DYNAMIC TREE ASSET MANAGEMENT

REVIEW & OUTLOOK Q1 2018

AGENDA

ANOTHER SOLID QUARTER FOR OUR DT 15

The DT Top 15 had a good start in the first quarter, advancing by +0.39% in USD terms.

With this result, we have beaten the MSCI World and most markets

Investors had a rough ride during the first quarter of 2018, and the record breaking markets seen in the past few years now seem like a thing of the past. The key question now is whether the current setback is already the end of the big equity bull market or only a temporary correction to be followed by new record highs in due course. What is fairly certain, however, is that the low volatility seen in 2017 is gone for the time being, as on the one hand global economies are still expanding rapidly, while on the other hand markets are no longer ignoring bad news like they have in the past. Furthermore, positive surprises seem less likely as the overall environment – at least in terms of inflation expectations and monetary policies – becomes less predictable.

And there has been plenty of bad news for the markets to digest. The trend reversal started as early as February, with the US job report showing wage increases on a level not seen for years. That was quickly followed by interest rates reaching new highs and even surpassing the 3% mark at the long end (30-year treasury). During the last few weeks, the headlines have been dominated by the US administration's protectionist trade policy, and the potential for retaliatory measures by China and other countries. If a full-on trade war were to develop, it could be very damaging for international trade, economies and equity markets. Although that scenario is not priced into stock markets and is unlikely to happen, the current situation still has the markets a little nervous.

Other factors that led to increased market volatility were various unrelated negative news items involving technology stocks – the markets' leading sector – such as the regulatory crackdown on Facebook, the uncertainty around Tesla's future, and Trump's accusations against Amazon and their uncertain consequences, to name only a few. With the leadership of tech stocks being called into question, the equity markets seem to have lost their direction.

As was widely anticipated, the US Federal reserve (FED) hiked the Fed funds target range to between 1.5% and 1.75% in March 2018, while at the same time delivering a more upbeat forecast for the US economy. It also signalled that it plans to continue gradually increasing interest rates, indicating that two more hikes are possible before the end of this year.

Stock Markets

Most equity markets reached their peak on January 26, 2018, which was also a new all-time high in most cases (S&P 500: 2872). Since then, all markets have fallen to different extents, with all losing more than 10% from their highest value. The steepest daily decline was recorded on February 5, when the Dow Jones lost more than 800 points, or 4.6%, ending a record-breaking 310 days without a correction of more than 3%, and rising by 29% during the same period. The immediate reason for that market correction was a strong US payroll report showing that US job growth had surged and wages had increased by 2.9% (annual average hourly earnings growth), which was the fastest growth rate seen since 2009. Shortly after that report was released, the US treasury 10-year note also rose to 2.88%, the highest rate seen in four years. The following table shows the Q1 2018 performance of equity indexes in local currency terms (total return including dividends):

	Q1 2018 (%)	2018 YTD (%)
S&P 500	-0.76	-0.76
Toronto TSX	-4.52	-4.52
Euro Stoxx 50	-3.71	-3.71
SMI Swiss Market Index	-5.55	-5.55
Japanese Nikkei 225	-6.36	-6.36
MSCI World	- 1.21	- 1.21

Source: Bloomberg

Most markets fell in Q1 2018, the notable exception being the NASDAQ 100 Index, which managed – despite all the noise – to climb another 3.15% during the past quarter. The MSCI World Index lost only a modest 1.21%, one reason for which being that the Asian and some other emerging market indexes outperformed more developed economies, the best-performing index being the Brazilian IBOVESPA Index, which managed to climb by 11.73% in local terms (BRL). Europe and Switzerland did not perform well in Q1 in local currency terms. However, if one includes the appreciation of the euro into the calculation, the EURO-STOXX 50 was only down by 1.55% in USD terms (instead of 3.71%), and was thus almost in line with the MSCI World. Canada's Toronto TSX Comp Index was weak in CAD terms (see above table) and even worse in USD terms, where it lost 7.29% in Q1 2018.

Looking ahead into 2018, we expect volatility to remain high, and feel that strong global earnings growth, in connection with positive earnings revisions, is promising. As a result, we will remain invested in equities, and even view the current correction as a potential entry point. The upcoming earnings season will reveal how individual companies perform and will provide further guidance.

