►On Target

Martin Spring's private newsletter on global strategy

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America Flexes Its Muscles

There's been an outbreak of media hysteria over the threat of a global trade war. Commentators are terrified that the world is about to repeat the error of the Thirties, when an outbreak of protectionism, symbolized by the America's Smoot-Hawley tariffs of 1930, made worse a depression that was already under way.

It's important that investors keep a sense of proportion.

► Actions taken by the US and China so far are going to have a very limited impact.

If the US, having imposed tariffs on steel and aluminium, follows up as threatened with penalties on $50 billion worth of Chinese imports, and that produces equivalent counter-measures from targeted countries, the effects on the world economy will be minimal. Bloomberg Economics says the tariff increases will be equivalent to an across-the-board increase of just 2½ per cent… "pretty much nothing." And, in the case of China, have a "close to zero" impact on its economy.

► Even if the conflict does gather momentum, the consequences will fall far short of disaster.

If the US imposes tariffs averaging 10 per cent on all its imports and the rest of the world retaliates, raising equivalent levies on US exports, the cost by 2020 will be 0.5 per cent of global GDP, or no more than one mid-sized economy such as Thailand generates in a year. What's more, that's "an extreme scenario," Bloomberg says. And after the first couple of years, the negative impact would be far less.

► Although all economies would be adversely affected somewhat, China would suffer less than the US, and Germany even less, but Canada would be hit hard.

Interestingly, such protectionism would pay off for America in one respect – its foreign trade deficit would fall by an amount equivalent to 1.4 per cent of GDP, worsening the trade balances of almost everyone else.

Another interesting point that explains why there is widespread support in the US for Trump's tariff policies is that although global free trade has been enormously rewarding for many, especially the Chinese, it's been far less so for Americans.

It opened up the US market to intense competition from abroad which, together with a shift toward more capital-intensive production, has held down workers' pay. Between 2001 and 2016, real income for the bottom fifth of US households

In this issue: Trade war ▫ India ▫ North Korea ▫ Vietnam ▫ Rules for investors ▫ European car industry risks ▫ The subscription model ▫ Gold

didn't rise at all, while wages for those in the middle only managed a 4 per cent increase. A handful of very talented Americans have made fortunes out of globalization, but they have very few votes. No wonder Trump's popularity rating has now risen above 50 per cent (higher than Obama's at the same point in his presidency).

NTAsset's Kenneth Ng is right when he argues that the American tariff hikes so far "do not amount to a declaration of war… The US, for all its recent threats, seems more likely to use these tariffs to build additional leverage with China that it can use in negotiations, and to score political points at home."

India: Better Governance Is the Key

Back in August 2015 I posed this question: "Which of the three Asian giants – China, Japan or India – offers most promise for international investors?" The surprising answer, according to GAM's investment director Paul McNamara, was "India is the strongest story." CLSA's Christopher Wood described that country as "the most promising major emerging-market story on a five- to ten-year view."

How have things turned out so far? Well, comparing broadly equivalent international funds denominated in US dollars, China has done best, with its shares up 45 per cent. But India has done well, up 38 per cent -- and far better than Japan, at 21 per cent.

My friends at *FullerTreacyMoney* were asked recently how they compared India, where its vibrant democracy is seen as an obstacle to rapid and firm decisionmaking, with China, whose lack of democracy enables the government to act without vested interests standing in its way, and is seemingly accepted as the price to be paid for advancing material wellbeing.

Here is how Eoin Treacy responded. It deserves being reported at some length…

I have just returned from a visit to India and I visited China last autumn. I was struck by the difference between the two societies.

It is easy to be impressed by Chinese efficiency in infrastructure development. When one visits Shanghai, Beijing, Shenzhen or any of the other Tier 1 cities, one could be forgiven for thinking, how can China still be an "emerging" market? China has built a domestic digital economy through protectionism and copycatting that rivals the efficiency of the global technology mega-caps; an incredible achievement.

However, I heard someone say once that for every 100 kilometres you get from a Tier 1 city, you go back ten years in time. The vast majority of development has occurred along the coastal periphery, while the inner hinterland is still underdeveloped.

China's administration is doubling down on crowd control. Everything from artificial intelligence to phone tracking and cameras are being deployed to exert a degree of control over the population unheard-of in human history. The Party is reversing corporate independence so that companies are rapidly becoming organs of government control.

