Alpesh Patel's March Newsletter

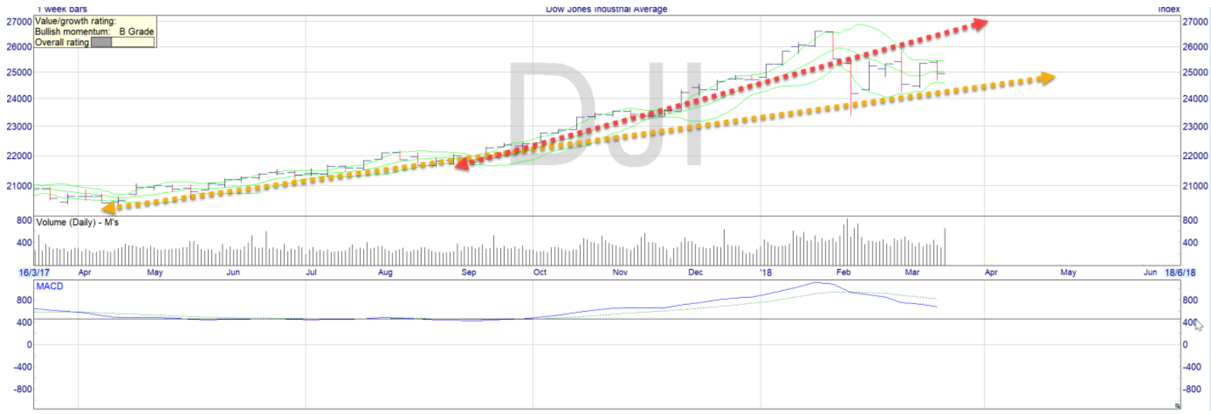
Exclusively for ShareScope Alpesh Patel Special Edition Subscribers

21 March 2018

Welcome to my March newsletter. What would a global trade war look like, according to Goldman Sachs? And what is exciting and profitable at the moment?

My view on the markets

It's little wonder we are a little trapped sideways with all the global uncertainty.

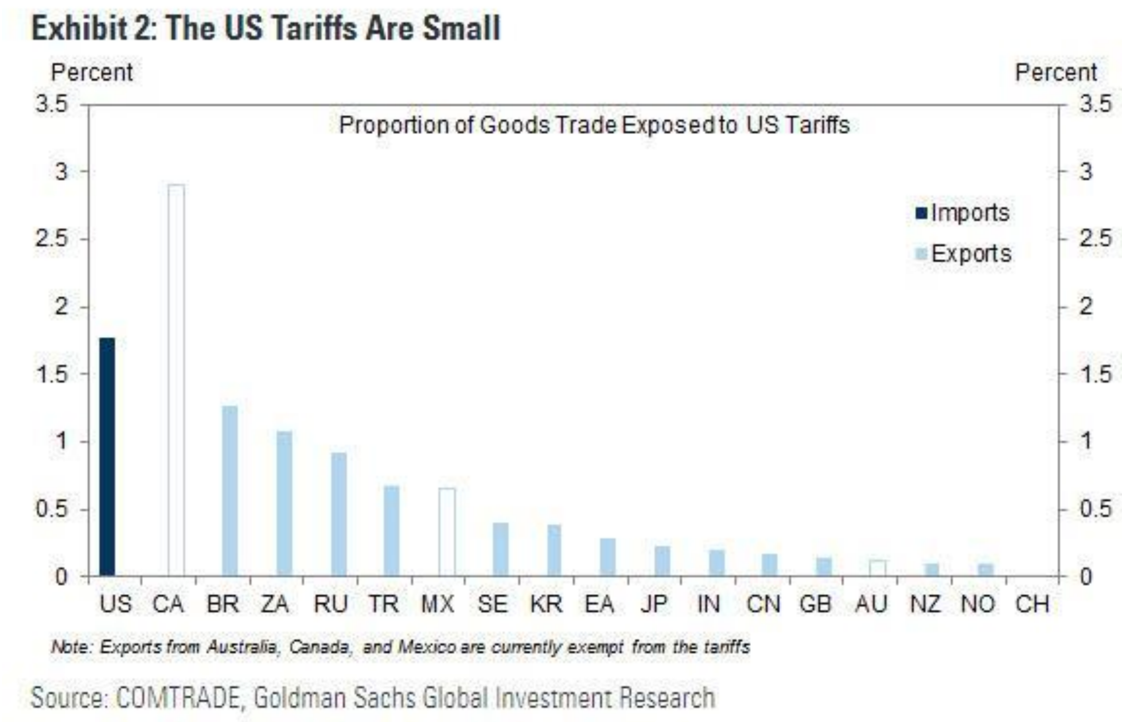


Top insights from the City

Here you can see how Goldman Sachs says the trade war will play out.

