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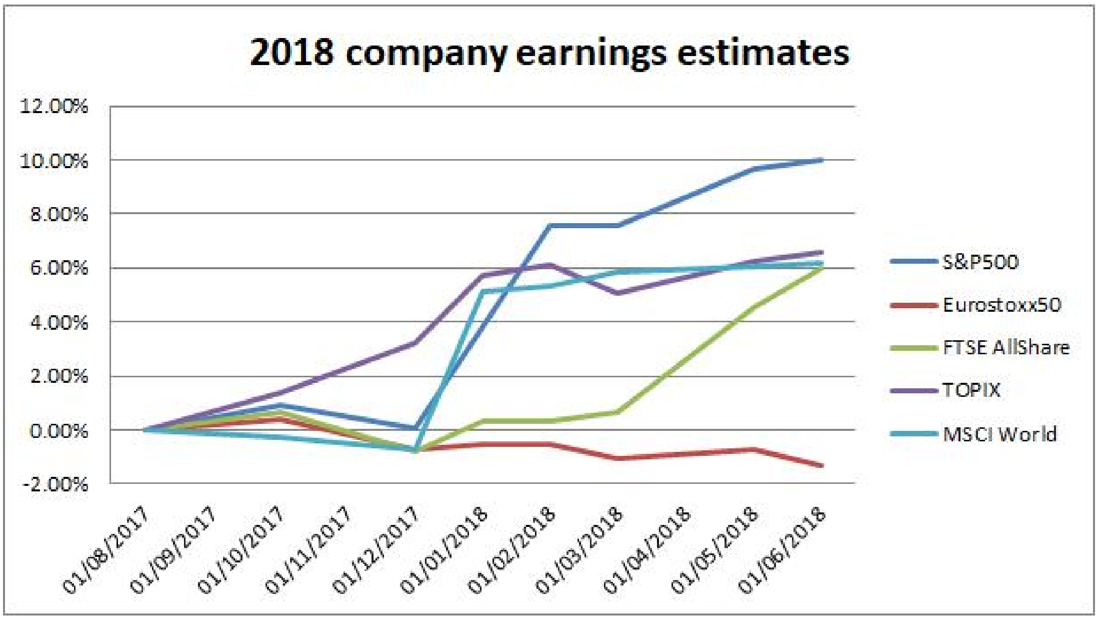
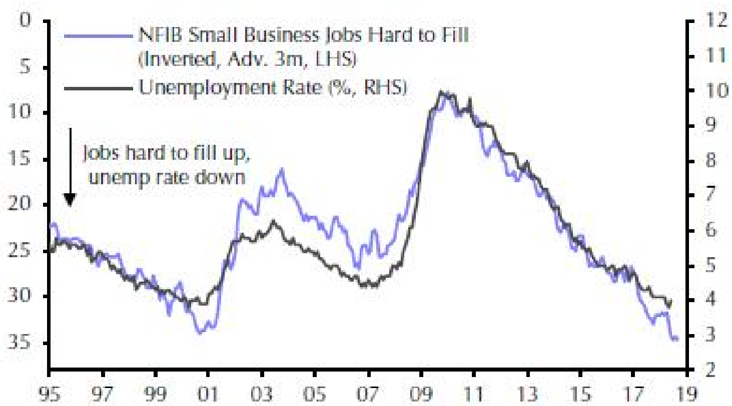
Manager's Report
For the Quarter to 30 June 2018

Markets continued to be quite volatile in the second quarter as positive economic data competed with increasingly hawkish rhetoric on global trade.
The global economy continues firing on most cylinders, with the US economy in the lead. Revisions to corporate earnings estimates have been mainly positive, as per the chart below:



Source: Bloomberg

Stock markets have only made very modest gains so far this year so valuations are quite reasonable. The one region where earnings estimates have been scaled down slightly, on relatively disappointing economic data, is the eurozone. But leading indicators for the eurozone point to a likely revival of relative growth in the second half of the year. The US economy is going from strength to strength; the recent tax cuts have extended the economic cycle by perhaps another year (the effects of the tax cuts were quite front loaded and are expected to start petering out in 2020). The US jobs market is strong. Companies indicate that job openings are harder to fill with qualified staff, pointing to a pickup in wage growth which will further underpin consumer spending:



