DYNAMIC TREE ASSET MANAGEMENT

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REVIEW & OUTLOOK Q4 2017

Driven by the most synchronised global growth upturn since 2010, and spear-headed by a robust US economy, 2017 was a record year for equity markets. Even Europe managed to deliver major revisions in growth expectations, while steady growth rates were seen in China and other emerging markets.

Politics took centre stage at the start of the year as the uncertain outcome of pending elections in the UK, France, Germany and other countries loomed over the markets. In France, for example, it was considered a real possibility that Marine Le Pen's right-wing party would win the election – with unknown consequences for France, the rest of Europe and all related economies. When it was not election hype, it was Trump with his outspoken unpredictability as markets were forced to get used to his tweets. And when it was not Trump, it was political tension in Asia, including prolonged controversy surrounding North Korea. Woven into all these uncertainties was a general sense of apocalyptic bleakness. The contrast with what was happening in the markets could not have been starker, however, as risky assets continued their up-swing into new record highs.

As always, a lot went wrong in 2017 too. To assess what influenced investors most, one need only look at the 'most-read' articles from the newswires. The ten most-read news stories in 2017 involved news out of the White House, terrorist attacks, and natural catastrophes, while the political tensions in Asia did not even make the list. Pinpointing what went right is not that difficult. One thing for sure was the economy. The global economy expanded with a breadth and depth not seen in a long time, and corporate earnings followed suit. Other things that went right were election outcomes in Europe, the political transition in China, and last but not least, the monetary policy of central banks, in particular the US Federal Reserve (FED). Of course 'going right' in this context means what was beneficial to the financial markets, and is in no way meant as a political statement. On the whole, 2017 began full of question marks, and in the end, almost everything went right – for the markets at least.

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EXCELLENT PERFORMANCE IN 2017 FOR OUR DT 15

The DT Top 15 had a good run in the fourth quarter, advancing by +3.4% in USD terms.
For 2017, the strategy is up +29.81% (gross of fees) in USD terms, beating the MSCI World

Stock Markets

With the notable exception of Europe, equity markets enjoyed another strong quarter, extending their already powerful performance in 2017. Most markets once again reached new all-time highs (S&P 500, Dow Jones, MSCI World) and in Q4, even Toronto's TSX60 broke into unknown territory. The following table shows the Q4 2017 and the overall 2017 performance of equity indexes in local currency terms (total return including dividends):

	Q4 2017 (%)	2017 YTD (%)
S&P 500	+5.99	21.82
Toronto TSX	+4.41	9.08
Euro Stoxx 50	-2.21	9.95
SMI Swiss Market Index	+2.45	17.88
Japanese Nikkei 225	+10.56	21.29
MSCI World	+5.62	23.09

Source: Bloomberg

The strongest market in the forth quarter by far was the Japanese Nikkei 225 Index, while the S&P 500 as well as the MSCI World continued their steady and almost linear advance by climbing another 5%. In 2017 as a whole, the MSCI World Index beat most major country indexes, one reason for which being that the Asian and some other emerging market indexes outperformed more developed markets. Europe lagged behind in local currency terms in 2017. If we include the appreciation of the euro in performance calculations, however, the EUROSTOXX 50 was up 25.32% in USD terms, making an investment in Europe one of the better bets in 2017.

Looking ahead into 2018, we expect the recent outperformance of European and Asian stock markets in USD terms to continue to some extent. In terms of earnings growth, eurozone companies are still lagging behind their US peers and thus have more catch-up potential, while in terms of valuation, the eurozone offers better value with cheaper price/earnings ratios. Asian equities should profit from the higher growth rates generated by many Asian economies in comparison to more developed countries.