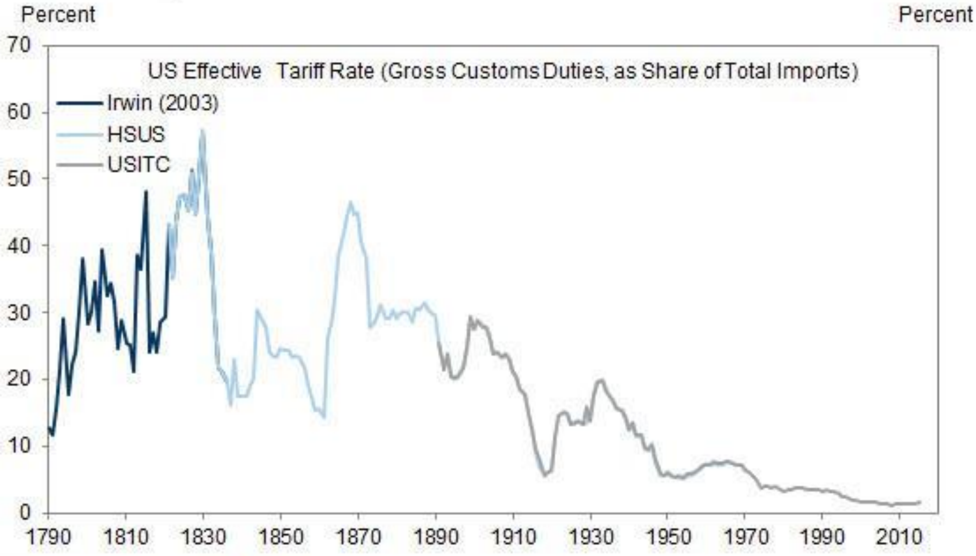
Logic tells us that President Trump's recent announcements on tariffs should have created a threat to the US Stock market as well as to the other nations that would be involved in a trade war. The trade headlines have a major concern with the future of US Stocks.

Let's not forget Canada, Mexico and Australia are already exempted. Plus the announced tariffs cover hardly any US trade as the Goldman Sachs image below shows.



So why was there all this panic? Well there wasn't. The markets didn't crash. Go out and look at them. The reason for it being in the headlines was that it goes against decades of tariff reduction as evidenced by the image below:

Exhibit 1: Proposed Tariffs Contrast With a Trend Towards Less Protection



Source: Irwin(2003), HSUS, USITC

Investors can feel a little relaxed because the President is not in a mood to begin a massive trade war on international grounds. But it doesn't mean that this new tariff plan will not have any impact on US Stocks. It seems like the genie has now come out of the bottle meaning we have uncertainty ahead – something markets do not like.

When President Trump tweeted his statement that trade wars are good, investors around the world felt threatened and stocks everywhere fell albeit modestly. The US dollar was greatly affected by the President's social media deliberation and soon investors started tracking US steel stocks with a thought to avoid losses.

US stocks managed to rise slowly after the President's tweet but, if we look at the broader spectrum, the confusion initiated with the fear of a trade war will leave the higher burden on the shoulders of investors. It doesn't take a genius to work out that there is confusion when there is uncertainty. I appeal to your logic for my source.

The ultimate impact of this confusion will be observed for several months ahead on the US economic performance. If the 25% tariff on steel goes ahead, US stocks will suffer I would surmise. The red states will lose more with this trade war as conjectured by Goldman Sachs in the table below. European politicos know that if they target domestic markets that are populated by Republicans, it will be much easier to force the President's focus on this issue. This tit for tat has not yet begun, and may well not. But even that uncertainty is not good for markets. But it is better than all out trade war! A slippery slope in other words but we are not racing downhill yet. We are at the top, looking downhill and could yet change our mind and pullback from the brink.

Exhibit 3: Retaliation Likely From Trading Partners

	Reaction so far	Likelihood of Retaliation	Severity of response
Euro area	Explicit promise of retaliation, targeting specific trade including motorcycles, whisky and jeans. Press reported that EU officials are drawing up a list of over 100 US goods targeted for retaliation, covering 2.8bn euros. *GS View: the EU is likely to follow a WTO-compatible approach, and to seek a broad-based tariff response. Likely to seek exemption.*	High	Severe
Canada	Government described proposed temporary Canadian exemption as a "step forward", having initially described the tariff as "unacceptable". *GS View: government will continue to press for permanent exemption, so unlikely to retaliate*	Low	
UK	Government expressed "deep concern". *GS View: since the UK is currently a member of the EU, it has no independent response*	High (with EU)	Severe
Turkey	Government has indicated that it will co-ordinate its response with the EU. *GS View: unlikely to retaliate unilaterally, but response alongside EU would include response within WTO rules*	High	Severe
China	Government statement that they will assess the damage caused by the US move, and defend its interests. *GS View: if China chooses to respond, most likely move is reciprocal trade sanctions possibly targeted at agriculture or transport equipment*	Moderate	
Mexico	Granted temporary exemption alongside Canada. Initial reports before this was granted pointed towards severe retaliation. *GS View: government will continue to press for permanent exemption, so unlikely to retaliate*	Low	
Japan	Government expressed "concern" to US. *GS View: on the basis of the muted official reaction, we think retaliation is unlikely.*	Low	
Russia	Government "carefully analyzing the situation". *GS View: proposed tariffs less damaging than feared, as did not single out Russia; unlikely to retaliate*	Low	
Brazil	No official reaction. *GS View: unlikely that the government would retaliate in isolation; more likely to support a WTO-based initiative with the support of other economies*	Moderate	
Australia	Government has confirmed it will be granted an exemption. *GS View: it is unlikely that the government would retaliate, given its exemption*	Low	

Source: FT, Reuters, Bloomberg, Goldman Sachs Global Investment Research

The tariff plan proposed by Trump was actually unexpected in the market and it seems fundamentally illogical as well. It drew sharp rebukes from the leaders of the Republican Party. Investors must keep on expecting some changes in the plan as the President does this with most of his proposed initiatives in their early days. The trade war will likely affect the headlines for several weeks ahead.

