DYNAMIC TREE ASSET MANAGEMENT

# MARKET REVIEW & OUTLOOK Q1 2021



**A STRONG USD HAD A NEGATIVE IMPACT ON Q1 PERFORMANCE FOR OUR DT 15**

The DT Top 15 underperformed in Q1 2021 due to a strong USD. The DT Top 15 advanced by +2.41% in USD terms (+5.80% as of April 8, 2021).

Two topics dominated the market during the first quarter of the year: 1) sharply rising bond yields, especially the 10-year US Treasury bond yield, and 2) a stock market rally that was primarily led by value stocks, with the much-loved stay-at-home stocks not doing so well during the quarter. The triggers for the rally in the market were in part the Democratic victory in Georgia earlier this year, which led to hope of massive additional stimulus in the US, as well as the success of the vaccine rollout, particularly in the US. With over 30% of Americans now having received at least one dose of vaccine and the number of people being hospitalised due to COVID-19 now much lower than at the start of the year, the continued rally in equity markets seems justified, as investors look ahead to a hopefully sustainable reopening of economies. The common theme driving markets now is a rising optimism about the outlook for global growth.

The US dollar staged a strong comeback in the first quarter of 2021 after having fallen continually since March 2020. The comeback was mainly based on the idea that accelerating US economic growth and inflation could force the Fed to abandon its pledge to keep interest rates near zero until 2024. Up until March 31, the USD gained about 4% against the euro and about 6.6% against the Swiss franc. Along with the USD, and due to its status as a commodities currency, the CAD rallied sharply during Q1 2021. It rose 1.5% against the USD and a whopping 8% against the CHF. The strength of the USD and CAD is the main reason that our mandates that have either currency as a reference currency underperformed during Q1 2021. Nevertheless, we believe that the strength of the US dollar is temporary and that it will resume its gradual downtrend again soon.

The US Federal Reserve plays a very important role for markets. If it raises interest rates too quickly, economic recovery is put in jeopardy. If it does nothing, it could allow new asset market bubbles to occur, with significant potential consequences if they burst. On April 7, the Federal Open Market Committee (FOMC) released the minutes from its March 16-17 meeting as investors looked for indications about where policy may be heading in the future. The meeting summary indicated that while officials saw the economy gaining substantially, they see much more progress being needed before ultra-easy policy changes can take place. At the meeting, the Fed's policy making arm voted to keep short-term borrowing rates anchored near zero, and to continue buying at least USD 120 billion in bonds each month. Officials also indicated that the unemployment rate could fall to 4.5% by the end of the year and inflation could run to 2.2%, slightly above the Fed's traditional 2% target. Although the word 'inflation' shows up 64 times in the minutes, Fed officials seemed to show little concern that it might become a problem anytime soon. One entry in the minutes even said that inflation forecasts were right around where FOMC members expected them to be. The recovery outlook for the job markets has also brightened, according to the Fed. Despite the upgrade, officials did not move to raise interest rates, however. In addition, most members expect to keep borrowing costs near zero until after 2023. This is another bullish sign for risky assets, as the economy grows sharply and short-term rates will stay low for an extended period of time, which is the right mix for potential further gains in equity markets. We expect rates to remain low for some time as central banks globally look to maintain support and see that economies return to more normal levels, and ultimately, to full recovery.

In Europe, the flash manufacturing purchasing manager's index (PMI) for March reached a record high of 62.4, signalling very strong growth. However, rising COVID-19 infection rates and new lockdown curbs in some countries cast doubt on the prospects for the services sector, in particular tourism.

## Stock Markets

Equity markets made further gains during the first three months of the year. In particular, cyclical stocks performed very well, while technology stocks did not fare so well during the quarter. The reason for this is that economic expectations are becoming increasingly brighter, coupled with rising interest rates, which has led to a sector rotation in favour of cyclically sensitive stocks such as banks and insurance companies. This trend is expected to continue during the second quarter. Against the background of ongoing vaccination campaigns and the continued extent of the monetary and fiscal policy support being provided by governments, a strong economic recovery should take place toward the end of the year.