Economics & Politics

The US tax bill was finally passed in December 2017. By itself, the anticipation of this move served as a stimulus to the US stock market during most of the year, which was one of many reasons for its record-breaking development. As often happens, on the day the bill was finally passed, the markets even closed down somewhat according to the old trading rule: 'Buy the rumour, sell the fact.' In the end, however, the tax reform turned out to be not nearly as radical as the original tax proposed by the Republicans in the House of the Representatives. Nevertheless, it is still primarily business friendly. Another area where the new US administration is making changes that could have long-term positive consequences for the economy is the reversal of regulations and/or cutbacks at numerous government agencies. Furthermore, market-orientated individuals are being put in charge of decision making in various political positions. All of these developments are bullish for US markets, and especially at a time when the European financial services industry is being engulfed by the 1.5 million paragraphs contained in MIFID II.

The main events in Europe in Q4 2017 were the coalition negotiations in Germany, where no mainstream party seems to be eager to form a government with Angela Merkel, and the Catalonian regional elections. Q1 2018 will see elections in Italy in March, while there is surprisingly

"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.

still no working government in Germany, the final terms of Brexit are still pending, and the situation in Catalonia is far from being solved. Other worldwide hotspots of 2017 – such as Syria, North Korea, Qatar, and Iran – will most probably remain in the headlines in 2018, perhaps to a different degree of magnitude although their economic impact is not always as high as the amount of media attention they receive.

Another new phenomenon which emerged significantly in 2017 was cryptocurrency, with the Chicago Mercantile Exchange (CME) starting to trade Bitcoin futures in December. Like most people, we understand that blockchain technology is potentially ground-breaking and is an area worth investing in. The risk now is that the speculative fever surrounding Bitcoin trading, amidst growing evidence of retail participation for pure speculation only, could cause a dramatic sell-off at any point in time, which, temporarily at least, would blow up the whole blockchain ecosystem. One obvious trigger for such a bust would be regulatory intervention similar to that in the financial industry, and any such intervention may very likely be introduced in many countries to varying degrees in the near future. As an example of such measures, in early 2018 South Korea ordered a ban on opening anonymous cryptocurrency accounts and new legislation to allow regulators to close virtual currency exchanges if necessary. Bitcoin and other Cryptocurrencies fell sharply after the announcement.

Impact by Asset Class

Liquidity / Fixed Income

Heading into 2018, we are holding a relatively high cash position to protect portfolios from potential losses in bond markets, as bond prices are poised to fall once interest rates start to raise. Fixed income remains one of the most unattractive asset classes for the time being, as there is almost zero reward to the upside while bond yields are trending higher on a global scale, reflecting the longevity of the expansion and the diminishing support from the easy money that goes along with it. The argument in favour of permanently low or negative real bond yields is losing support, as employment is increasing and productivity rates are rebounding. The flattening of the US yield curve remains a point of interest for 2018, as more US Federal Reserve rate hikes may cause short-term yields to rise, while muted inflation will prevent long-term rates from moving up. Our approach in this scenario is to buy only floating rate notes, very short–term bonds with maturities not exceeding three years, bonds with an inflation hedge, or a certain percentage of high-yield bonds, but again only of short duration.

Equities

A look at the past 12 months offers valuable lessons for the current year. The main surprise in 2017 was the breadth of the global economic upturn, including Europe, China and other emerging markets – which was a stark contrast to the bleak developments of 2016. Earnings growth, rather than

politics, has been the major driver for financial markets over the last few months. Technical analysis also confirms a structural bull market for equities.

We have had a positive view on equity markets throughout the year, as stated in our three latest quarterly reviews, and consequently increased our equity weighting in balanced portfolios from 44% to 46% in 2017. Our latest addition – the ETF Global Robotics & Automation (ticker symbol: ROBO) – has been a success so far, rising by 17.9% (as of January 16, 2018) since we purchased it four months ago. We continue to like this ETF, which invests in the rapidly growing robotics and automation industry. Another of our core holdings, the Cyber Security ETF (ticker Symbol: HACK), rose by 19.68 % in 2017. As we saw the highest growth potential in Asia, we increased our existing position in the iShares MSCI ASIA ex-Japan from 2% to 4% (the index went up 41.22 % in 2017 in USD terms), and in 2018 we may well add another ETF in the Asian marketplace.