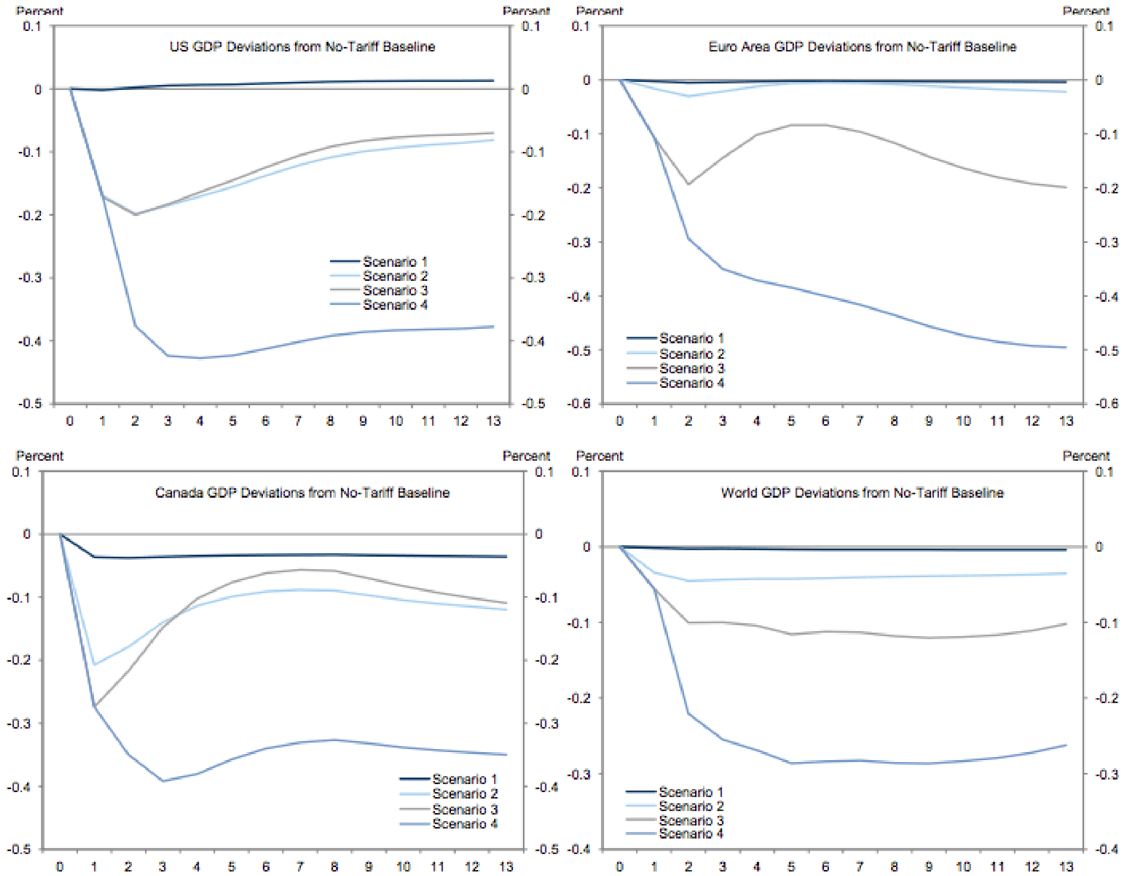
After President Trump's tariff announcement, the experts are trying to determine the health of the US Stock market for the coming future. They have some expectations that the halls of Congress will act opposite to the White House. If Republican legislators such as Senate Majority Leader Mitch McConnell and House Speaker Paul Ryan can somehow force President Trump to control the trade war, investors can feel a little relaxed.

Announced tariff changes have shown a great impact on almost all sectors of US market. The US car dealers say that auto sales have flattened within the past few months and the manufacturers are not ready to absorb this sharp shift in the cost of trucks and cars in America. This burden will be further passed to the consumers in America. Note that almost two million jobs in America depend upon the Beer Industry. There are chances that the current tariff change will result in job losses.

Goldman Sachs sees four scenarios:

1. **US tariffs without retaliation.** We round up the announced tariffs to 1% of total imports, partly because the Trump administration has already announced a few specific tariffs (e.g. on Canadian lumber) and partly because some further restrictions are likely even in a mild conflict scenario. We allow the interest rate and exchange rate to respond endogenously to the tariffs, but assume that equity prices remain unchanged.
2. **A US-focused trade war.** We assume that the US tariffs lead to retaliation from trading partners and further US tariff increases. In this scenario we assume that tariffs on all trade to and from the US rise by 5pp. But we assume that trading partners do not put up tariffs between each other; for example, the EU and China both put up a tariff against US imports but do not erect trade barriers between each other.
3. **A global trade war.** We assume that each country imposes a 5% tariff on everyone else. For example, the EU puts up a tariff against China in response to the US steel tariffs in an effort to prevent Chinese steel from flowing to Europe.
4. **A global trade war with a global equity sell-off.** We assume that global equity markets drop by 10%, in addition to the global 5% tariff.