The economy has been expanding for decades and debt levels are rising. [But] no country in history has had uninterrupted growth. What will happen when we get that interruption? The Communist Party is fully aware of that, which is why they are acting now to secure control. If one is a long-term investor, the only conclusion is that China now deserves a higher risk premium than it did a year ago.

India is chaotic and crowded. With a third of China's land mass, India has a larger population. There is a cacophony of competing objectives for the nation's myriad ethnic minorities; each with its own language, religion and traditions.

India has always had a dynamic domestic economy. With English as a first or second language for most people, it has had few obstacles to engaging with the global economy. [But] India's sclerotic bureaucracy and deep-seated corruption, where bribes are integral to the functioning of the system, tend to put people off investing; the historic volatility of the Rupee reflected the mismanagement of the economy.

David [Fuller] pioneered the term "Governance is Everything" decades ago. Standards of governance are vitally important for an international investor for the simple reason that once you invest, it would be nice to know that your money will still be there when you come back to get it.

Minority shareholder rights are vital so that vested interests cannot overwhelm our smaller shareholdings. You need an independent judiciary if you are going to have minority shareholder rights upheld. A free press is vital if the worst temptations of power are to be contained by outing improprieties in public.

China has none of these three characteristics of improving standards of governance, while India has all three. If we look at history, democracies are messy and prone to crises. But they promote a sense of people striving for a common good and are therefore inherently more stable over the long term.

The JPMorgan India Trust and the China Fund Inc both started in the early 1990s and both are US dollar denominated, so by comparing their performance we have a reasonable basis for a total return comparison. India has outperformed by a considerable margin over that time frame, and that is despite the currency devaluation over the same period.

China had a lower GDP per capita than India in 1990. Now it is a multiple of India's. However, GDP growth does not transfer into broad stock-market gains without standards of governance improving.

North Korea: Don't Believe the Propaganda

Quite contrary to what you might expect from what passes for reportage and analysis in all the mainstream media, things may be moving towards a reconciliation between the US and North Korea that would amount to victory for the Kim Jong-un regime.

That is not as unlikely as you might think. Remember that the US was unable to win the Korean War – it ended in a draw – and later was eventually defeated in Vietnam.

The Americans could be moving towards abandoning hope of achieving North Korea's nuclear disarmament and switching to more realistic objectives. For

example, getting North Korea to commit not to sell nuclear weaponry to terrorist groups or other nations, in exchange for a lifting of sanctions, or even an aid programme.

CLSA's Christopher Wood says Kim continues to "play a blinder" after successfully exploiting the public relations opportunity provided by the Winter Olympics in Pyeongchang, by getting the Americans to agree to a Kim/Trump summit in May.

"There has been more dialogue between America and North Korea… than what has been admitted to in public," Wood reports. The path is being cleared "for America to accept longstanding reality – which means formally accepting in public that North Korea is a nuclear power.

"Once that happens, the way is open for negotiations to be held over ending the Korean War (North Korea and America are technically still at war."

What does that mean for investors?

CLSA's Korean head of research Paul Choi suggests there would be a potentially huge positive catalyst should Kim decide, "once a peace treaty is concluded and his regime's stability ensured, to open up the economy to 'foreign' investment… most particularly from South Korea."

That "possibility," even "probability," would offer huge opportunities for South Korean companies.

Strategies, Signals and Stock Selection

Last month I introduced you to some useful tips/comments from financial publisher Harriman's new *Book of Investing Rules: the Do's & Don't of the World's Best Investors*. Here are a few more that caught my attention…

Technical analysis (charting): Anthony Bolton says when he was managing funds he used it to help with decisionmaking, helping him determine the size of the bet to take. "It the technical analysis supported the fundamental analysis, I would be prepared to take a bigger position."

Alistair Blair says shares are worth considering if the charts "form a nicely-shaped, months-long bottom, including at least several weeks of sustained recent upside."

Eoin Treacy says base formations are about the easiest thing in the world to identify because you will see a lengthy period of often volatile ranging. It's what the subsequent uptrend is built upon and appears to emerge from. "I define ranges as explosions waiting to happen.

"I scour the investible universe of shares for signs of a progression of higher reaction lows inside the formation… Long base formations occur in every asset class and they are all, without exception, explosions waiting to happen."

Kathleen Brooks, a forex trader, says if you are scared off by lots of statistical analysis, "don't fear… a chart will often tell you what you want to know."