Currency Impact

During the fourth quarter of 2017, the USD continued to weaken against the euro by losing another 1.6%, resulting in a decline of 14.15% over the entire year. The downtrend of the USD does not correspond with the stock markets, however, as US markets clearly outperformed other markets, capitalizing on the stronger American economy in comparison to Europe. Into the future, however, we anticipate increasing support for the USD, as the interest rate advantage gains momentum. Indications from the US labour market show that wage pressure is slowly building, making higher inflation the next inevitable step. The Fed will raise rates again as soon as March 21, 2018 (according to a 76% consensus estimate from Bloomberg), with more hikes to follow in due course. The question only remains whether long-term rates will join the upward trend, and will be a key issue into the future.

The CAD lost 0.8% to the USD in Q4, but advanced by 6.9% in 2017 overall. The so-called commodity currencies (CAD, AUD and RUB) are in high demand at the moment, as economic growth in those countries is solid and broadly based, and is driving up commodity and energy prices. In the beginning of 2018, the CAD resumed its 2017 uptrend and is likely to go even higher.

Helped by the weak USD, gold managed to increase by 13.5% in 2017, climbing for the second year in a row and recovering somewhat from the five-year decline it experienced after peaking during the summer of 2011 (at $1921 on June 9, 2011). We believe gold could advance well above 1400 in 2018, but will subsequently resume its secular downtrend as interest rates – the archnemesis of gold – move higher.

DT Top 15

Our DT Top 15 continued its excellent performance in 2017, advancing by 3.40% in Q4, which equated to an overall increase of 29.81% (gross) in 2017 (both figures in USD terms). With this result, we outperformed all major equity markets in 2017, and simultaneously also surpassed our main benchmark, the MSCI World, which increased by 23.07% overall in 2017.

During the last quarter, we added the Swiss cement producer LafargeHolcim to our portfolio, the reasoning for which is outlined below. We also sold Dufry, because the situation surrounding its major Chinese stockholder, HNA Group, became unclear and too risky.

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

LafargeHolcim – (new addition) – In December 2017, we bought shares in this French/Swiss conglomerate, which was created as a result of the merger of Lafarge and Holcim. The leading global supplier of cement and aggregates, LafargeHolcim operates in 90 countries, and has a strong presence in emerging, high-growth markets. We expect the merger to result in a significant reduction in capital expenditure, as the new entity goes into consolidation mode. Its strong balance sheet and high cash flows will also allow higher shareholder returns. Infrastructure expenditures around the globe are expected to increase over the coming years, which the company

should be able to capitalize on. The valuation is moderate compared with the overall market and some of its competitors, with a forward price/earnings ratio of 14.61, a price/sales ratio of only 1.24x, and a price/book ratio of 1.05, all of which leave enough room for stock appreciation.

Royal Dutch Shell (up 14.21% in euro, and 30.18% in USD in 2017, both including dividends) – Shell is a globally leading, integrated oil company, both upstream and downstream, and is also involved in natural gas, chemicals and power generation. By cutting operating expenses, it has positioned itself according to a lower-for-longer oil price environment, with a base scenario of around USD 62 per barrel Brent. The company has entered a harvesting phase after years of exploration investment and the large acquisition of BG (British Gas). It should also profit from global growth in demand for LNG (liquefied natural gas), particularly in emerging markets. The valuation is not demanding, with a forward price/earnings ratio of 15.49, a price/sales of only 0.90x, and trading at around book value. One more reason we keep the stock despite its recent run – resulting from the rise in oil prices – is the high dividend yield of 5.94%.

Salesforce (up 49.32% in 2017) – The company has a leadership position, as it is one of the few pure-play providers of cloud services offering software on demand. It supplies customer relationship management (CRM) services to businesses worldwide to assist with the building and running of business applications. Its serves more than 60% of the Fortune 600 companies. The CRM market has continued growth potential due to the ever-increasing need to interact with customers through new channels like online and social media. The company enjoys defensive, stable cash flows supported by its largely-established customer base, which generates recurring revenues. Given all this momentum and the positive outlook for cloud services, we feel the fairly high valuation for the stock (including a forward price/earnings ratio of 63.3) is justified. We agree with the analysts, who have on average allocated a price target of USD 121.7, and 88% of whom list the stock as a buy recommendation. Consequently, we will hold on to the stock for the time being, despite its run of 49.32% last year.