Exhibit 4: Trade Wars Weigh on Growth…



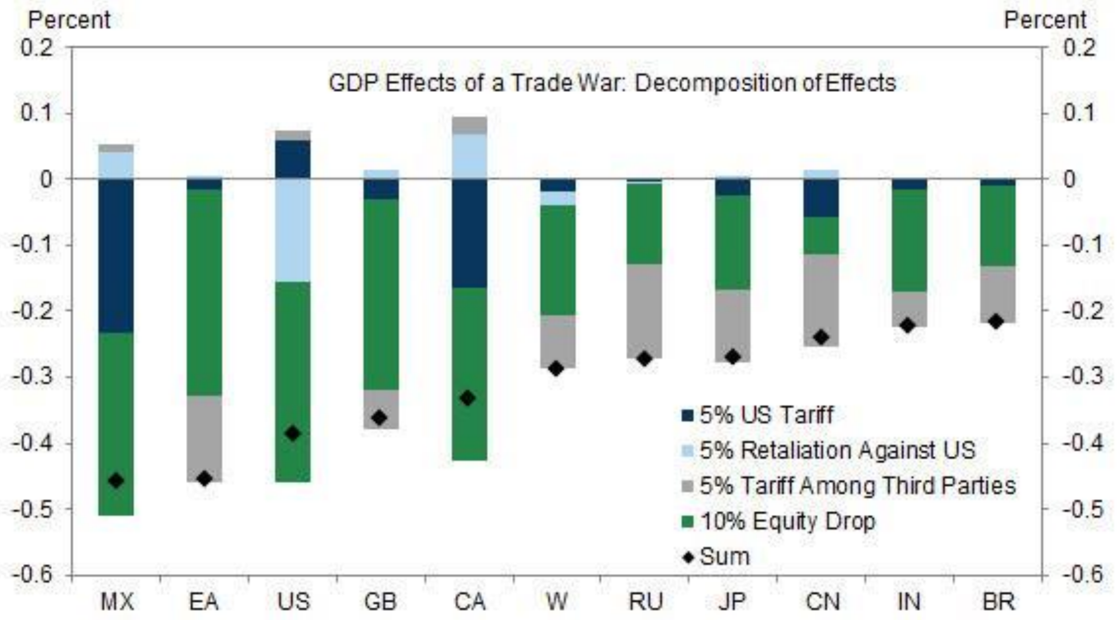
Note: charts show the real GDP effects for each of the four scenarios in percent deviation from a hypothetical baseline in which no tariffs are applied.

Source: Goldman Sachs Global Investment Research

The US chamber was observed to show more concern towards this trade war and it is going to risk the economic momentum for a long run. Experts in the business sector say that they expect administrative authorities to take some serious decisions about tariffs on aluminum and steel. The new tariffs will harm American manufacturers to a great extent and the impact will be seen on larger grounds with potential trading partners.

Beyond this, there are few companies that are expecting huge benefits from the new tariffs such as the aluminum and steel producers in the United States. The CEOs of most big steel companies are invited to the White House for a meeting with President Trump. The impact of all these fluctuations will be seen in the US Market after the month of March.

Exhibit 7: The Anatomy of a Trade War



Source: Goldman Sachs Global Investment Research

My favourite Value/Growth picks this month

Using the APSE Value Growth data mining filter for the LSE shares list, I can see slim pickings – maybe a sign of overvaluation?

