DYNAMIC TREE ASSET MANAGEMENT

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REVIEW & OUTLOOK Q4 2018

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THE DT 15 FINISHES DOWN FOR THE QUARTER

The DT Top 15 finished down in the fourth quarter by 14.74% in USD terms. In 2018, the strategy was down by 5.35% in USD terms.

So far a good start in 2019, the strategy is up by 5.66% (as at January 16, 2019).

During the past quarter, the markets were dominated by geopolitical events such as the US midterm elections, a looming no-deal on Brexit, tensions between Brussels and Italy over Italy's budget, and, last but not least, the US-China trade war saga. The outcome of the US midterm elections in November was by and large as expected, with the Democrats taking control of the House of Representatives and the Republicans increasing their majority in the Senate. The consequence of this is that it is now less likely that the Republicans will be able to extend fiscal stimulus in an attempt to please voters before the 2020 presidential elections.

President Trump's hostile approach to global trade played a major role in prolonging investor risk averseness throughout much of Q4, with the US-China trade war being at the centre of attention. The US believes Chinese laws undermine intellectual property rights by forcing foreign companies to engage in joint ventures with Chinese companies, which then gives the Chinese companies access and permission to use, improve, copy or steal their technologies. The US also raises concerns that China fails to recognize legitimate patents and copyrights, and discriminates against foreign imported technology, and that China has instituted numerous non-tariff barriers, which have insulated sectors of the Chinese economy from international competition. So far, the US has already slapped tariffs on USD 250 billion worth of Chinese products and has threatened tariffs on USD 267 billion more. Given the potential magnitude of this trade war with China, markets are nervous about the impact on growth outside of the US, but also the effects for growth in the US, as tariffs raise cost pressure for consumers and corporates. The tense situation relaxed somewhat on December 1 as President Trump and President Xi agreed to a temporary truce to de-escalate trade tensions following a working dinner at the G20 Summit in Buenos Aires. According to the agreement, both the US and China will refrain from increasing tariffs or imposing new tariffs for 90 days (until March 1, 2019), as the two sides work towards a larger trade deal. Although the meeting between President Xi and President Trump at the G20 at the end of the month showed some willingness to de-escalate the tensions, significant areas remain where it will be difficult to find common ground.

Brexit is another never-ending story. The UK is leaving the EU on March 29, 2019, either in an orderly fashion with a deal (which is what global markets are hoping for), or a disorderly one without a deal. Some progress was made as a withdrawal agreement was concluded between the UK and the European Union. However, it

seems a far cry from reaching a mutually beneficial agreement, as the withdrawal agreement still needs to be ratified by UK parliament, which is highly uncertain. On December 10, 2018, UK Prime Minister Theresa May cancelled the vote planned by UK parliament for the following day, admitting that she faced a heavy defeat. The vote is now planned for the week of January 14, 2019. It is highly doubtful that the deal as it stands now will pass the UK parliament and, as a result, uncertainty may continue to linger.

To the relief of global markets, Italy and the European Union reached a deal on Italy's budget on December 19, averting a long-expected crisis in the eurozone and allowing Europe's fourth largest economy to avoid sanctions from Brussels over its government budget for 2019. After weeks of back and forth, the two parties agreed to allow Italy to run a budget deficit of 2.04% in 2019. Italy had previously insisted on increasing its deficit to 2.4% of GBP, which risked breaking spending rules. As of January 8, 2019, the spread between Italian and German 10-year government bond yields stands at 268 basis points, having peaked in December 2018 at 327 bps.

Stock Markets

What an extraordinary end to the year it has been! As a turbulent December in equity markets came to a close, there's one thing traders and investors could agree on: these were not usual times, especially for that time of year. Christmas Eve saw a drop in the Dow Jones of 653 points, or 2.91%, triggered for the most part by Treasury Secretary Steven Mnuchin's efforts to calm the markets by communicating that he had spoken to the heads of major banks and that they had assured him there was ample liquidity for lending. However, Wall Street had generally not been feeling there was a shortage of liquidity. Given the very negative sentiment around Christmas time, it was completely bizarre that the Dow shot up 1,086 points on December 26, the largest increase by points on record, and another 260 points on December 27, staging a staggering 900-point intraday recovery. Extraordinary times indeed! Nevertheless, the Dow was down over 9 percent in December alone, marking the index's worst performance in the year's final month since 1931, when it dropped 17% in December of 1931).

