DYNAMIC TREE ASSET MANAGEMENT

REVIEW & OUTLOOK Q2 2017

AGENDA

ANOTHER STRONG QUARTER FOR OUR DT 15

The DT Top 15 had another very good run in the second quarter, advancing by +10.47% in USD terms.

Year-to-date the strategy is up +18.11% in USD terms.

The 8-year equity bull market continued its Q1 uptrend into Q2 2017, albeit at a slower pace. Surprisingly, the USD remained on the downward trend seen so far in 2017, even accelerating its fall. The US Fed raised interest rates as expected by 0.25%, but bond interest rates did not follow suit and remain low – even artificially low in Europe.

On the political front, the most significant events in Q2 were the elections in France and the UK. As opposed to the outcome in France – with a strong, new leader who is outwardly business friendly, which helped increase positive financial sentiment – the outcome in the UK came as a bit of a surprise to the markets and their stakeholders. The result may not help the UK in its upcoming Brexit negotiations with the EU, but for the global economy it is essentially a non-event on the whole , as the importance of the UK continues to decline in that respect. With both elections out of the way, however, a great deal of uncertainty has been removed from the table, and one immediate side-effect was the strengthening of the euro against the USD. European politics were a major source of distraction at the beginning of the year, and with only the upcoming German elections remaining, where most expect Chancellor Merkel to win again, Europe is no longer seen as a source of uncertainty. On the other hand, Donald Trump's position is still far from secure, and that does not help predictions concerning the effects of the much-awaited tax stimulus program on the markets.

The US Fed rate increase of 0.25 % in mid-June was expected, and thus did not surprise the markets. The wording that accompanied the decision was extremely defensive, however, and as a result, the markets no longer anticipate two more rate hikes this year as they did at the beginning of 2017 (only 41% of all market participants expect another hike before year-end, according to Bloomberg).

Nevertheless, economies around the world continue to deliver strong data and most leading indicators have accelerated. The European Central Bank (ECB) is starting to prepare the markets by informing the participants that the bond purchasing program will slowly be phased out after its expiry in December 2017. However, the ECB has not yet given any signals to eliminate their negative interest rate policy as core inflation, economic growth and wage dynamics remain too weak to take any further tightening measures.

Stock Markets

Equity markets delivered another strong quarter, albeit to a lesser extent than in Q1. Some markets hit new all-time highs (S&P 500, Dow Jones, MSCI World) or did so for the first time (the German DAX 30 beat its old high of April 2015). The following table shows equity index performance (in %) in local currency terms in Q2 2017, as well as 2017 overall to date (total return including dividends):

	Q2 2017	2017 YTD
S&P 500	+3.09%	+9.34%
Toronto TSX	-1.64%	+0.73%
Euro Stoxx 50	+0.34%	+7.32%
SMI Swiss Market Index	+4.49%	+11.79%
Japanese Nikkei 225	+5.95%	+5.78%
MSCI World	+4.19%	+11.01%

Source: Bloomberg

Unsurprisingly, the Canadian TSX has lagged behind other markets so far in 2017, as oil and commodity prices trade southbound.

We anticipate that commodity prices might be ready for a revival soon, but we also expect oil to continue trending sideways, spending more time in the high 40s than the low 50s, in part because growing output and stagnant demand for oil in the West are undermining the efforts of OPEC (and Russia) to restrict supply. European markets did not perform well in Q2 either (after a strong Q1), and Asian markets have started to outperform those in other regions.

The main driver behind US market growth was the technology sector, led by its big names (the so- called FAAMG stocks: Facebook, Amazon, Apple, Microsoft and Google), with the Nasdaq 100 rising by an astonishing 17.8% as of June 9, 2017.

On the same day, Goldman Sachs issued a report warning that the valuations in this sector are too high, while volatility remains too low. These five stocks account for almost 55% of Nasdaq's YTD performance! Since then, the Nasdaq has been trending down, but still finished the first half of 2017 with a 14.1% surplus.