01 Filter Alpesh Value/Growth - All sectors - Alpesh DM Table (Linked)

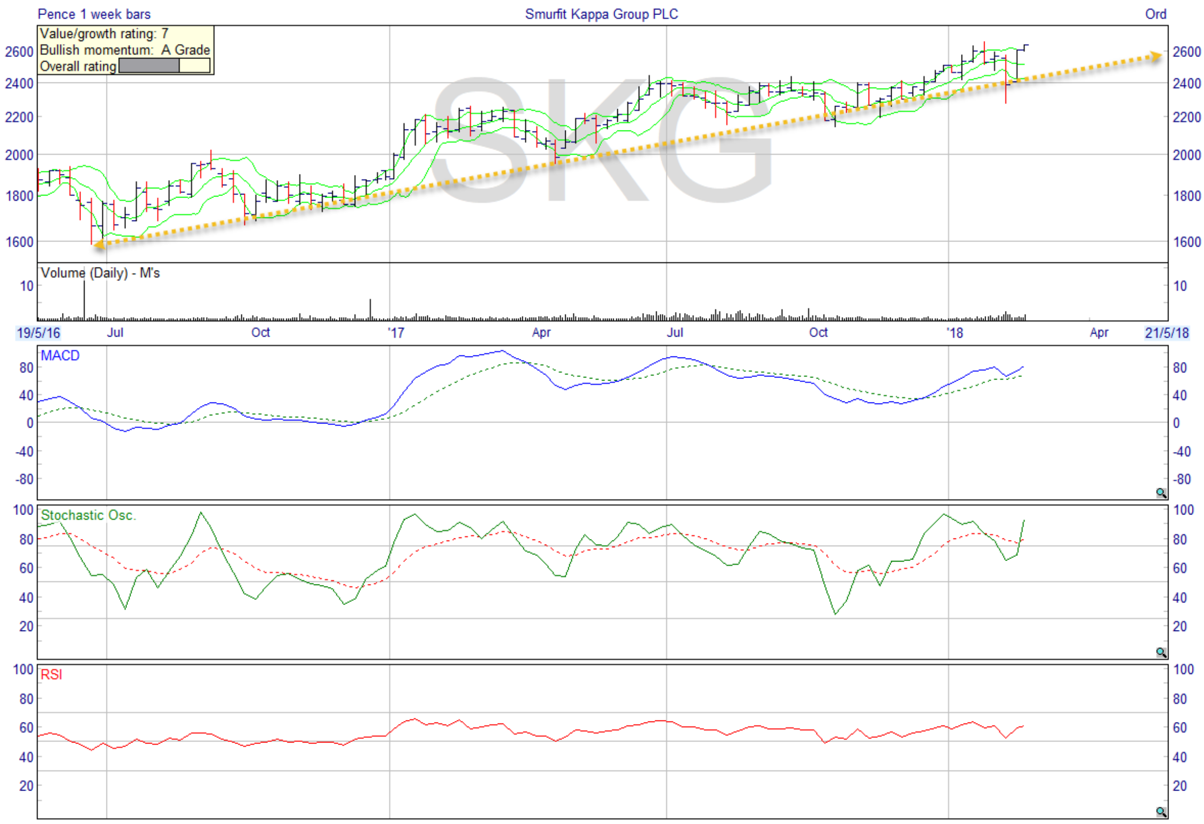
No.	Name	EPIC	**Alpesh value/ growth rating**	Alpesh bullish momentum rating	Alpesh overall rating
1	Costain Group PLC	COST	9	A Grade	
2	IMPAX Asset Management (	IPX	9	B Grade	
3	International Personal Finan	IPF	9	A Grade	
4	Macfarlane Group PLC	MACF	9	A Grade	
5	National Express Group PL(	NEX	9	A Grade	
6	Prudential PLC	PRU	9	A Grade	
7	Telford Homes PLC	TEF	9	A Grade	
8	Vitec Group (The) PLC	VTC	9	A Grade	
9	Bilby PLC	BILB	8	B Grade	
10	Flowtech Fluidpower PLC	FLO	8	B Grade	
11	Haynes Publishing Group P	HYNS	8	A Grade	
12	Ibstock PLC	IBST	8	A Grade	
13	Ladbrokes Coral Group PLC	LCL	8	B Grade	
14	Norcros PLC	NXR	8	A Grade	
15	Premier Asset Management	PAM	8	B Grade	
16	Smurfit Kappa Group PLC	SKG	8	A Grade	
17	St Ives PLC	SIV	8	A Grade	

My favourite Momentum/Value picks this month

The point with this radar is to find undervalued stocks showing some momentum using our algorithms.

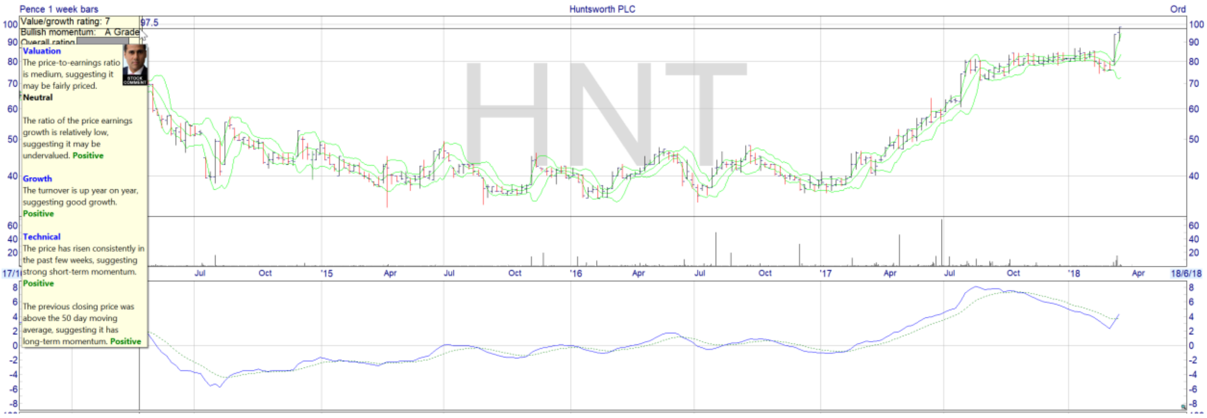
Top trades for this month

Last month I picked this:



And this is where it is now:

Not a bad return for you. This month, take a look at Huntsworth, Vitec and Dechra.



Stocks and the Tariff War

Just a few days ago, Trump signed the deal on tariffs. More specifically, a tariff on aluminium and steel imports that will take effect soon in full force. This move has caused people to speculate on a possible trade war. For us traders, and I venture to guess every trader, it begs the same questions traders always ask, 'what does this mean for me?'.

However, before going any further, let us first start by defining tariffs. According to CNN, a tariff is a form of taxes imposed on a category of imported goods. This then causes the particular goods or products to be more expensive. In turn, this should benefit the manufacturers of the product.

This then begs the question: what prompted such a move from President Trump? His move was prompted by the need to revive two industries in the US - aluminium and steel. These particular industries have been performing poorly in terms of employment rate and so forth.

President Trump is imposing a 10% tariff on aluminium imports and a 25% tariff on steel imports. This move, of course, was much anticipated after President Trump assumed office. Nonetheless, experts foresee a possible trade war, perhaps even a global one.