Stock markets around the globe were clobbered during the fourth quarter. The US S&P500, for example, lost over 15% during Q4, while other global markets did not fare much better, as can be seen from the table below:

	Q4 2018 (%)	2018 YTD (%)
S&P 500	-15.01	-7.03
NASDAQ 100	-17.79	-1.74
Toronto TSX	-11.69	-12.26
Euro Stoxx 50	-13.90	-15.25
SMI Swiss Market Index	-7.64	-10.15
Japanese Nikkei 225	-17.45	-12.08
MSCI World	-14.50	-11.06

Source: Reuters

Europe was hit particularly hard during 2018. Whereas the Euro Stoxx 50 outperformed the S&P500 in 2017 in US terms, it finished 2018 with a severe underperformance.

2018 was also a terrible year for Chinese stocks. Chinese markets' 2018 performance was their worst in a decade since the year of the global financial crisis, when they collapsed by more than 65 percent. As shares on the mainland fell sharply, Hong Kong stocks performed slightly better. The Hang Seng index only fell by 13.61 percent in 2018. Two major factors rattled the Chinese markets for much of 2018: the trade war between Beijing and

"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.

Washington (as mentioned above), as well as the overall slowdown in China's economy following decades of strong growth. China's economy has also shown signs of weakness, with its manufacturing sector contracting for the first time in more than two years in December. The official manufacturing Purchasing Managers' Index (PMI) came in at 49.4. On that index, a value above 50 indicates expansion, whereas a value below 50 signals contraction. We will continue to follow market developments in China, and may take a position if and when we feel it is appropriate.

January started the same way as the old year had finished, with stocks being clobbered. On the first trading day in 2019, the Dow Jones Index lost 660 points, or 2.83%. Thereafter, a substantial recovery propelled the Dow up over 1,000 points as market participants placed bets that the Q4 shakeout was overdone and signs appeared that a trade deal between the US and China – one that is acceptable to both sides – may be possible after all. We believe the situation will remain volatile in the months to come but are cautiously optimistic that the worst is behind us. We are following the situation closely, and will take action when and where appropriate.

Oil prices were hit very hard in Q4 2018, with WTI losing USD 27.84/bbl., or 38%. The causes were fairly straightforward: oversupply and fears of lower future demand amidst an overall slowdown in global economic growth. To counter the price collapse, OPEC and its allies (including Russia) agreed to cut oil production by 1.2 million barrels per day for the first six months of 2019.

Gold, on the other hand, performed well in Q4, rallying 8.5% and providing much needed support to portfolios. The reasons for gold's outperformance during the quarter are easy to find: flight to safety coupled with signs that the FED may pause on its rate-hiking path.

DT Top 15

After gaining almost 31% in 2017, the DT Top 15 investment strategy had a great run during the first nine months of 2018 (+11%), after which it corrected sharply along with all major indices. In 2018, the strategy was down by 5.35%, but still significantly outperformed most major equity markets (all figures in USD terms). At the same time, we also surpassed our main benchmark, the MSCI World Total Return Index, which was down by 8.85% in 2018. The DT Top 15 outperformance was due to the fact that we were overweight in Technology and Healthcare in 2018, two of the best sectors in 2018 from a relative standpoint. It has been off to a good start in 2019 with the DT 15 advancing by 5.66% (as at January 16, 2019).

With our solid mix of growth and value investments, we hope to continue to perform well during the course of 2019 and beyond.

During Q4 2018, we made no changes to the composition of the DT Top 15. Below is an overview of some of our holdings:

Zalando – With its high brand recognition, Zalando is the leading company in the fast-growing European online fashion retail market. 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.

The stock was under heavy selling pressure in Q4 after Zalando had to reduce revenue guidance following a disappointing quarter. Making matters worse, in December Zalando got dragged down by a profit warning from one of its competitors in the UK. We continue to hold Zalando, as we believe recent weakness is only short term and that the company will return to above-average revenue growth. Moreover, the company is an attractive takeover target. A company wanting to enter the German market, such as Alibaba, could purchase Zalando. We initially bought the stock back in May 2017 at EUR 39 and sold it at about EUR 47 in January 2018. We bought Zalando back at the end of September at around EUR 34. This, in hindsight, was unfortunate timing. Shortly after our purchase, Zalando issued a profit warning and to make matters worse, global markets started their sell-off.

Novartis – Novartis AG (Novartis) engages in the research, development, manufacturing and marketing of a range of healthcare products including innovative medicines, eye care and generic drugs. The company operates under three main segments – Innovative Medicines, Alcon and Sandoz. We bought Novartis back in March 2017 at approximately CHF 75. In 2018, Novartis was more or less unchanged, significantly outperforming the Swiss Market Index (SMI), which lost 10% for the year. We like the defensive, non-cyclical growth nature of Novartis, which provides for stability in volatile times such as this. Also, Novartis has a strong and growing dividend and has further potential to optimise their product portfolio after the recently announced 100% spin-off of Alcon, their eye-care division).