Source: Capital Economics

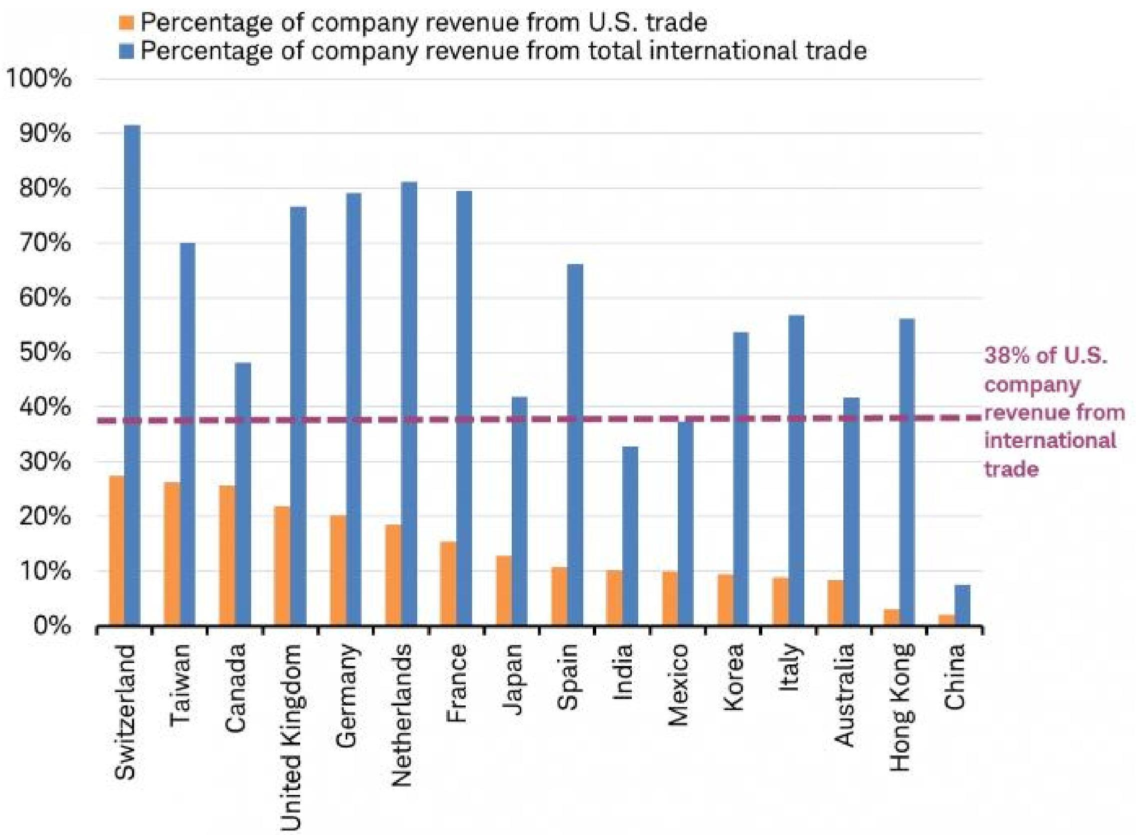
The positive US labor market and emerging wage pressures have pushed up US core CPI inflation to 2.3% year on year, which is likely to keep the Federal Reserve on its gentle upward path, delivering a quarter percent rate hike each quarter, so a further two hikes this year.
Global growth is picking up again after a mild (inventory driven) slowing from the blistering 2017 pace. GDP growth in the US will probably be 2.8% this year, 2.2% in the eurozone, 1.3% in the UK (which is better than was initially expected given the Brexit negotiations) and also in Japan, where the Bank of Japan will continue its QE program. Growth in emerging markets is expected to average 6% this year; the recent uncertainties around the imposition of trade tariffs have hit emerging market asset prices and currencies relatively hard though. All in all, global GDP looks set to grow by 3.3% in real terms this year, while a pick up in inflation will continue to gently lift interest rates.
Bond markets have underperformed equity markets year to date; now that US bond yields have risen we see some value in US corporate bonds but remain quite defensively positioned in fixed income portfolios and overweight relatively short durations.

How do we see the economic cycle evolving, and how are we positioning portfolios in the maturing cycle?
The current economic, and market, upswing has been one of the longest recoveries on record as it has taken a long time, and highly unorthodox monetary policy, to recover from the "great recession" caused by the 2008 financial crisis. The cycle has been led by the US economy, where growth (and finally inflation) have been the first to recover. Due to the dominance of the US stock market globally (US stocks comprise over 50% of the MSCI All World index and there has never been a serious correction in the US market that did not effect global markets) we track US fundamentals closely through our twin "market peak" and "recession risk" monitors. Each monitor contains a number of well-defined key indicators that have historically signaled major market peaks and the advent of a recession. Next to these specific monitors we also track a large number of global "risk sentiment" and "market liquidity" indicators. Our decision in January this year to move from an overweight to a 5% underweight allocation to global equities was based mainly on "risk sentiment" indicators having reached overly bullish levels. This move proved to be quite timely as stock markets corrected strongly in February and March. Global risk sentiment has since normalized, even turned slightly negative – usually a positive contrarian indicator. Meanwhile most liquidity indicators remain positive, though less abundant than in 2017, when all major central banks were still pursuing QE. The majority of our "market peak" and "recession risk" monitors continue to give the green light to maintaining stock market exposure at current levels. What could change this?