Why so? It is very likely that any country affected will retaliate as well. Of course, the retaliation will be in the form of tariffs of their own. This would not only hurt the country's economy, it would affect stock markets as well.

There are a lot of theories on this matter. Stock markets are likely looking at a negative future due to impending trade wars. Which stock markets, specifically, are going to be affected by this move?

It goes without saying that the tech market is not directly affected but tech stocks could be the subject of, say, Chinese retaliation. However, steel companies are affected and not in a good way.

Since the announcement, certain companies like Steel Dynamics (STLD) experienced a drop in stocks. The S&P 500 experienced a decrease as well. More specifically, a 1% decrease. (Source: ShareScope)

The copper and aluminium industry also seems to have been affected. In recent news, it has experienced a drop by 1%. Most experts expect the drop to increase if a trade war breaks out.

Treasuries are also said to have increased considerably. Moreover, most investors expect inflation to increase rapidly, as a result of looming trade wars.

Back to America's strong global brand in the corporate world - when I look at Tech stocks over the past two weeks on ShareScope, I find it difficult to see much impact as a result of tariffs.

01 List: NASDAQ 100 - All sectors - Alpesh Table (Linked)

No.	Name	EPIC	Close	**Price% 2 weeks ago**	Price% 5 years ago
1	Dollar Tree Inc	DLTR	$94.29	-11.23	111.22
2	Monster Beverage Corp	MNST	$58.43	-11.21	279.50
3	Hasbro Inc	HAS	$90.07	-8.58	113.69
4	DISH Network Corp	DISH	$41.35	-8.01	18.08
5	Comcast Corp Cl A	CMCSA	$36.96	-6.62	81.53
6	QUALCOMM Inc	QCOM	$62.81	-6.23	-6.31
7	JD.com Inc	JD	$46.01	-5.72	
8	PACCAR Inc	PCAR	$67.74	-5.32	34.94
9	O - Discovery Communications Inc	DISCK	$22.62	-5.08	-35.30
10	Ross Stores Inc	ROST	$76.43	-4.40	173.45
11	Celgene Corp	CELG	$92.28	-4.36	62.29
12	Biogen Idec Inc	BIIB	$279.90	-3.49	58.99
13	Tesla Inc	TSLA	$345.51	-3.33	783.21
14	O - Viacom Inc CL 'B'	VIAB	$32.82	-3.13	-47.02
15	Discovery Communications Inc Cl A	DISCA	$24.42	-2.98	-68.66
16	Kraft Heinz Co	KHC	$67.70	-2.93	
17	Norwegian Cruise Line Holdings Ltd	NCLH	$56.56	-2.35	83.34
18	Twenty-First Century Fox Inc	FOX	$37.50	-2.34	21.67
19	O'Reilly Automotive Inc	ORLY	$249.12	-2.29	139.84
20	Hologic Inc	HOLX	$38.93	-2.26	73.33
21	Liberty Interactive Corp QVC Group Ser	QVCA	$27.93	-2.24	
22	O - Twenty-First Century Fox Inc	FOXA	$37.98	-2.14	24.67
23	Liberty Interactive Corp	LVNTA	$53.42	-2.00	42.30
24	JB Hunt Transport Services Inc	JBHT	$120.82	-1.92	72.35
25	Tractor Supply Co	TSCO	$63.66	-1.85	23.71
26	Costco Wholesale Corp	COST	$189.37	-1.78	82.53
27	Gilead Sciences Inc	GILD	$81.06	-0.89	75.53
28	Mondelez International Inc	MDLZ	$44.39	-0.85	57.36
29	Walgreens Boots Alliance Inc	WBA	$70.15	-0.64	70.93
30	Paychex Inc	PAYX	$66.50	-0.49	96.22
31	Electronic Arts Inc	EA	$128.12	-0.35	565.56
32	Automatic Data Processing Inc	ADP	$117.53	-0.31	83.73
33	A - Vodafone Group PLC	VOD	$29.04	-0.31	-15.51
34	Facebook Inc	FB	$184.76	-0.09	563.89

So is the market under-pricing, or correctly pricing, the news?

Personally, as I said on the BBC, the market is correctly pricing the threat. It hasn't fallen sharply because it sees the potential problem and knows the impact could be huge but, for the moment, knows the probability it will happen is small.

Use stop losses like a professional trader

A lot of people will ask me, as a professional trader, how do you use stop losses? To me, they are the most important thing in trading because none of us want to suffer losses. If you look after your losses, the profits take care of themselves. So, let me explain it to you.

Okay, one of the most important principles of all successful hedge funds in the world, and I've never seen a hedge fund which is successful which doesn't deploy this rule, is they have something called Volatility Based Stop Losses (VSL).

What does that mean? Well, imagine a particular entry point. Professionals interviewed in my book, *The Mind of a Trader (Financial Times 1998)*, make sure their stop loss is such that they don't get hit by market noise.

So, how do you determine market noise? Well, that's dependent on the volatility of the instrument. What does that mean? Well, that means that we look at all of the movements in each period, whether it's a one-minute chart you're looking at or the 60-minute or whatever.

This up and down range of the price from high to low is how volatile the market is in any given period. So, you might look back over, say, the past 14 periods and work out that on average it tends to move up and down 20 points. That's its noise on average for each time period you are examining.

