DYNAMIC TREE ASSET MANAGEMENT

REVIEW & OUTLOOK Q3 2018

ANOTHER VERY STRONG QUARTER FOR OUR DT 15

The DT Top 15 had another good run in the second quarter, advancing by +7.42% in USD terms.

Year-to-date the strategy is up +11.01% in USD terms.

During the past quarter, markets continued to shrug off politics and be driven by upbeat economic sentiment. US equities reached another all-time high toward the end of Q3 2018, when the S&P 500 reached 2940 points. In addition to the usual technology stocks, it was the financials that were the major driver behind the recent advance. They profited from rising long-term US Treasury bond yields, with the 10-year bond rising above 3% again and reaching a multi-year high. This was primarily the result of the upbeat sentiment among US companies during the Q2 reporting season, as well as the rise in oil prices, which will be reflected in higher consumer prices in the coming months.

In September 2018, US employers created 134,000 new jobs, bringing the unemployment rate down to 3.7%, the lowest level seen in 49 years! September also marked the extension of the longest hiring streak on record, with millions of Americans having returned to work since the Financial Crisis. Healthy consumer and business spending has been fuelling brisk economic growth in the US, and is emboldening employers to continue hiring. The September gain also extended an 8½-year streak of monthly job growth. Led by the US, global economic activity remains strong as businesses in the developed world continue to enjoy tailwinds. In general, interest rates are still at a very low level (when adjusted for inflation), but are on the rise particularly in the United States where employment and inflation dynamics warrant such increases. While the strong US economy is the envy of the world, the eurozone is also growing firmly above potential, and even Japan is showing improved economic data. In short, growth momentum in developed markets is robust and is expected to last well into 2019.

The robust economy and the resulting solid stock market in the US are holding strong despite turmoil in some major emerging markets and headwinds coming from the political front. An escalation of trade disputes, in particular between the US and China, geopolitical tensions in the Middle East, and the EU's continuing tense negotiations with both the UK (regarding Brexit) and Italy (in terms of budget) are likely to continue to dominate the headlines and unnerve investors. The US is also entering what is perhaps the most critical phase of its midterm elections, and with the possibility looming that the Republicans could lose the House of Representatives, Trump is still trying to prove the success of his policies by intensifying trade quarrels and forcing new deals. All in all, it will be a tense political season for the US during the last quarter of 2018.

Stock Markets

Numerous geopolitical uncertainties, together with the length of the current bull market, raised the question at the beginning of the year of how much longer markets will continue to rise. After Q3 is over, the bears in the equity realm have for the most part been wrong again as most markets continued their long-term uptrend, reaching new all-time highs on September 21, 2018, when both the S&P 500 and the Dow Jones Industrials reached unknown territory. They were driven by strong economic sentiment, impressive quarterly results (helped by the US government's tax reform), and a sufficient amount of liquidity ready to enter the market.

The following table shows the overall performance of equity indexes for Q3 2018, as well as the year-to-date figures for 2018 in local currency terms (total return including dividends):

	Q3 2018 (%)	2018 YTD (%)
S&P 500	7.19	10.56
NASDAQ 100	8.61	20.18
Toronto TSX	-0.56	1.37
Euro Stoxx 50	0.40	-0.15
SMI Swiss Market Index	5.67	0.21
Japanese Nikkei 225	8.80	7.67
MSCI World	5.08	5.89

Source: Bloomberg

All equity markets except the Canadian market managed to deliver a positive Q3 performance, which in most cases even turned the year-to-date figures for 2018 from minus to positive, with the exception of the main European index, the Euro STOXX 50. Looking at the numbers, it is striking to see how the US markets managed to outperform those in the rest of the world. A closer look, however, reveals that it is still mainly technology stocks that are driving those markets. Tech stocks have pushed the NASDAQ up by over 20% this year, and are also the main reason behind the relatively strong performance of the S&P 500 (US technology stocks now represent 25% of that index). Europe's lack of technology stocks (IT only counting for 5% of European stocks) is one reason for its negative performance so far this year, in addition to the weak euro, which has led to outflows of money into the US dollar realm.

Going forward, we expect positive fundamentals to prevail over politics. In the past, the second year of the presidential cycle has corresponded to the best returns for the S&P 500, with a 17.7% gain on average for the 12 months starting in September. Although this seems an unlikely scenario this time with markets already at such high levels, it could nevertheless give some indication of the future direction of the markets.