Many of the sectors that did well during the height of the pandemic in 2020 are now showing less earnings momentum. Mega-cap technology stocks, long considered bastions of stability, also suffered as a result of the recent increase in interest rates. As large tech stocks are long duration equities in terms of their cash flow and growth prospects, they reap the greatest benefits from low interest rates and, in turn, have suffered the most as rates normalize upward.

European equities put in a strong performance in Q1 2021, although equities in Switzerland performed less well as its index is composed primarily of defensive names. Hopes of a global economic recovery supported sectors that fared poorly in 2020, such as energy and financials. Consumer discretionary stocks also performed well, with car manufacturers such as Volkswagen announcing ambitious electric vehicle targets. Underperformers were in defensive areas that are less tied to the overall economic recovery, such as utilities and real estate. The following table shows the performance of selected markets:

| World Indices | Price Change Q1 2021 |
|---|---|
| S&P 500 | +5.77% |
| NASDAQ 100 | +1.58% |
| TSX Composite | +7.27% |
| Euro STOXX 50 | +10.30% |
| Swiss Market Index | +3.21% |
| German DAX | +9.40% |
| Japanese Nikkei 225 | +6.30% |
| MSCI World Index | +4.50% |

*Source: Refinitiv (in local currency terms)*

*"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.

## DT Top 15

In Q1 2021, our DT Top 15 strategy was up by 2.41%, increasing to 5.80% as of April 8, 2021. The main reason for the underperformance in Q1 was the strong USD, which had a negative impact of approximately 3% on our strategy's performance. The USD gained 6.60% on the Swiss franc and 4% on the euro, and around two-thirds of the investments in our strategy are denominated in either EUR or CHF. Furthermore, our strategy also lagged behind the overall market somewhat in Q1 2021 due to the fact that we held a number of defensive stocks such as Nestlé, Roche, and McCormick, which, in light of the current 'risk on' sentiment, underperformed somewhat.

The top three performing stocks within our DT Top 15 strategy in Q1 2021 were: 1) AXA, advancing by 17.30%; 2) Royal Dutch Shell, up by 14.95%; and 3) LafargeHolcim, up by 13.67%. The three stocks with the worst performance during the quarter were: 1) Zalando, dropping 11.10%; 2) Alibaba, down by 2.60%; and 3) Roche, down by 1.34%.

During the first quarter, we sold both McCormick (at around USD 86.50) and Merck (at around EUR 134), and bought Bank of America (at around USD 38) and Volkswagen (at around EUR 190) instead.

**McCormick** – We sold McCormick on March 12 at around USD 86.50. We had originally added McCormick to our portfolios back in early September 2020 at around USD 103.50 (split adjusted). Although we do not consider McCormick to be a bad stock, we feel there is more upside in Bank of America at this point, as banks, and in particular US banks, are currently benefitting from higher US interest rates. Stay-at-home stocks like McCormick benefited from trends spurred by the COVID-19 pandemic. However, as progress in vaccine distribution leads to an encouraging decline in daily numbers of new cases, we are now questioning how sustainable the demand for McCormick's products will be as the pandemic slowly subsides. As such, we believe McCormick will be range-bound going forward, in an environment that may favour more cyclical stocks.

**Merck** – We also sold Merck on March 12, at a price of around EUR 134. We originally added Merck to our portfolios back in March 2018 at around EUR 78. As with McCormick, we do not think there is anything fundamentally wrong with the company. However, we decided to take the profit (as the stock was up by about 72% since we purchased it) and allocate the proceeds to a company we are very bullish on in the medium to long term: Volkswagen.