So, you might say, well, I want to make sure I don't get hit by market noise because that doesn't tell me that I should exit. That just tells me it was market noise, so I'll put this stop loss at 40 points away from my entry.

Now, maybe on another day, on another instrument, the volatility isn't 20, the volatility's 40. Well, on that basis, the stop loss would not be at this distance, of 40, it'd be at the distance of 80, double that, on the same principle.

Now, I'm not saying double's the right answer. It's the principle that's important. You might put it 2 or 3 times away. Either way, it's the principle that is important.

The ingenuity of it is that you ensure that every stop loss is bespoke to the market conditions. Now, what if the stop loss is very far from the entry price because the market was more volatile? We know volatility can mean bigger losses so what do we do?

Volatility Based Position Sizing

Well, that's why we're going to have volatility-based position sizing (VPS). In other words, if the stop loss is twice as far away, we half our position size so we're not risking more money with a further away stop loss. Those are critical elements and principles behind setting stop losses.

Screens, Screens, Screens

Let me tell something else which is critical to trading success. Having lots of screens, that's not the secret to trading success. So, don't be fooled into thinking I will get a lot screens therefore I must be good.

It comes down to your managing risk. This is what I've written in the Financial Times as far back as 2004. So, I'm experienced at this okay? And from my research, professionals use volatility based stop losses the way I've said.

This does not guarantee profits – no one can in trading. Professional traders like George Soros in his book the Alchemy of Finance illustrates that out of a hundred trades you might have about 40 to 45 which will be small losses. Why would they be small losses?

Well, we don't have a crystal ball and while we think every trade is going to go up and up and up, sometimes they don't, other things happen in the market. A President does a tweet. God knows what else happens, and all of a sudden the market turns. You would limit them because you did a volatility based stop losses and of course, for the same reasons, you'll have some small wins. I wish they were all big wins but they're not.

And you have some big wins according to professionals like Soros in his book and the professional traders in my book. Now notice, the small losses are pretty much wiped out by the small wins. So, where we are getting rich as fund managers, where we're really making our money - whether it's me, George Soros or anybody else - is from the few 15% big wins.

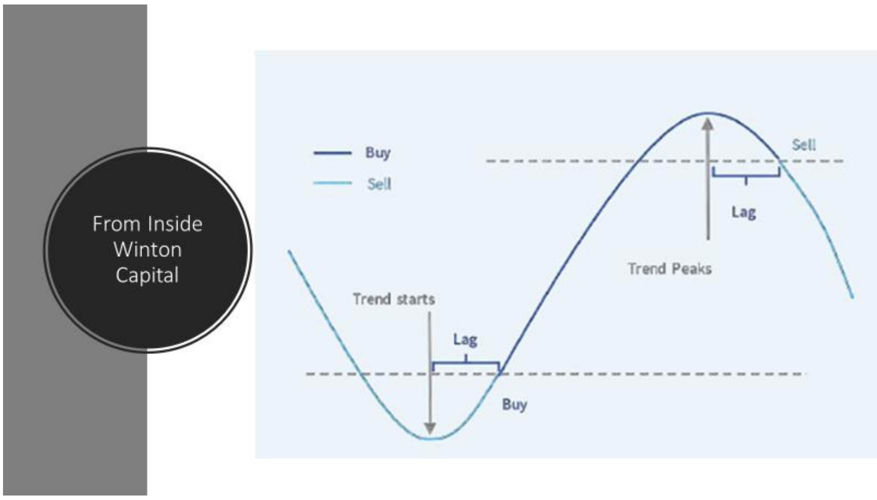
Private investors often have big losses; that's what wipes them out. Make sure you never risk more than 2% of your total trading capital on a trade.

The other mistake private investors make when it comes to things like stop losses is they put them so far away that they have larger losses than if they had tighter stop losses, and that puts even more pressure on them to take profits, which otherwise might have continued to be greater too.

Trend Following – What, Why, How, When, Who

Let's look at trend-following trading. Now the first thing you need to know is why we should even look at this. Well, let me show a slide from inside a multi-billion dollar hedge fund. This one happens to be Winton Capital. You see, I don't want you to trust me, I don't want you to rely on me. I want to source knowledge from independent third parties.

What we're trying to do, whether it's me or anybody else's trend following strategies is that we are not trying to get in the bottom or out at the top. Nobody can forecast that accurately – well not without a crystal ball or time-machine.

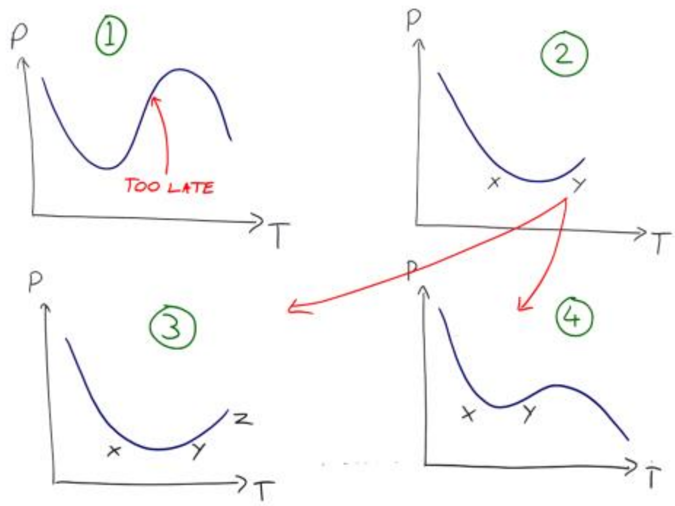


If a multi-billion dollar fund doesn't do it, anybody else telling you they're doing it and showing you pretty pictures, whether I got out here and got in here and they just happen to hit the bottom and the top, is lying.