Economics & Politics

The summer of 2018 will go down in history as a period of trade war jitters and accompanying economic uncertainty. New tariff announcements were made on an almost weekly basis, and each new tariff imposed by the US government was immediately countered by the Chinese authorities.

At the beginning of October, the US and Canada finally agreed to a trade deal with Mexico (USMCA), which replaces NAFTA (the North American Free Trade Agreement). Canada made a major concession by giving the US improved access to its dairy market. If the lawmakers of all three countries approve the new trade pact, it would be a major success for President Trump, who has repeatedly portrayed the old trade agreement as being unfair toward

"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.

the US. News of the deal was received with great relief by the financial markets, and also caused the media to shift its focus back to the trade dispute between the US and China, but the ongoing geopolitical rivalry between those two countries makes it unlikely that any agreement will be reached in the near term.

Soon the upcoming US midterm elections will also come into focus. One possible outcome is so-called political gridlock, which arises when a single party does not control both the presidency and the two chambers of Congress at the same time. Some studies suggest, however, that such a scenario would be good for the stock market, since the resulting government would be less likely to enact legislation that will hamper stock performance.

Meanwhile, emerging markets (EMs) are playing an increasingly greater role in the global marketplace, and will soon account for about 50% of global economic output. The main concern here is that the political turmoil in some major EMs such as Turkey and Argentina could spread like wildfire to other EM countries. However, EMs are no longer a homogeneous group, and there are many such countries that have strong external finances and are thus well positioned to withstand the current EM crisis. Perhaps even more importantly, China – the elephant in the room among EMs – has enormous financial reserves and is still in the middle of its transition toward a consumer-oriented economy that will be less dependent on exports.

Impact by Asset Class

Liquidity / Fixed Income

As expected, the Fed decided to hike interest rates by another 25 basis points at its meeting on September 26, 2018, reaffirming that the strong US economy is very likely to warrant further gradual increases both this year and the next. Markets are now expecting another rate hike in December 2018. In this scenario, our conclusion remains that any bonds with a duration of more than two years are unattractive. Nevertheless, we have still invested some USD cash into two-year corporate bonds with an ‘A’ rating yielding above 3%, rather than just sitting on the cash. Other potential instruments remain Floating Rate Bonds and Treasury Inflation Protected Securities (TIPS).

In the eurozone, short-term rates are still in negative territory and one has to invest for 10 years or longer to receive 1% in the corporate sector, whereas the 10-year German government bond still only pays about 0.5%. We will keep such accounts for high cash positions and Floating Rate Notes, and will switch some cash into higher yielding USD bonds.

Equities

We continue to maintain our equity allocation at 46% for balanced accounts as we feel comfortable with this fairly conservative stance, taking into consideration the continued unattractiveness of other assets classes such as Fixed Income. The yield gap between equities and other asset classes remains close to historical wides. Although we agree that that is not necessarily an indication that equities in aggregate will continue to perform strongly, we acknowledge the argument regarding the lack of viable alternatives to equities, especially in Europe, where bond yields are still at all-time lows. At the same time, European equity valuations are becoming increasingly compelling. The EuroSTOXX 50 trades at a forward price-earnings ratio of 12.8x (the long-term average is 13.5x), whereas the S&P 500 is already trading at 20.9x, making European equities look like bargains in comparison.

While we anticipate that economic activity will remain strong well into 2019, and that equities should thus continue to perform well, the length of the current bull market and the numerous ongoing geopolitical uncertainties raise the question of how much longer the markets can continue to rise. We believe our equity portfolio is well structured to weather any possible financial storm, however, owing to the fact that in addition to some growth stocks, it also holds a significant portion of value stocks that should preserve their value better in the event of a potential downturn. These include stocks such as the pharmaceutical companies Novartis and Merck, the food and beverage manufacturer Nestle and the financial companies Citigroup and AXA.

Currency Impact

In the world of currencies, there is only one rule: *there are no rules*. The fact remains however that the US economy has not yet reached its peak in terms of its supremacy over other economies, which means that the USD should appreciate further, supported by widening interest rate differentials that will attract cash lying in accounts with zero or even negative interest rates in the eurozone, as well as by the trade tensions that have been contributing to the USD rally since April this year. This has of course been helped by the fact that the US economy is also delivering much better results than European economies, including those within the eurozone and the UK. It is difficult to imagine the USD not inching up even more, but then again, currencies can always move either way, and sometimes based on a mere headline.