Economics & Politics

The global economic backdrop is expected to remain solid as most leading indicators point to a continuation of the positive economic momentum already seen. There will be some divergences, however. The US is likely to continue its economic extension thanks to supportive fiscal policies. The eurozone has also experienced strong growth momentum, but more recent data has been somewhat disappointing. Momentum in emerging Asian economies has also increased, while Latin America has continued its recovery, which is particularly reflected in its strong stock markets (e.g. Brazil).

The quantitative easing measures introduced by central banks are now past their peak, as the low inflation environment seems to have finished, putting pressure on

"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.

central banks to tighten their monetary policies. The FED was to first to do so in 2017, hiking its target range to between 1.5% and 1.75%, as anticipated, and will likely introduce further increases in 2018. The European Central Bank is tapering asset purchases, but no rate hike is expected there as of yet.

During Q1 2018, there were no elections or other votes of global significance like in 2017, when politics and the new US administration dominated the headlines. The only electoral event of significance was the elections in Italy on March 4, with some noise made by one party about Italy possibly leaving the eurozone, but global markets quickly went on to other news. Other headlines in Q1 involved the Olympic Games in South Korea, and the unexpected behaviour of the North Korean regime there, as it showed some signs that it might actually be ready to talk rather than launch nuclear missiles, which had been a looming negative scenario for some time, and a headache for world politics and the financial markets.

In the UK, a 21-month transition period is due to come into effect after its official exit from the EU at the end of March 2019. Only after this period will the effects of Brexit really start to hit home. This has pushed changes to the trade regime into 2021, creating some continuity and fewer Brexit-related headwinds for the moment. The inflation data for February shows that the pound-related surge in inflation is fading. Rising wage growth might justify the Bank of England's continued hints at a rate hike in May this year.

Impact by Asset Class

Liquidity / Fixed Income

At Jerome Powell's first FOMC meeting as Federal Reserve (FED) Chairman on March 21, 2018, Fed officials increased the Fed funds target rate by a quarter of a point, as was widely anticipated. Furthermore, the 2018 GDP forecast was revised upward from 2.5% to 2.7%, and with a solid outlook for the US economy, we expect three further rate hikes this year. Growth in the eurozone economy is starting to pick up, and the European Central Bank (ECB) is reducing its monthly asset purchases. Nevertheless, we believe the ECB is still not ready to adjust interest rate levels. The Swiss National Bank also continues to adopt a hands-off approach, and is sticking to its negative CHF Libor target of -0.75%.

Under the current scenario, buying any EUR or CHF denominated bonds remains an unattractive prospect, although we have started to buy some USD denominated bonds with maturities shorter than two years yielding between 2.5% and 3%, as well as preferred stocks from major banks yielding 5-6% and not trading much higher than $25. We are also buying CAD preferred shares with a fix-to-floating rate structure, and a price below CAD 25, from solid entities like banks, insurers or utilities.

Equities

The first quarter of 2018 proved to be more rewarding than most investors had hoped. After an especially strong start to the year, rate fears triggered a flash crash in equity markets and once they had recovered somewhat, fears of a global trade war kicked in. Surprisingly enough, those fears were much more prominent in headlines and the minds of investors than in the markets themselves. This was also in contrast to 2016 and 2017, which were heavily influenced by the US elections, causing policy uncertainty to skyrocket.

We have maintained our equity allocation of 46% for balanced accounts, as we feel comfortable with this fairly conservative stance and intend to keep it for the time being. To better participate in long-term trends, we have created a new investment category called Future Trends Exposure, for which we seek to identify companies or ETFs with a competitive advantage in structurally-growing markets. As of now, we have included in this category the ETF Global Robotics & Automation (ticker symbol: ROBO), which invests in the rapidly growing robotics and automation industry (up 1.21% in Q1 2018), and the Cyber Security ETF (ticker Symbol: HACK), which rose by 8.31% in Q1 2018 and invests in companies that are either classified as cyber security infrastructure providers or cyber security service providers. Others possible candidates for this category include the Lithium & Battery Tech ETF (ticker symbol: LIT), which invests in listed companies active in the exploration and mining of lithium, and the production of lithium batteries.