Economics & Politics

With the start of 2017 was being characterized by more politically-driven markets overall, the focus should now return to economics. In developed markets, the combination of reasonable growth and negative (inflation-adjusted) real interest rates is supporting financial markets. The world economy is still experiencing a cyclical upturn and almost all leading indicators have again reached new highs. Taken together, these observations suggest that the global economy should keep improving in 2017, and perhaps even well into 2018. In the US in particular, the labour market is at close to full employment.

The inflation threat is not over, but appears to have been delayed once again. The global economy is expanding at a decent rate, with growth in most countries having returned to the long-term average. Although recent inflation readings are still extremely moderate, this does not mean price pressure will not be felt. The latest setbacks in consumer prices are not a sign of stagnation (or even deflation), as there is other evidence of rising inflation rates elsewhere. The reaction of central banks to inflation will be watched closely. The ECB will more than likely continue to talk about the normalisation of monetary policy in the near future, without actually taking steps to implement it. Consequently, it is unlikely the ECB will raise interest rates in 2017. Compared to Europe, the business cycle in the US is more advanced, and as a result,

"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 Fed is in a different position. However, even in the US inflation is expected to slow to 1.2% toward the end of the year.

Political developments in Europe were a big worry at the beginning of the year. Now that the most troubling elections are over, however, one could easily argue that the markets have been the real winners. After all, the outcomes were business friendly in France and neutral in the UK, and most people still expect Chancellor Merkel to be re-elected in Germany. More importantly for the markets, however, the uncertainty felt at the beginning of the year has now all but disappeared. Although the position of Donald Trump remains somewhat unstable, much of the original heat directed his way has since cooled down, and as mentioned above, the markets are waiting to see the effects of his corporate tax relief program.

In Asia, the Chinese economy continues to show signs of stabilization and Chinese economic policies are counterbalancing the country's structural weaknesses. After a four-year waiting period, the decision finally came down this June to include the A shares of the Chinese domestic stock markets in the MSCI Emerging Market Index in two steps. The move is seen by many as a further indication of the strength and future potential of China. The country's predicted economic growth of 6.5% for 2017 is lower than in the past, but is still an impressive figure.

Impact by Asset Class

Liquidity

With long-term interest rates being as unattractive as they are, we continue to hold a relatively high cash allocation in order to safeguard portfolios from expected losses in bond markets in 2017 and for the years to come. In portfolios denominated in USD, we have slowly started to buy USD short-term bonds and have reduced our cash levels accordingly. For EUR and CHF mandates, we will consider adding an interest rate hedge if and when European interest rates start to rise, which we no longer expect to happen in 2017.

Fixed Income

The fixed income investment realm is perhaps one of the most unattractive asset classes seen in decades in many currencies, as there is almost zero reward to the upside and significant potential bond losses ahead should interest rates start to rise. In October 2016, we added the Proshares Short 20+ Year Treasury to our positions to hedge against rising yields in the US. While 10-year positions were yielding 2.39% at the end of Q1 2017, they were back down to 2.30% by the end of June 2017. Therefore, the trend for higher long-term interest rates start to rise. Our solution under this scenario is to buy only short–term bonds, bonds with an inflation hedge, or a certain percentage of high-yield bonds with short duration.

As expected, the ECB decided to leave all interest rates unchanged at its meeting on June 8. However, it slightly changed the wording of its forward guidance and reduced its readiness to cut rates further. It also raised its growth forecast, but at the same time lowered its inflation expectations.

Equities

Positive sentiment has been a key factor behind the strong performance seen in most equity markets in 2017, and in the US there is still optimism about pro-growth reforms coming from Washington. Stronger than expected economic growth has boosted sentiment even further, and the Q1 earnings season reports in April 2017 came in with most companies showing solid results. Therefore, the recent performance of the stock markets is not only the result of euphoria but is based on stronger growth data both from the overall economy and individual companies.