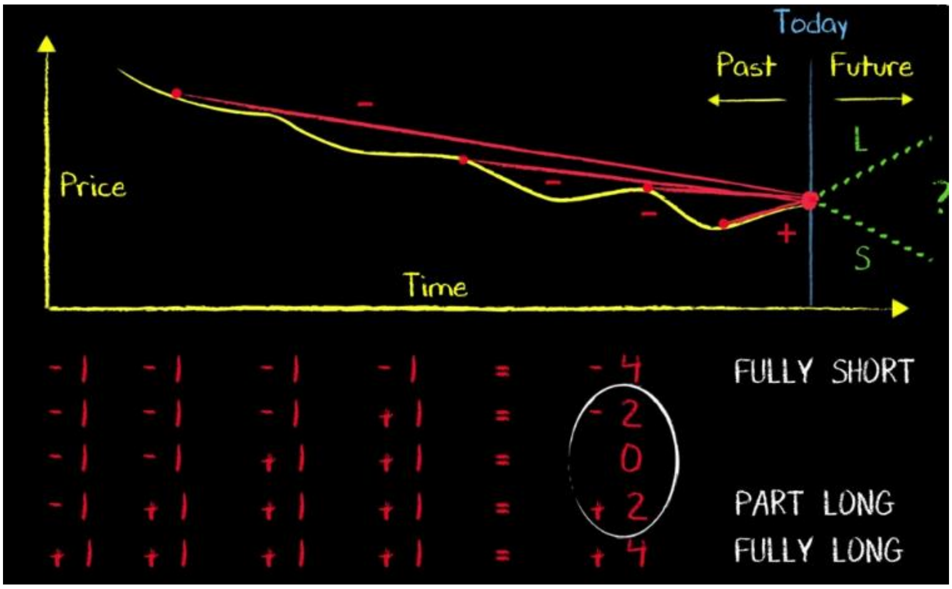
After a bit of a lag, that's when the likes of Winton buy. They get the meat of the move. And after a bit of a lag, that's when they end up selling. Why do they wait for the lag? They don't have a crystal ball; all they know is, 'oh, now the trend has started.'

They don't know ahead of time, they can't buy the upward trend when the market is still falling because they don't have perfect foresight, they don't have that crystal ball, so I want you to know that. So, remember, a multi-billion dollar hedge fund is telling you, yes there is lag, the way we do it in my fund is this. I also know from speaking to clients of brokers that this is a popular approach with private investors.

Trend following theory works on the appeal to logic that prices can only ever be one of 4 different moves shown in the image below.



Another multi-billion dollar hedge fund explains how they measure in the image below



One theory for measuring trends is to use momentum technical analysis indicators. One of the things we do is look to measure the strength and momentum. How do we do that? We measure how close to the high the prices close in any given period; by measuring that, by examining that, we have a better idea that there's an increased probability, not a certainty, that the price in the next period is likely to move higher – that is the theory behind the MACD, Stochastic and RSI.

And remember, we know the coin is right 50/50, so we're just trying to be a bit better than a coin, we're trying to be right 60/40, that's all when trend-following. Not 100% because we don't have a crystal ball, not 90, not 80, not 70 because even George Soros is only right about 55% of the time according to his book, The Alchemy of Finance.

Trend-followers follow the theory that they are riding the coat-tails of big players who may be the cause of buying and price movements. Put another way, we think the probabilities are higher if the price closes near the high of there being some pent up demand. It's a bit like when you see an auction and the auctioneer says, 'I've got 40, anybody give me 50, I've got 50, anybody give me 60, got 60 anybody give me 70, I've got 70 anybody give me 80' and so on, that's what it is.

It's just a probabilistic indication of the likelihood of a trend moving higher. And, if you want to know how well they do, well in 2016 according to the Financial Times it was the best performing strategy.


FINANCIAL TIMES

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Hedge funds + Add to myFT

Trend-following hedge fund strategies lead performance in 2016

Computers are beating their highly paid human counterparts so far this year

FTfm

We don't capture every trend. Trend followers miss whole downwards sometimes. They have losing trades too. In reality with trading what happens is, you get a big win there, you got a medium win there, a small win here, and a loss here and there too.

My point to you is this: it is not about trying to capture every top and bottom and trying to forecast the market, you can't do that. Nobody knows what's going to happen to the market.

Personal Activities

There were key events all surrounding the birth of my son and the markets: he made his first TV appearance, according to the BBC they have a global News audience of 373m at any one time watching! And he was welcomed and financially planned upon by Investec.

It's only day 3...and he's had his first TV appearance to a mere 373m people worldwide...gotta earn his keep...boy outdoing daddy...gonna need an agent.

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Congratulations to @alpeshbp on becoming a dad for the first time! Just before the baby was born, we asked if his financial mindset had changed since he found out he was going to be a father. See the full interview bit.ly/2FLe3q8

Capital at risk.

Inspiring investor: Andrew Summers meets Alpesh Patel

A leading financial analyst and commentator offers his top tips on investing for the first time