Zalando (up 13.1% in 2017 since purchase in May 2017) – This company leads the European online fashion retail market, and sells over 1500 brands, including clothing, shoes and accessories. It has a strong balance sheet with a high cash pile, and enjoys solid top-line growth on the back of continued market share gains. However, similar to its giant US rival, Amazon, it is barely profitable, as its management team continues to prioritize growth over profitability – which is the correct strategy, in our view. Furthermore, Zalando still has untapped potential in some leading European countries such as Italy, Spain, and the Benelux markets. As with all stocks in the online industry, its valuation is demanding if you only take into account the price/earnings ratio (59 forward), but including the sales figures (forward price/sales ratio of 1.85x), it is even below some of its competitors. All things considered, we continue to like this leading stock in the fast-growing online industry.

Sony ADR (up 13.9% in 2017 since purchase in September 2017) – Since we bought the stock a few months ago, Sony has reported smashing quarterly results for its latest quarter. Sales were up 22% year on year, beating the consensus estimates by more than 10%, with growth across most segments. The main driver was gaming consoles (up 35%), spearheaded by an increase in PlayStation 4 (PS4) sales. Software, and the home entertainment and sound sales divisions were additional strongholds, as there is a shift towards high-value added models in the television segment, where Sony is also a market leader. The only threat that remains is the smartphone division, which continues to lose market share with no improvement in sight. Taken as a whole, however, we believe that this technology and consumer goods giant, with its global brand recognition, will continue to deliver strong results, which is mirrored by the fact that Sony itself has raised its outlook for the coming quarters.

Outlook

Global economic growth is set to continue, and an imminent easing off of the growth dynamic is not yet in sight. However, developed economies are in a mature stage of the upswing. The gradual recovery of emerging economies – particularly in Asia – is likely to continue. Interestingly in this context, inflationary pressures have remained tame, given that the economy is running close to full capacity. Against this background, the US Federal Reserve is expected to stick to its gradually-tightening monetary policy, and the European Central Bank (ECB) will start tapering its asset purchases from January 2018 onwards, as announced at the end of October 2017. Meanwhile, the Bank of Japan (BoJ) has not yet signalled an end to keeping its 10-year government bond yields at 0%, meaning they will continue to print money! Neither the ECB nor the BoJ are expected to hike rates anytime soon.

In view of the above, corporate earnings are expected to remain strong, supported in the US by the tax stimulus decided in December 2017. **All of these facts mean that equities continue to be the asset class of choice.** Although we are currently in a rather late stage of the bull market, this phase has often emerged as the strongest, and valuations are still in line with long-term averages.

For equities, the start of 2018 was a continuation of the 2017 run. The S&P 500 managed to rise during the first five days of the year, which is usually a bullish sign for the remainder of the year. Furthermore, the consensus S&P 500 target for 2018 is only 6% higher than the current price, which is historically a low figure, and shows that investor sentiment is not too bullish and that markets might continue climbing their wall of worry.

With regard to fixed income, we remain cautious and underweight. We are keeping durations short, and with upcoming redemptions will only buy papers with maturities of three years at the most, and/or variable-rate instruments. Due to lagging inflation, the normalization of monetary policies will largely depend on the US Federal Reserve, which will likely increase rates twice during 2018.

If political risks or growth concerns materialise, then gold could continue to appreciate in 2018 given its safe-haven status. We will therefore hold on to our gold position for now.

Overall for 2018, we expect markets to rise further, but any increase may be interrupted by a correction of unknown magnitude, which is already overdue. In any case, we only see the next recession looming toward 2019 at the earliest. For the time being, we will continue to adhere to the wise words of Denis Waitley: "Expect the best, plan for the worst, and prepare to be surprised."

"Put not your trust in money, but put your money in trust"
— Oliver Wendall Holmes Jr. —

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