Currency Impact

During Q1 2018, the USD continued its downward trend, weakening against the euro by another 2.4%, which equates to an overall loss against the euro of 17.2% since the beginning of 2017. That downtrend is not in line with the stock markets, however, as US markets continue to outperform European markets, owing to the stronger US economy. Into the future, we expect support for the USD to increase over the short term as the interest rate advantage gains momentum. US labour market data suggests that wage pressure is building, making higher inflation the next inevitable step. The Fed raised interest rates in March, and is set to do so again already on June 13, 2018 (according to Bloomberg, with a 78.36% consensus estimate), with one or even two more hikes to follow during the remainder of 2018. Over the longer term, however, the outlook for the USD appears rather negative as the trade and budget deficits continue to rise, resulting in a twin deficit. The proposed tax cuts and higher military spending will almost certainly increase the budget deficit, and whether the US government's new trading rules can manage to decrease the trade deficit without hurting the US economy still remains to be seen.

The CAD lost 2.6% to the USD in Q1, after the clear uptrend seen in 2017. The underlying reason for that decrease was the threat of a trade war with the US, and its potentially negative impact on the Canadian raw materials industry. The situation has cooled down somewhat in the meantime, however, and based on the recovery of the CAD seen since its low of 1.3125 on March 19, 2018, we feel it might even resume its 2017 uptrend.

Gold was disappointing in Q1 2018, as it did not manage to take advantage of the equity market flash crash and continue its strong performance of 2017, when it increased by 13.5% (helped by the weak USD) and climbed for the second year in a row, recovering from its five-year decline beginning in 2011. Its current underperformance is yet another sign that gold can no longer be regarded as a valid hedge against falling markets.

DT Top 15

Our DT Top 15 stock portfolio had a relatively solid start into 2018, advancing by 0.39% in Q1, after increasing by 30.86% overall in 2017 (both figures in USD terms). With this result, we have managed to outperform all major equity markets in Q1 2018, which were down between 0.76% and 6.36% (see table in page 2), and at the same time, have also beaten our main benchmark, the MSCI World, which fell by 1.21%. It is very encouraging that we managed to outperform the markets not only during the bull market and uptrend situations seen in 2017, but also that our portfolio is still doing well, and, thanks to our sound mix of growth and value stocks, held its value during the bear market seen during the first three months of 2018.

During the past quarter, we added the German pharmaceutical and chemical company Merck KGAA to our gain of 19.6%. With this move, we have reduced the overall volatility of our portfolio by switching from a growth stock to a value stock, thereby reducing risk.

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

Merck KGAA (new addition) – In February, we bought shares in this German pharmaceutical and chemical company, which operates mainly in the field of oncology (cancer treatment) and autoimmune and inflammatory diseases. It has a strong pipeline of drugs in the second phase of development, which in our view is currently underappreciated by the market. The company is also the world's largest supplier of liquid crystals, with flagship technology such as organic light-emitting diodes (OLED), which are used in the manufacture of liquid-crystal displays (for LCDs, mobile phones, etc.). The stock has had a mediocre performance during the last two years and, as a result, is not as highly valued as some its peers. However, with its fair valuation we feel that it offers real value considering its growth potential. Its price/earnings ratio of 13.3 is moderate, and the average analyst target price of EUR 106 is 37% above the current purchase price. The company is not related to the US company Merck, despite having the same name.

Swatch (up 6.04% in Q1 2018) – The Swiss watch and jewellery manufacturer owns various brands in different price segments including high-end brands like Omega, Breguet and Blancpain, and lower-price names like Swatch and Tissot. It produces its mechanical and quartz components in-house, and is a supplier of watch parts to most other firms in the industry. Swatch will continue to profit from the growth seen in the global luxury market, driven by the rising disposable income of middle-income households in Asia and Latin America. Its 2017 results were better then expected, with EBIT up by 24.5%, and sales up by 6%. It was also able to improve its operating margins, and the company has reported a good start into the current year in all segments. All of the above positive figures make Swatch one of the few Swiss stocks to have performed positively so far in 2018.

