president and major stakeholder, A. Rihs, the stock is considered by many as a possible takeover candidate.

Outlook

Global growth should continue to remain strong, but unlike in 2017 it will not take place in all regions at the same time, nor are we expecting it to accelerate significantly in Q3 2018. Inflation and interest rates should increase beyond current levels, but only gradually. Profit margins and earnings will likely continue to rise, which will help equities, and although we are clearly in a very late stage of the current economic cycle, a recession – which is now statistically overdue – is not likely to happen during the next few quarters. Nevertheless, geopolitical developments will continue to hold the attention of investors – from trade war talks, to the unsolved situation with North Korea, to unstable European governments, to numerous other challenges. Those developments will also inevitably affect the markets – in particular with regard to day-to-day business – but we continue to believe that such developments are more likely to be noise than they are to cause long-term disruptions, and that investors should attempt to look beyond the daily headlines.

Overall, equities remain the most attractive asset class in an environment of strong economic growth and accelerated company earnings growth – and even in spite of the expected rise in bond yields. Historically, inflation only becomes challenging for equities once it remains above 3% for an extended period, which we are still far away from. We believe cyclical stocks will do well in light of the late stage of the economic cycle we are currently in, and in investing heavily in information technology, which is now the fastest growing sector in the developed world.

Owing to the anticipated future increases in interest rates, fixed income was and continues to be an unrewarding asset category (even for the USD), and we remain underweight in that area. We intend to keep durations as short as possible and meaningful, and with upcoming redemptions to buy instruments with maturities of less then two years, or variable rate instruments (FRN). Preferred stocks may also be a valid alternative after careful selection.

Geopolitical uncertainties in the Middle East, Venezuela, and elsewhere, have caused oil to climb to levels not seen for years, but the future trend is still difficult to predict. Gold has disappointed so far in 2018, but might well have found a bottom at its current level. We will hold on to our gold position for the time being, but are ready to sell and will watch it closely. In terms of protection against inflation, real estate funds are another alternative for generating income, but could suffer baldly once interest rates start to rise.

In summary, for the rest of 2018 we expect the robust global economy to have a stronger impact on markets than political events – including any potential trade wars – and remain slightly positive in our view going forward.

“The stock market is a wonderfully efficient mechanism for transferring wealth from the impatient to the patient“

— Warren Buffett —

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