Value v growth: Ashton Bradbury says he's never understood why people view these as mutually exclusive investment styles. "If I am able to identify a business with good long-term growth prospects (a growth stock), I can also identify a

company which, notwithstanding potential short-term problems, is fundamentally undervalued (a value stock)."

Take, for example, a company trading on an apparently expensive 25 times future annual earnings. That could actually represent compelling value if you genuinely feel it is likely to produce compound earnings growth of, say, 15 to 20 per cent over the long term. "Is that a growth company, a value stock, or, more reasonably, a fast-growing business that represents good value?"

Value investors, says Ian Hislop, look for bargains. They like to buy shares cheaply, because they will recover from their low prices. One way to measure "cheap" is a share's "price-to-book" ratio – its price divided by the value of its equity as stated in the company's balance sheet. The lower it is, the cheaper it is. Another measure is its price/earnings ratio – the share price divided by earnings (annual profits) per share.

Growth investors look for companies whose earnings are growing faster than average. They like to buy products in companies with innovative or superior products or services that are in high demand. They tend not to mind so much that the shares may be expensive when measured by value metrics.

Portfolio design. "Use low-cost collective investments like index funds and ETFs," says Frank Armstrong. "They deliver market returns at the lowest cost, risk and tax costs.

"Accept market returns. Don't try to time markets or identify mispriced securities. It's a loser's game. The evidence against active management is clear beyond a reasonable doubt."

But do "consider overweighting your portfolio to favour small companies, cheap stocks (value), and more profitable companies. Those tilts have been shown to reliably enhance returns over reasonable periods of time."

Fund selection: Research studies have shown, says Tim Hale, that only around 3 per cent of managers appear to be truly skilled – but they take most of the rewards for themselves in fees.

Sharpe ratio, says Andy Bell, "is a quick way of thinking about whether you are being adequately rewarded for the risks you are taking.

"If a fund takes a lot of risk and you are getting a good return it is likely to have a good Sharpe ratio. If the fund takes a lot of risk and you aren't getting a good return, the Sharpe ratio will be much less. As a rule of thumb, a fund with a ratio above 1.0 is said to be doing well. A ratio above 2.0 is considered to be excellent."

Selling signals: Ashton Bradbury says these are telltale signs that it's time to unload a stock…

► Weakening cash flow or increased use of provisions.

► Language used in company statements that becomes longer, less specific, more ambiguous.

► Odd decisions that don't fit with the company's previous business strategy. For example, a firm with a long history of strong organic growth suddenly starts making acquisitions.

► A highly-regarded chief executive suddenly decides to step down.

► Companies operating in similar businesses start making statements that are increasingly cautious.

Momentum strategies: This investment style is based on the view that shares whose price has been going up are likely to continue doing so. If very bright and well-informed fund managers are prepared to buy at ever-higher prices, that must mean the business is doing well. Although this seems illogical, it's one of the styles that research has shown to outperform.

However Ashton Bradbury says that charts based on such momentum patterns have a horrible habit of breaking down when you least expect it. A more valuable form of momentum is one based on rising profits. "If a company reports higher profits than the market is expecting (and so, everything else being equal, the share price goes up), it is quite likely to do so on a number of occasions over a period of time.

"The opposite is also true; one negative profits warning often leads to another."

Value strategies: Tobias Carlisle says the odds of finding the next high-growth or high-profit stock are no better than flipping a coin. "The best place to find future growth and profit is in businesses enduring hard times. These businesses are also likely to trade at a wide discount to value. Buyers… can enjoy both an improvement in the business, and a narrowing of the market price discount."

John Kingham says to avoid investing in a company that seems good value but subsequently goes down the tubes, look for features such as:

► A clear and consistent strategy, a dominant core business which has operated for many years, is a market leader.

► Freedom from major projects that could permanently damage the company if they fail, sales generated from a large number of small-ticket items rather than a few large projects or contracts, a stable pattern of market demand, markets that are expected to grow.

► Total capital expenses that have been less than total profits over the past decade, ditto, acquisition costs.

► Key products or services which are likely to remain largely unchanged over the next decade, immunity from volatile commodity prices, freedom from current problems which could cause the company serious long-term damage.

"If the company is missing more than half of these features, then it is probably a value trap and should be avoided."

Asia's Best-Looking 'Frontier' Market

Vietnam is by some distance "the best macroeconomic story" in the ten-member Association of Southeast Asian Nations, says CLSA's Christopher Wood. Its capital markets are finally beginning to catch up with the dynamism of the story, which is about foreign investment and a growing-middle-class consumption boom.