**Volkswagen** – Volkswagen AG is a German-based company that manufactures and sells vehicles. It operates through four segments: 1) passenger cars, covering the development of vehicles and engines, the production and sale of passenger cars, and the corresponding genuine parts business; 2) commercial vehicles, comprising the development, production and sale of light commercial vehicles, trucks and buses, as well as the corresponding genuine parts business and related services; 3) power engineering, consisting of the development and production of large-bore diesel engines, turbo compressors, industrial turbines and chemical reactor systems, as well as the production of gear units, propulsion components and testing systems; and 4) financial services, comprising dealer and customer financing, leasing, banking and insurance activities, fleet management and mobility

services. Its brand portfolio includes Volkswagen, Audi, SEAT, ŠKODA, Bentley, Bugatti, Lamborghini, Porsche, Ducati, Volkswagen Commercial Vehicles, Scania, and MAN.

We bought shares in Volkswagen on March 12 at a price of around EUR 190, just prior to the release of the Group's quarterly earnings figures, which were very positive. The recent announcement concerning its electric vehicle (EV) plans for the future confirms our view that Volkswagen is one of the most favourably positioned car manufacturers for the transition to EVs. Volkswagen plans to launch 75 new EV models by 2030, and to invest EUR 40 billion in EV technology. Furthermore, Volkswagen plans to have six battery cell factories up and running in Europe by 2030 with a production capacity of 240 gigawatt hours, which should allow for annual production of approximately four million EVs, transforming Volkswagen into a leading battery manufacturer. Its current status as the largest car manufacturer in terms of global unit sales, coupled with its determination to become one of the world's dominant EV players (having already developed the most advanced dedicated EV platform among incumbent car manufacturers), bodes very well for Volkswagen's share price. If the market were to apply multiples similar to those of Tesla and Nio Inc. to Volkswagen's electric vehicle business, it would be worth some EUR 195 billion. The current market cap for Volkswagen's entire business stands at EUR 140 billion, meaning that its production of 10 million combustion engine cars effectively comes for free. As a result, we see significant upside potential for Volkswagen shares in the time to come.

**Bank of America -** Bank of America is one of the world's largest financial institutions, offering a full range of financial services and products across banking, capital markets, asset management and risk management. It operates through the consumer banking, global wealth and investment management, global banking, global markets, and legacy assets and servicing segments. Bank of America is headquartered in Charlotte, North Carolina.

We bought Bank of America on March 12 at a price of around USD 38. Bank of America has a dominant share of the retail deposits and wealth management business in the United States. It has a well-balanced revenue base across multiple business segments: with US Consumer Bank representing 36% of its 2020 segmental earnings, Global Markets 29%, Global Banking 19%, and Wealth Management 17%. Banks have been out of favour for a considerable amount of time, and we believe they have some catching up to do. In addition, higher interest rates tend to benefit banks as their margins tend to improve. We expect bond yields to rise from record low levels and macroeconomic momentum to accelerate as soon as the fears surrounding COVID-19 start to fade. The financial sector is usually the best performing sector in periods of rising yields and accelerating macroeconomic momentum. As such, banks will benefit from a reflating global economy that increases demand for loans and pushes interest rates higher, boosting the profits on lending. Bank of America, with its well-diversified revenue base across multiple business segments, its global footprint, and its dominant share in the retail deposit market and wealth management business, is well positioned to benefit from a continuing shift towards financials.

**AXA -** Based in France, AXA is the world's largest insurer in commercial lines, and one of the largest global insurers in health and protection. It mainly operates through three segments: Property and Casualty, Life and Savings, and Health, along with minor operations in Asset Management and Banking Services. AXA has strong presence in Europe, the US, and Asia. After completing the acquisition of XL Group in September 2018, its profile changed fundamentally, moving from a capital market dependent, life-centric Europe/emerging markets/US player to a globally leading property and casualty commercial insurer with a moderate exposure to life business.

AXA was the best performing stock among our DT Top 15 in Q1. We added AXA to our portfolio in March 2015 at around EUR 23.50. As of the end of March 2021, AXA was trading at EUR 22, close to where we initially purchased the stock. However, we have already collected significant dividends during the time we have held it. AXA is a dividend play, currently yielding a robust 6%. Its risk profile has improved significantly since the deconsolidation of its US business, AXA Equitable, and the benefits of the XL Group acquisition still remain to be seen. AXA's disciplined pricing and focus on higher-margin markets in life insurance, as well as its re-pricing efforts in non-life insurance, should continue to support earnings growth, which should create room for an increased dividend going forward. AXA's revenues were resilient in 2020, down just 1% compared to the previous year, reflecting the relevance of their strategic choices and business mix. Furthermore, AXA's solvency II ratio as of December 31, 2020 was 200%, up 20 points from September 2020, which is a very positive development.