Sony ADR (up 7.54% in USD terms in Q1 2018; ticker: SNE) – Since we bought this stock a few months ago, Sony has twice reported impressive quarterly results. Last quarter, its operating profit nearly quadrupled, buoyed by gains from the sale of equipment. Even on an adjusted basis, it grew by 67% year on year. Its main drivers remain the PlayStation (PS4), persistent growth in paid subscribers, and the strong performance of its Music and Home Entertainment division, as the trend in the television category is currently shifting toward high added value models, where Sony is a world leader. The main problem remains its mobile phone division, in which sales have dropped by 13% year on year, particularly due to lower smartphone sales, with no improvement in sight. Nevertheless, we believe that this technology and consumer goods giant, with its strong global brand recognition, will continue to deliver strong results. The company itself has raised its outlook for the upcoming quarters, and with a forward price/earnings ratio of only 15.5, its valuation remains modest.

Salesforce (up 13.76% in Q1 2018) – Salesforce is the world's top client relationship management (CRM) company, and has become the leading global cloud ecosystem enterprise. It is also one of the few pure-play providers of cloud services. 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 is expected to see continued growth due to the increasing need to interact with customers through new channels such as online and social media. The company enjoys defensive, stable cash flows, supported by its largely established customer base and recurring revenues. Given all this momentum and the positive outlook for cloud services, we believe the fairly high valuation for the stock (including a forward price/earnings ratio of 59.8) is justified. We agree with the assessment of analysts, who have set an average price target of USD 138.15, and 90.7% of whom list the stock as a 'buy' recommendation. Consequently, we will keep the stock for the time being, regardless of its recent run.

Microsoft (up 7.19% in Q1 2018) – Since we bought this stock in March last year, it has risen by more than 40%, and we will continue to hold on to it as we think it has even more upside potential. While Microsoft enjoys a near monopoly in personal computer operating systems and office productivity software with its global distribution network, the company is also showing strong momentum in its cloud offerings (such as Office 365 and Azure), and is well on track with its transition into a cloud-based software company. During the last quarter, its revenues increased by 12% 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 2% (personal computing revenues). 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 by cross-selling products.

Outlook

Leading indicators point to ongoing strong global growth, which is set to continue for the remainder of 2018 in the US, Japan and Europe, with the United States taking the lead. At the same time, the expectations for a cooling of the Chinese economy have been shifted into the second half of 2018. With economies expanding at the rate they have the last few months, current cyclical enthusiasm has set the bar for expectations high. As a result, the risk of negative surprises has been increasing, as has been reflected in recent equity market jitters. Nevertheless, the economic uptrend will continue to support earnings growth and balance sheet quality over the coming months.

Conditions in the US are ripe for inflation to pick up at any point. The exact timing and extent are uncertain, however, as both are difficult to predict. A sudden rise in inflation would put the gradual, expected monetary policy normalization of 2017 at stake, as we expect three more rate hikes to be introduced in the US during the remainder of the year in order to address these risks.

Equities as an asset class remain attractive owing to accelerated earnings growth and positive revisions in connection with economic growth. Furthermore, equities are an inflation hedge, and in the past they have performed well when inflation increased within a range of 1% to 3%. Historically, inflation only becomes challenging for equities when it rises above 3% over an extended period, which is still far from happening.

Fixed income remains an unrewarding category, particularly outside of the USD, and we remain cautious and underweight in that area. We are keeping durations short, and following upcoming redemptions will only buy instruments with maturities not exceeding two years, or variable rate instruments. Preferred stocks are also a valid alternative to some extent.

Strong global growth underpins commodities, especially in the later stages of an economic cycle. Amid the geopolitical uncertainties in the Middle East and elsewhere, oil has climbed to levels not seen for years, and, in line with crowded trades by hedge funds and expectations from Saudi Arabia, we anticipate further price rises. We will keep our gold position for the time being, but are ready to sell it if the current trend does not continue to accelerate upwards.

In summary, for 2018 we expect markets to remain volatile but to be higher at year-end than they are today, with the next recession only looming towards 2019. We will maintain our conservative stance regarding asset allocation for the time being, and will be on the lookout for more corrections.

“It‘s not how right or how wrong you are that matters but how much $ you make when right and how much you do not lose when wrong“

— George Soros —

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