One of the most dependable leading indicators of a change in the US business cycle is the shape of the US yield curve. When the US yield curve becomes "inverted", specifically, when the 2 year treasury bond yield rises above the 10 year T bond yield, a recession invariably follows. All the US recessions and bear markets after the second World War (11 in total) were preceded by a clear inversion of the yield curve, which happened an average 12.9 months before the stock market peak, so giving ample warning. Also, in all recessions (except the 1973 recession, which was caused by a sudden oil price shock) monetary policy played a decisive causal role, with the Federal Reserve continuing to tighten monetary policy to combat inflation while the economy was already slowing down. This is in fact what causes the yield curve inversion: short term rates reflect the (expected) actions of the Fed while the 10 year yield already moves lower as the ever forward looking "market" expects an economic slowdown, and lower rates on the back of that. We attach an appendix which gives a brief overview of US recessions, and bear markets, since WW2, along with yield curve inversions. Presently the US yield curve has flattened quite a bit, with the 10 year rate at 2.858% and the 2 year rate at 2.598% - a difference of only 0.26%. But no inversion. Clearly this is an indicator we monitor very closely; a persistent inversion will trigger us to further decrease equity risk.

The flattening of the yield curve is likely partly caused by worries that increasingly hawkish rhetoric around trade tariffs could damage the global economic recovery.
Large investment houses and market strategists are quite divided on the risks of an actual trade war. Some see the rhetoric as the US president's "art of the deal" type negotiating tactics, meant to achieve some concessions which can then be shown as a victory ahead of mid-term elections, and unlikely to lead to a full blown "trade war" with damaging consequences for all.
Others point to the real money consequences of an increase in tariffs, which, when calculated as an additional "tax", are actually not that large. A back of the envelope calculation shows that the 25% tariffs on USD 50 bn of Chinese imports already announced amounts to an extra "tax" on US consumers (and businesses) of USD 12.5 billion. An additional 10% tariff which could be raised on USD 200 bn of Chinese imports (as recently put on the review list by the White House, to be decided by the end of August) would amount to another USD 20 billion – so USD 32.5 billion in total, which will be partly offset by the recent weakness in the Chinese currency and possible expenditure switching. USD 32.5 billion comes to only 0.19% of US GDP, and is minor compared to the estimated USD 170 billion positive impact of last year's tax cuts on the US economy.

Of course there are other factors in play that complicate the picture beyond these simple calculations. Global supply chains are intricately connected with many goods passing multiple borders multiple times as components are sourced from and assembled in different countries. New tariffs and uncertainty around trade barriers could adversely affect some companies and countries disproportionately, and exact an additional cost as global supply chains are disrupted and become less efficient. Research firm Capital Economics estimates that a full blown global trade war, with tariffs of 25% imposed by all countries on all imported manufactured goods, would reduce world GDP by 2 to 3%. Of course manufactured goods are only equivalent to 11% of world GDP, and barriers could also be erected on services, foreign investment, and migration, with further damaging consequences.



Source: Charles Schwab Market Perspectives

The chart above shows that many countries are much more exposed to international trade than the US, where 62% of company revenues are domestically generated. Interestingly China, on which much of Mr. Trump's displeasure is focused, is relatively under exposed to global trade on this measure, generating the bulk of its companies' revenues domestically.
We initially viewed the trade spats as negotiations and unlikely to be escalated to damaging levels. We are gradually becoming a bit more pessimistic regarding this issue.
In the initial phases of the US-China stand-off, China offered some concessions, focusing on specific products it would buy from the US. But this has not been accepted. It is likely that the Trump administration is intent on slowing down the technological lead China is currently aiming for in its "made in China 2025" economic plan, which we described in our previous report. In that case the Chinese leadership, which has a long term view, is not up for re-election, and has many tools at its disposal to smooth a possible trade disruption, is unlikely to back down. The US President's cabinet, after some resignations, has become less balanced than it was at the start of the year. The way in which China has obtained technological know-how from Western companies has been a bone of contention for both the US and Europe, but the US administration seems recently to have eschewed the opportunity to encourage cooperative ties with the EU to jointly tackle this issue.
Meanwhile Europe has its own challenges with increasingly nationalist governments in Eastern Europe and Italy, and ongoing Brexit negotiations.
In short, we see a growing risk globally of go-it-alone, nationalistic policies and changing political agendas disrupting trade flows and definitely affecting sentiment. Uncertainty has never been conducive to investment, expansion or indeed global growth.