AXA shares hit a low of EUR 11.84 during the height of the pandemic (March 19, 2020), and have almost doubled since. AXA, along with many other financial services firms, is benefiting from higher interest rates, a trend that we think may continue and provide further support for the share price going forward. We like the attractive dividend yield of 6% and will stick with the stock for the time being.

**Tudor Gold -** Tudor Gold Corp. is a Canada-based gold and base metals exploration company. The Company has properties in British Columbia's Golden Triangle, with its key project being the Treaty Creek Project. The first mineralized zone at Treaty Creek to have a maiden resource is the Goldstorm Zone. It contains 19.4 million ounces at 0.74 g/t gold equivalent Measured and Indicated, and 7.9 million ounces at 0.79 g/t gold equivalent Inferred, making it one of the largest gold deposits discovered in the last decade. Critical factors with metal deposits are not only their size, but also their shape, consistency, and depth. The richest mineralization at Goldstorm is located in the close to surface '300 Zone'. The deposit is also contiguous and remarkably consistent. All of these factors create the potential for Goldstorm to be an open pit operation, which is the least expensive route both in terms of capital expenditure and operating expenses, with the added advantage of being able to mine the highest grade gold first.

Tudor Gold is not currently a part of our DT Top 15 Investment Strategy. However, we added Tudor Gold to most mandates back in in July 2020 at around CAD 2.50. Currently trading at around CAD 3.10, Tudor Gold recently came out with their initial resource estimate for their flagship Treaty Creak project in British Columbia, and the results are nothing less than stunning: 27.3 million ounces gold equivalent Discovery, with the system's edges remaining to be discovered and its depth also appearing open in certain spots. In addition, there are other massive gold systems at Treaty Creek, some of which will be drilled later this year and are thus not included in this initial resource. This is already a world-class deposit and we expect it to grow significantly larger during the 2021 drilling season.

We expect there to be significant interest from larger gold mining companies needing to replenish their reserves, and consequently think Tudor Gold will eventually be taken over. We could easily see a double or triple in price compared to today's share price (if not more), as long as the price of gold does not collapse. As such, we are holding onto the stock with conviction.

## Market Outlook

Rising long-term bond yields have been a concern for equity investors over the course of the last few months, partly because increased bond yields will make other asset classes more attractive in comparison to equities. Moreover, higher bond yields can impact the stock market negatively as they may signal tighter monetary policy and lower growth expectations for companies. This may in turn lead to a stagnation or lowering of company profits, which can mean depressed share prices and lower dividends. According to UBS, however, rising nominal yields and equity rallies tend to go hand in hand. In the past 25 years, there have been 10 periods in which the US 10-year bond yield has risen by more than 100 bps. In all cases, global equities delivered flat or positive returns. Furthermore, the current rise in yields is being driven more by a stronger growth outlook than by concerns over monetary policy tightening.

We believe that long-term bond yields may have further room to rise as economic growth continues to gain momentum. Therefore, we intend to stick to our strategy of holding a very low fixed income component in our portfolios, as fixed income securities decrease as interest rates rise. If interest rates rise further, we may look at adding more fixed income to portfolios again, but for now, we prefer to have the flexibility that cash offers.

As for equities, we believe the market has further room to run although we admit that valuations are becoming elevated. Markets are priced for positive vaccine news, and while we believe the good news will continue on the vaccine front, any future disappointments regarding vaccine supply, distribution or adoption, or increased risk from new virus variants, could stoke volatility or trigger a market correction. As a result, central banks around the globe will continue to prop up markets with 'cheap' money, supporting risky assets.


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*"An important key to investing is to remember that stocks are not lottery tickets"*

— Peter Lynch —

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