Commodities continue to present a mixed picture in 2018. Gold is still disappointing as it has dropped by 7.58% during the first three quarters of 2018, despite financial market jitters and geopolitical tensions. It has been hovering around 1200 for the last few weeks and may even have found a bottom at that level. High interest rates, which are the archenemy of gold, are looming. Agriculture products present an even more mixed picture as wheat has risen sharply, while coffee and sugar are still falling.

Oil has been another story entirely, with Brent Crude rising by an unexpected 28.53% YTD 2018 due to strong demand, the Iran embargo, Venezuela's supply collapse and production restrictions in petro-nations such as Russia and Saudi Arabia. The oil markets remain under the spell of politics, and although demand is still strong, it could slow down somewhat as we approach the final phase of the current economic cycle.

DT Top 15

Our DT Top 15 stock portfolio rose by 7.42% in the third quarter of 2018, which brings its overall performance for the first nine months of 2018 to an encouraging 11.01%, following the increase of 30.86% in 2017 (all figures in USD terms). With this result, we have outperformed most major equity markets during the first three quarters of 2018, all of which had very different outcomes ranging from -0.15 % (Eurozone EuroSTOXX50) to +20.18% (NASDAQ 100). At the same time, we have also beaten our main benchmark, the MSCI World, which reached +5.89% (see above table). We do not wish to compare ourselves to the NASDAQ, however, as that index is based on only a few technology stocks. Nevertheless, by beating the world index by more then 5%, and the European Index by more than 10%, we have proven that our stock selection is meaningful and adds value to portfolios. With our solid mix of growth and value investments, we hope to continue to perform well once the current rally is over and markets shift sideways or even downward.

During the last quarter, we added the German e-commerce company Zalando to our portfolio. We already owned this stock last year and sold it in March 2018 with a profit of 19.6% at around EUR 47.8. After its recent earnings disappointment, the stock has fallen to around Euro 34. We believe the market has overreacted to that news, however, creating a good buying opportunity to re-enter this stock at a price of around EUR 34, which is already 40.5% below the price we sold it at. Meanwhile, we took profits in Allianz, the German life insurer, because we were concerned about its high exposure to sovereign debt in southern European countries such as Italy and Greece. Below is an overview of some of our holdings and latest additions:

Zalando (new addition, replacement for Allianz) – Zalando is the leading company in the fast-growing European online fashion retail market and has high brand recognition. It has a strong balance sheet and enjoys solid top-line growth backed by the overall growth of the online industry, but it is also still likely to gain in market share. The company, like many of its competitors, is barely profitable as management is prioritising growth over profitability, which in our view is the right strategy at this stage of the economic cycle. Its Q2 sales rose by 20.9% to EUR 1.3 billion, which was 3% below consensus and caused the stock to decline. Active customers stood at 24.6 million (+15.9% year on year), with average orders per customer of EUR 4.2 (+13.4%). Management maintained its 2018 outlook and still expects revenue to grow in the range of 20-25%, although now toward the lower half of that range. We believe Zalando's growth story will continue, albeit at a slightly slower pace, and are confident that the current correction created the right entry point.

Salesforce (up 56.37% YTD in 2018) – Salesforce is the only pure-play provider of cloud services, is the world's top Client Relationship Management (CRM) company, and has become the leading global enterprise in the cloud ecosystem. It supplies CRM services to businesses worldwide to build and run business applications, serving more than 60% of the Fortune 600 companies. The CRM market has continued growth potential due to the need to interact with customers through new channels such as online and social media. The company enjoys defensive and stable cash flows supported by its largely established customer base, generating recurring revenues. In Q2 2018, it managed to increase its revenue yet again, by 27% year on year, despite the high expectations required to beat consensus estimates. Given all this momentum and the positive outlook for cloud services, we believe the fairly high valuation for the stock and its demanding forward price-earnings ratio of 67.65 are justified. We agree with the analysts' average price target of USD 173.97, and 90.5% of them list the stock as a 'buy' recommendation. We will hold on to the stock for the time being regardless of its recent run, but may consider taking profits if it starts to overshoot too much.