Given our positive view on equity markets, we have decided to increase our equity weighting in balanced portfolios from 44% to 46%. With Asian markets lagging behind the US markets in recent years, we consider them to have more upside potential at the present time, in addition to the fact that most Asian economies are enjoying faster economic growth. Consequently, we have increased our position in iShares MSCI ASIA ex-Japan from 2% to 4%. The Asian market is extremely diversified – with legal restrictions or barriers in certain markets and multiple currencies involved – meaning that a regional, USD-denominated ETF is a suitable solution to allow investors to participate in the growth of Emerging Asia.

Currency Impact

During the second quarter of 2017, the USD softened against the euro, which gained 6.74 % (-7.93% in 2017), as well as against the Swiss franc, which gained 4.46 % (-6.00 % in 2017). The decline of the USD came as a bit of surprise both to us and the markets, particularly with regard to the size and magnitude of the move. The fall was in stark contrast to predictions made earlier this year of a strong USD, which seemed to lose some momentum after the Trump rally. Relative economic momentum shifted from the U.S. to the global economy as some of the political uncertainties in Europe were eliminated.

However, we expect the US dollar to strengthen again during the second half of 2017 as it receives support from rising interest rate differentials for the time being. Although the ECB may increase the negative deposit rate in the not too distant future, ECB action in this regard remains largely in the realm of speculation, and as a result, we do not anticipate a further uptrend for the euro in 2017.

The USD also fell against the CAD by 3.7% in 2017, despite the weakness in the oil price. Although the Canadian economy is showing some strong results, the expected trend in oil prices will limit its upside potential.

DT Top 15

The DT Top 15 continued its excellent performance in 2017 by advancing 10.47% in Q2, and 18.11% in 2017 YTD, both in USD terms. With this result, we have outperformed most equity markets in 2017, and also have beaten our main benchmark, the MSCI World (+11.01%). It must be noted, however, that part of the strong performance is currency related, as 11 out of 15 stocks are not denominated in USD, and the US dollar lost 8.22% versus the euro, and 6.38% versus the Swiss franc. Another reason for the positive performance was that 11 of 15 stocks were winners, and the four losers were down only slightly.

During the last quarter, we added two mid-cap growth stocks to our portfolio, which are in the attractive, fast-growing markets of online fashion and medical equipment – Zalando (Germany) and Sonova (Switzerland), more details of which are provided below. Furthermore, we bought shares of US-bank Citigroup, which offers good value in our opinion as it is still undervalued and is a main player in the banking industry. We currently anticipate a comeback in the US banking industry after many years of lagging behind the markets.

In addition, we sold shares of car manufacturers Renault and GM and accepted the public offer of the Chinese suitor for the shares of Syngenta. With these moves, we shifted the DT15 portfolio more into growth stocks, although we still believe that the overall portfolio contains a balanced mixture of growth and value stocks.

Following is an overview of some of our current holdings and latest additions:

Sonova: This Swiss medical equipment company is one of the world's leading hearing healthcare companies, providing solutions such as wireless communications systems for audio applications, cochlear implant systems, as well as hearing protection. Boasting a dominant market position, Sonova is supported by its strong brand image and new retail channels. The aging population in the developed world, paired with ever-increasing noise pollution and low penetration rates, make the company well positioned for long-term growth. For fiscal year 2017, Sonova's management projects sales growth between 10% and 12% year on year, and EBITA growth between 10% and 14% year on year. After trading sideways for two years, the stock started trading upwards again this year (up 25.6% in 2017), and we expect the uptrend to continue over the long term.

Zalando: This German retail company is currently leading the European online fashion industry, with products including clothing, shoes and accessories. It has a strong balance sheet, with a steep cash pile for strategic acquisitions in markets such as Italy or Spain. In recent years, it has enjoyed solid top-line growth, as well as market share gains in its core markets (Germany, Austria, etc). For 2017, Zalando's management expects revenue growth of between 20% and 25% year on year. As with other online companies, its valuation is not cheap with a forward price/earnings ratio of 73. However, its price/ sales ratio of 2.7 is well below that of Amazon's 3.2. With current analyst consensus at around 61.5% buy, we anticipate large upside growth in the online shopping market, and are confident in the ability of Zalando's management to capitalize on the potential of this exciting industry.