Merck – Merck KGaA is a global pharmaceutical and chemicals company. The company researches drugs in oncology, as well as in the areas of neurodegenerative, autoimmune, and inflammatory diseases. It also markets cardiovascular, fertility, endocrinology and over-the-counter products, as well as products for flat screens and the pharmaceutical, food, cosmetics, packaging and coatings industries. Merck was one of the only companies in Germany that ended the year unscathed. Q3 sales rose to EUR 3.7 billion, 4% above market consensus, led by beats in all three divisions. Merck has a strong pipeline of drugs, with a number of drugs in phase II development, which bodes well for the medium term. Merck is also the largest supplier of liquid crystals, with flagship technologies, such as self-aligned vertical alignment (SA-VA) and organic light-emitting diodes (OLEDs), which are used in the manufacturing of liquid-crystal displays (LCDs). Demand growth for LCD and OLED displays should continue to benefit Merck in the future. We bought Merck in March 2018 at around EUR 78, just after they had announced disappointing numbers. We continue to hold the stock as we believe in its near to mid-term potential.

Salesforce – Salesforce.com is a pure-play provider of cloud services and offers software on demand. The company supplies customer relationship management services to businesses worldwide, as well as technology platforms for customers and developers to build and run business applications. Clients use salesforce.com to manage their customer, sales and operational data. We bought the stock back in 2016 at around USD 80 and continue to hold it as we expect the customer relationship management (CRM) market to continue to grow due to the need to interact with customers through different channels. During Q4, it delivered strong Q3 results and lifted full year guidance. We believe Salesforce will continue to be one of the best-positioned players to benefit from companies digitally transforming their businesses. With a P/E ratio of 69 times earnings in 2018, the company is by no means cheap. However, given its strong growth, we believe the high valuation is justified.

Sonova – Sonova provides hearing healthcare solutions. The company develops and manufactures hearing systems, such as wireless communication systems for audio applications and cochlear implant systems. Sonova also provides solutions for hearing protection. Sonova is greatly benefitting from the strong volume trends (aging population, emerging market growth) in the hearing aid market. We believe that this trend will continue and that Sonova, being a major player in this market, will benefit disproportionately in the years to come. We bought Sonova back in April 2017 at around CHF 144.90. The stock has done well since but we believe it offers further upside potential.

Outlook

Lower earnings growth, tighter financial conditions, US-China trade, and other geopolitical tensions make us slightly more cautious going into 2019. On the bright side, amid the market gloom, equity valuations have become more attractive and offer some solace. Global equities closed 2018 with a forward price/earnings ratio of 12.9 times earnings, in contrast to 16.3 times earnings at the end of 2017. Moreover, falling bond yields have improved the equity risk premium, which refers to the excess return that investment in the stock market provides over a quasi risk-free rate. This excess return compensates investors for taking on the relatively higher risk of equity investing. While valuations tend to offer little support in times of crisis, at least they point to the fact that current entry points could be attractive over the long term.

Global economic momentum is set to ease in the months ahead. Nevertheless, developed economies are still likely to grow at around potential growth rates. Despite the steep sell-off in 2018, we continue to remain invested in equities, as we believe a recession is unlikely in 2019 and the sell-off during Q4 2018 was overdone. With bond yields still extremely depressed, there is simply no alternative to equities. We will selectively pick investments that should do well under the current conditions. In particular, we will continue to hold a mix of growth stocks and value stocks.

In terms of our fixed income allocation, we remain invested in short term instruments as we still see no incentive to purchase longer term instruments, particularly given the inverted US yield curve. In the eurozone, bond yields continue to remain at very low levels. As a result, we only selectively invest in EUR-denominated fixed income securities. Now that the ECB is ending is quantitative easing program, yields could start to slowly rise over time.

We are also looking closely at commodities, as the latter stages of the economic cycle have historically been a good time to buy commodities. We also believe the recent collapse in the price of oil – which was triggered by higher US oil inventories, rapid supply growth, and worries about global demand – is overdone. As long as OPEC maintains production discipline, we are optimistic about the price of oil.

Gold has benefited from the market meltdown in 2018, rallying about USD 100, or approximately 8.5%, during Q4 2018. We continue to hold our gold allocation, as we believe gold should benefit from a potentially weaker USD, higher equity market volatility and, last but not least, signs that the US central bank is nearing the end of its rate hike cycle.

Contact Us

Dynamic Tree Asset Management
Speerstrasse 12a
8832 Wilen
Switzerland
+41 44 787 59 00
info@dynamictree.com
www.dynamictree.com

“The worse a situation becomes, the less it takes to turn it around, and the bigger the upside.”

— George Soros —

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