It is important to be guided by facts rather than sentiment when managing investments.
We will therefore continue to observe the concrete facts and data offered by our different monitors and follow through with appropriate actions in the portfolios. We used a rebound in European markets in the first week of July to slightly reduce exposure to European stock funds; valuations are attractive but growth expectations have been lowered and European companies are more dependent on global trade, with a relatively high percentage of revenues coming from exports.
We reinvested the proceeds into a US smaller companies fund; smaller companies in the US are relatively more immune to trade frictions and are currently thriving in the booming domestic economy.
Diversification (over asset classes, geographies, investment styles) remains an important cornerstone of our risk management. Should we see the need to further reduce equity exposure, the proceeds are likely to be added to alternative funds, where we seek to invest in funds with low correlation to stock and bond markets.
By the same token, we see no major imbalances in the global economy, such as the over exposure to sub prime debt that led to the 2008 financial crisis. So we do not expect that the next global slowdown, and market correction, whenever it comes, will be as violent as the one we witnessed in 2008-2009.
Meanwhile technological progress and sociological change is creating many exciting new business opportunities in the areas of technology, health care, energy and transportation, life style products, etc. We continue to seek out the best companies for your portfolio to profit from the long term compounding of excess returns, which is offered by quality stock investment more than any other asset class. We enclose a short report on one such company, held in our "Millennium" US share portfolio: Salesforce.com.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.
Portfolio Management Team ISGAM AG

Appendix - US Treasury Yields, Yield Curve Inversions, Recessions, Bear markets.

Green line: US 10 year Treasury Bond Yield
Yellow line: US 2 year Treasury Bond Yield

Vertical red and blue lines: bearmarkets - market peak and trough
Circles: Recessions
Arrows: point at which yield curve inverts

Name	Period Range	Start month	Duration (months)	Time since previous recession (years)	Peak unemploy-ment	GDP decline (peak to trough)	Date SPX Peak	Date SPX Trough	S&P 500 peak to trough	Market peak precedes recession by months:	Monetary tightening played role	ST rates moved above 10 yr rates	Months between inversion Yld Curve & Market peak
Recession of 1949	Nov 1948-Oct 1949	30/11/1948	11	3.08	7.90%	-1.70%	15/06/1948	13/06/1949	-20.57%	-5.51	YES		
Recession of 1953	July 1953-May 1954	31/07/1953	10	3.75	6.10%	-2.60%	05/01/1953	14/09/1953	-14.82%	-6.79	YES		
Recession of 1958	Aug 1957-April 1958	31/08/1957	8	3.25	7.50%	-3.70%	15/07/1957	22/10/1957	-20.66%	-1.54	YES		
Recession of 1960-61	Apr 1960-Feb 1961	30/04/1960	10	2.00	7.10%	-1.60%	05/01/1960	25/10/1960	-13.40%	-3.80	YES	31/08/1959	4.23
Recession of 1969-70	Dec 1969-Nov 1970	31/12/1969	11	8.83	6.10%	-0.60%	14/05/1969	26/05/1970	-34.73%	-7.57	YES	30/04/1968	12.63
1973-75 Recession	Nov 1973-Mar 1975	30/11/1973	16	3.00	9%	-3.20%	11/01/1973	03/10/1974	-48.20%	-10.59	Not major factor	31/01/1973	-0.67
1980 Recession	Jan 1980-July 1980	31/01/1980	6	4.83	7.80%	-2.20%	13/02/1980	27/03/1980	-17.07%	0.43	YES	31/10/1978	15.67
1981-82 Recession	July 1981-Nov 1982	31/07/1981	16	1.00	10.80%	-2.70%	28/11/1980	09/08/1982	-27.27%	-8.03	YES	31/10/1978	25.30
early 1990's Recession	July 1990-Mar 1991	31/07/1990	8	7.67	7.80%	-1.40%	16/07/1990	11/10/1990	-20.36%	-0.49	YES	29/07/1988	23.90
Early 2000's recession	Mar 2001-Nov 2001	31/03/2001	8	10.00	6.30%	-0.30%	24/03/2000	21/09/2001	-39.16%	-12.20	YES	31/01/2000	1.77
Great Recession	Dec 2007-June 2009	31/12/2007	18	8.83	10%	-5.10%	11/10/2007	06/03/2009	-57.70%	-2.66	YES	31/01/2006	20.60
AVERAGE			11.1	5.114	7.85%	-2.28%			-28.54%	-5.341			12.929