Vietnam has been the most successful of the emerging Asian economies in attracting foreign direct investment as multinationals have looked to diversify out

of China. FDI inflows exceeded $10 billion in the first three quarters of 2017, or 6.8 per cent of GDP.

The national currency, the dong, has stabilized in dollar terms, underpinned by foreign trade surpluses running at an average of nearly 4 per cent of GDP since 2012. This year economy growth is expected to reach almost 7 per cent.

The stock market has risen 73 per cent over the past 18 months. Dragon Capital forecasts listed-company earnings growth of 25 per cent this year, yet shares are still trading on price/earnings ratios of around 17 times.

Many stocks are currently unavailable to foreign investors because foreign holdings have reached allowed limits. However, it's suggested that it's still possible to find interesting companies whose shares have not yet reached their foreign limits.

The Threat of Car-tastrophe

Three potential crippling shocks now threaten Europe's motor industry, the Continent's biggest export earner…

► The Trump administration says it will slap tariffs on cars sold in the US, imported from Europe, unless Europe takes immediate steps to slash its $100 billion-a-year trade surplus. The Brussels-based thinktank Bruegel reckons a tariff of, say, 35 per cent would cost the industry about €17 billion a year.

► If Brexit takes place without an agreement for what is to follow—the so-called Hard Brexit scenario – the UK could then impose tariffs on cars imported from Europe. The hardest hit would be Germany. Britain is the second biggest source of Germany's huge foreign trade surplus.

► The industry has invested heavily in diesel technology, but that's under attack for causing air pollution. Buyers are evaporating as some major city governments plan to ban all diesel cars, with diesel's share of new car sales having plunged from near-50 per cent to about 35 per cent. The industry now faces having to make huge investment in electric vehicles, where it's been lagging behind China and America.

The Subscription Model

One of the keys to my successful investment newsletter publishing business in South Africa was offering investors the option to pay monthly by a continuing bank order, instead of a single lump sum, renewable annually. This not only encouraged more people to subscribe, it also gave my business reliable cash flow. When I eventually sold the company to retire, the relatively stable monthly payments accounted for an amazing 80 per cent of annual income.

The subscription model is now catching on in the wider world of global business, particularly with technology companies. Such enterprises are highly cyclical, with each new model of product or software producing a surge in sales always followed a tapering-off. Selling subscriptions to services instead, turns lumpy cashflows into predictable income streams.

Since Adobe first explored the concept about five years ago it's been introduced with some enthusiasm by technology companies, including Amazon, Microsoft, Netflix, Cisco and Autodesk.

It's Foolish to Trigger Panic

The latest version of the European Union's Financial Instruments Directive requires discretionary managers of funds to notify clients if their portfolio falls by 10 per cent or more during a quarterly reporting period.

This is "folly," says British adviser Tim Price. It focuses attention on temporary weaknesses. At such times you "may well become rattled by scary headlines and breathless commentary," and make bad decisions.

He quotes Charlie Munger, Warren Buffett's business partner, who has said it's normal for equity markets to suffer big falls, losing for example 50 per cent of their value. That's no reason to sell, if you're investing for the long term.

"If you're not willing to react with equanimity to a market price decline of 50 per cent, two or three times a century," you're not fit to be an investor in common stock" – and you deserve the mediocre result you're going to get compared to the people who can be more philosophical about these market fluctuations."

Gold: an Explosion Waiting to Happen

Gold has seen "some of its thunder stolen by cryptocurrencies," says *FullerTreacyMoney*'s Eoin Treacy. Meanwhile "the negative real interest rates it hedges against have been slow to materialize." Consequently, the price of the yellow metal has been largely rangebound for five years.

The counter-trend rally that happened in the first half of 2016 is viewed by technical analysts as important. It was probably, Eoin says, "the pivotal point in the reversal of gold's fortunes… It is quite normal after such a move that an extended period of ranging lows unfolds – and that is exactly what has occurred over the last couple of years.

"Ranges are explosions waiting to happen." So when gold eventually makes a clear breakout above $1,400 an ounce, "it is likely to be surprising in its ferocity."

Tailpieces

Life insurance: Interesting to see how companies are shaping their policies to encourage healthier living.

One example from the UK's The Exeter is that policyholders can reduce their premiums by up to 35 per cent by reaching annual fitness targets. On the other hand, if their medical condition worsens, premiums can rise.