Sony ADR (up 34.20% in USD terms YTD in 2018; ticker: SNE) – Sony has now reported smashing quarterly results three times in a row, each time beating the overall consensus, although not equally in all divisions. Last quarter, its operating profit rose by 24%, but its sales only rose by 5%. Those increases were mainly generated by the performance of its G&NS (Game and Network Services) segment, which we think will continue to provide sustained earnings growth into the future (owing to higher than anticipated Playstation4 sales and new game titles such as 'God of War'). We also see persistent growth in paid subscribers for its network business, and strong performance by its Music and Home Entertainment division, as there is currently a shift toward high-value added models in the television category where Sony is a clear leader. The main problem remains its mobile phone division, where sales have dropped by 27% year on year, mainly due to lower smartphone sales, and with no improvement currently in sight. Nevertheless, we believe that this technology and consumer goods giant will continue to deliver strong results due to its global brand recognition. Sony itself has once again raised its outlook for the coming quarters, and its valuation remains modest (with a forward P/E ratio of only 15.18), despite the recent price increase.

ABB (-0.4% since our purchase in June 2018) – ABB is a global leader in the fast-growing sector of power and automation technology, with a well-balanced global geographic presence and cash generating abilities that give it financial flexibility. Although 2017 was a self-declared transition year with a focus on cost savings and a reduction of business risks, growth should return in 2018 as the majority of its end-markets are picking up, which should lead to significant margin expansion. Q2 saw healthy growth in order intake of 8%, a revenue increase of 5%, and growth in operational EBIT of 12% (all figures year on year). Over the longer term, the company should profit from secular trends such as urbanisation, energy efficiency and clean energy requirements, and rapid industrialisation in emerging markets. The stock's valuation is moderate with a price-earnings ratio of 16.2 (2018E), a price-sales ratio of 1.29x, and an attractive dividend yield of 3.68%. Consequently, we anticipate further upside potential in this 'robotics' stock.

Microsoft (up 34.98% YTD 2018) – Although Microsoft enjoys a near monopoly in personal computer operating systems and office productivity software owing to its global distribution network, the company is also continuing to show increasing momentum with its cloud offerings (such as Office 365 and Azure), and is already well on track with its intended transition into a cloud-based software company. Its Intelligent Cloud division is already contributing 28.4% to overall sales. During the past quarter, its revenues increased by 17% year on year, once again ahead of consensus. More importantly, its Office 365 software registered revenue growth of 25%, and even its legacy business grew by 16% (personal computing revenues). Given these impressive numbers and its worldwide brand recognition, its forward price-earnings ratio of 26.9 seems high, but not excessively so. In addition, Microsoft has a strong balance sheet which it could use to acquire emerging trend leaders, and it could also utilise its strong gaming franchise to penetrate living rooms even further by cross-selling products.

Outlook

The US will continue to lead the momentum of global economic expansion, with strong growth well into 2019, and perhaps even beyond. Meanwhile, the eurozone will continue to expand, firmly above its potential. Despite these steady economic fundamentals, we should brace ourselves for possible short-term market volatility in the months ahead, caused in part by an escalation of trade disputes, tensions between the US and Iran, financial problems in Turkey, uncertainty in the Brexit process, Italian budget negotiations, and the US midterm elections. On the other hand, that kind of volatility also offers opportunities to enter the market. While the global economy will continue to do well, interest rates and inflation are expected to gradually increase beyond their current levels.

Equity markets remain the most attractive asset class in the current economic environment, as yields will only rise gradually from already low levels, and the impact on the real economy will only be felt after a time lag of nine to twelve months. We believe companies with high debt, negative earnings revisions and poor cash flow generation should be avoided, as such companies will struggle the most when rates continue to rise. The IT sector should be able to withstand rising yields, however, as it is the only sector with an aggregate net cash position. Within this sector, we prefer so-called GARP (growth at reasonable prices) stocks, with both Microsoft and Salesforce falling into this category.

In the fixed income segment, we anticipate that inflation-linked debt will be associated with higher yields, due to increased inflation expectations. As a result, we recommend TIPS. With regard to upcoming redemptions, we will buy instruments with maturities of less than two years, or variable rate instruments (FRN). Preferred stocks trading below their par value of USD 25 or CAD 25 are, following careful selection, another valid alternative.

Gold has disappointed so far in 2018, as it has faced headwinds from the interest rate cycle. Considering how bombed out sentiment currently is, however, a great deal of bad news seems to be priced in. Consequently, we will keep a small position as a safe haven in case of an overall market correction. Real estate funds also offer some inflation protection, but may suffer initially once interest rates start to rise.

"If you're not staying on top of your money, you are putting your financial well-being at risk."

— Suze Orman—

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