Citigroup: In anticipation of a comeback for bank stocks, we bought Citigroup shares in June. While the bank is no longer the powerhouse it was 10 years ago, it is still a dominant player in the banking industry. It offers global diversification, with growth opportunities in emerging markets reducing the impact of sluggish loan growth in the US. Receiving a 62% consensus buy rating, and backed by strong fundamentals, we feel that Citigroup offers good value. With a price/book ratio of 0.73x and a price/ earnings ratio of 11.2, it is currently trading at a discount to its peers. Its dividend yield of 1% leaves room for increases, and following our purchase, on June 28 the FED gave its blessing for the quarterly dividend to be doubled to USD 0.32, as well as for a share buyback program totaling USD 15.6 billion. Since the announcement came in, the stock has been trending upwards.

Novartis: Novartis is one of Switzerland's two pharmaceutical giants (the other being Roche), and is the world's second largest company in the field of oncology (the branch of medicine dealing with the prevention, diagnosis and treatment of cancer). It is also a dominant manufacturer of prescription drugs to regulate blood pressure, and in late June it announced the release of a new drug (ACZ885), which will assist the prevention of heart disease. We expect these developments to generate significant revenues for the company going forward. Given its pipeline of products, its price/earnings ratio of 17.5 (forward P/E), and its price/sales ratio of 3.8, the valuation is not stretched. The stock was trading sideways in 2016 but is now back on a long-term uptrend trajectory. As a result of its defensive earnings growth and its ability to generate cash, we view Novartis as a strong, long-term buy.

Salesforce.com: Salesforce.com, which we bought late in 2016, is a pureplay provider of cloud services and offers software on demand, supplying customer relationship management (CRM) services to businesses worldwide and technology platforms for customers and developers to build and run business applications. Salesforce.com enjoys defensive and stable cash flows supported by a large existing customer base, healthy order backlog, and recurring revenues. It has shown impressive sales growth in the past, and for 2018 the company's management predicts growth of 22-23% year on year. With an 89.6% consensus buy rating, and a consensus target price of 102.71 (up 19.3% from the current price), we see great potential for this company operating in a high-growth industry.

Outlook

As we predicted, equities continued to rally in Q2 2017, and we believe that stocks will continue to perform well throughout 2017. Market friendly political developments as well as strong earnings growth and economic developments both support the case for investing in equities.

However, as US economic expansion reached the eight-year mark in June (making it the third longest expansion in US history), the question remains as to how much longer the expansion can last, and how and when it will stop (incidentally, the expansion began three months after the the stock market hit its low point). For the time being, we consider that the chances that the expansion will continue to be greater than the risk of a major correction, and expect the S&P 500 Index to rise to the 2500-2600 level, which will in turn be followed by most other stock markets globally.

All in all, we remain invested in equities, with a 46% allocation in Balanced Portfolios. We will use any weakness to further add to our equity exposure, with a focus on either Europe or Asia.

Fixed income investments remain in a difficult situation and the key issue is not to lose any money while offering some degree of capital preservation. We remain underweight in this asset class. We keep a short duration, and with upcoming redemptions are only buying papers with maturities of two years or less. We will hold on to our positions in Treasury Inflation Protected Securities (TIPS), as well as some ETFs with High-Yield Bonds, and will keep our position in the Short 20+ Year Treasury as a hedge against rate increases.

In times of high equity markets and low interest rates, alternative investments are an attractive asset class for diversification reasons. We will hold on to our Gold position, but might add an industrial / agriculture commodity investment (without an overly heavy exposure to oil). We continue to like real estate and will hold on to existing positions, which have done well so far in 2017 and also serve as a hedge against inflation.

We remain optimistic for the remainder of 2017, and expect our portfolios to continue to perform well. As always, however, we will remain on the lookout and make necessary adjustments to our portfolios, if warranted.

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"The stock market is a device for transfering money from the impatient to the patient."
— Warren Buffet —

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