A 45-year-old man with a weight of 113 kg and body mass index of 39 who applies for £250,000 of level life insurance over a 20-year term is set a monthly premium initially of £52.80. He can reduce his premium by 4 per cent a year if he reduces

his weight to below 107.3 kg. However, if his weight increases to 122 kg, or he does not provide an annual reading, his premium goes up by 5.25 per cent.

Polluting the atmosphere: Although environmentalists continue to blame the natural gas industry in America for leaking methane. a greenhouse gas many times worse than carbon dioxide, it seems they're focused on the wrong target. According to the US Environmental Protection Agency, over the period 1990 to 2016, methane emissions increased "from sources associated with agricultural activities, while emissions decreased from sources associated with landfills, coal mining… natural gas and petroleum."

The biggest single source of methane emissions are animals – their flatulence and belching. This is a worsening global problem because billions of people in the emerging economies, as their incomes rise, are moving from plant-based to meat-based diets. The world needs to farm more animals.

Colluding with Russia: During the January Arctic cold snap, American utilities bought liquefied natural gas from Russia's Yamal project. New England politicians obsessed with alleged Russian interference in the presidential election nevertheless remained silent on this form of collusion with the enemy.

Energy investment banker Allen Brooks suggests this was because 'those politicians fear the blowback if their constituents' lights went out." Especially as they're the same politicians whose vocal opposition to coal and nuclear power, and to expanding pipeline capacity to import natural gas, as well as their forcing utilities to buy more expensive renewable energy, means New England has the highest electricity prices in the nation.

Political correctness: It serves ruling elites well as it allows them to continue pillaging the system, argues Charles Hugh Smith, whose blog is *OfTwoMinds*. "Symbolic speech acts as substitutes for real changes in the power structure."

Virtue signalling via social media, the parroting of progressive phrases, allows ruling elites to ignore demands for any radical restructuring of the incentives and distribution of the nation's wealth and income. "The labouring classes are being gutted by centralized financialization that rewards the few at the expense of the many."

Four tips from an expert: Here are four things you should NOT do when investing, according to Joel Greenbatt, the American investor, hedge fund manager and academic…

► Buy the big winners (in doing so, you eliminate "ugly" companies where the best opportunities may lie);

► Change the game plan after underperforming for a period of time;

► Change the game plan after suffering a loss (regardless of relative performance);

► Buy more after periods of good performance.

Oil: Global demand will remain as high in 2040 as it is now, says BP in its latest annual energy outlook. "The suggestion that rapid growth in electric cars will cause oil demand to collapse just isn't supported by the basic numbers, even with really rapid growth." By 2040 electric vehicles are expected to account for only 15

per cent of 2 billion cars on the road, while strong demand for oil will continue to come from trucks, ships and aircraft, which are harder to electrify than cars.

Coca-Cola: The world's biggest soft drinks company has decided to venture into alcoholic beverages after refusing to do so throughout its 125-year history. In Japan it's going to enter the market for Chu-Hi drinks – mixtures of vodka-like spirit shochu, flavourings and sparkling water whose sales have grown 40 per cent since 2011.

Looking East for income: A quarter of the world's corporate profits accessible to investors through listed shares are in the Asian emerging economies. Since the 2009 global financial crisis the net income of companies in emerging Asia has risen 2½ times, compared to less than 70 per cent at firms in the rest of the world.

Britain: Currently Brexit is the obsession of the political classes, but does it really matter? As Nicholas Wigdahl comments in a letter to the *FT*: "Most of the problems facing the UK have nothing to do with Brexit." He lists: Educational inequality, failing utility markets, poor infrastructure, low productivity and a non-functioning housing market.

Robotics: American private equity groups such as KKR are increasingly looking for takeover targets in Japan, said to be "still home to a group of companies with a leading edge in technologies including robotics and semiconductor chips."

Investment returns: Over the long term, equities have been the best asset class, according to the latest Credit Suisse global investment returns yearbook. They've delivered a real (inflation-adjusted) return averaging 5.2 per cent a year since 1900.

Finger trouble: A recent cyberattack on a petrochemical plant in Saudi Arabia only failed because the assailant made a single typographical error when inputting code. Without that, the hacker would have triggered a cascading explosion.

Australia: The housing market remains resilient, despite mortgage debt that has reached a ratio above 137 per cent of average household personal income.

Wise words: *The dumbest reason in the world to buy a stock is because it is going up.* Warren Buffett.

Martin

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