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Market Commentary

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The Pandemic

The Delta variant of Covid-19 emerged in India in April. It proved substantially more contagious than earlier variants and more virulent among the younger cohort. It drove a surge in infections in India which it is thought may have resulted in three million fatalities over the course of six weeks.

No one really knows as the regular cremation grounds were overwhelmed and the overflow was handled in neighborhood parking lots. As a result, the vital records are very incomplete. This variant has since spread around the world.

In the United States Delta is driving a new surge in infections. Although the vaccinated population is partially protected against Delta, only half the US population is vaccinated at present, so the US still constitutes a rich hunting ground for this predator. The unvaccinated population consists largely of four groups: Republicans, African-Americans with bad memories of the Tuskegee medical experiments, young people who only recently were cleared for vaccination and children who have not yet been cleared for the vaccine. Among unvaccinated adults, Republicans outnumber Democrats by 7 to 1. This striking partisan divide is an open invitation to use Covid as a tool with which to probe for a deeper understanding of American politics.

First, we note that the threat of the resurgent pandemic has caused a split in Republican ranks. In Kentucky Senator McConnell campaigns for the vaccine, while his colleague Senator Paul appears more interested in proving the highly doubtful theory that Covid was created in experiments funded by the Federal government. In Tennessee Dolly Parton campaigns for the vaccine against the far less famous governor, who nevertheless is proving more influential on this issue. Evidently there are limits to the powers of celebrity endorsement. In South Dakota, Republican governor Kristi Noem boasts of her reckless health policies, while in Alabama the Republican governor Kay Ivey castigates the unvaccinated for their lack of common sense. In Florida, Republican governor Ron de Santis claims the present surge is seasonal. He is apparently unaware that the variant now flooding his state's ICUs is a world-wide phenomena. More troubling, he seeks to forbid school districts from requiring students to mask up even as children start to form an appreciable number of ICU patients. School districts have long sent children with head lice home. We wonder if the governor also believes that head lice treatment should be left up to parental discretion. At Fox News, Sean Hannity vacillates on the vaccine, while colleague Tucker Carlson plays the role of Jim Jones distributing the anti-vaxxer kool-aid.

Interestingly, in each split it is the older person who favors vaccination, while the younger person leans against. We feel this alignment is not random. The older generation of Republicans are generally pragmatists focused on keeping taxes low and government regulation less intrusive. Younger Republicans, by contrast, are more ideological and more engaged by cultural issues than by economic issues. Certainly we see a similar alignment on the Democratic side, where it is the

younger generation of Democrats who appear more engaged by ideological concerns. From this point of view the true foil to the former President is not President Biden, but rather Bernie Sanders. Both Trump and Sanders are older movement politicians who have energized their respective party's younger cohorts with heavy dollops of ideological radicalism. When Democratic politicians boast that 'the adults are back in charge', they may speak more truth than they intend. American politics is roiled by a generational divide as much as by a traditional partisan divide.

Second, It is interesting to look at the mask/vaccine policy debate from a fiscal point of view. There is a lot of variation in costs and incidence figures, but even a rough calculation leads to a clear conclusion. The cost to mask up a group of 100 people is about \$500. The cost to vaccinate them is about \$8000 – of which half is the cost of the vaccine and half is distribution and administration cost. If no preventive measures are taken one or two persons in that group will die of Covid, typically after transiting a hospital ICU. Daily cost in the ICU is about \$10,000 and the typical fatal case will be resident for 10 days, leading to a cost of \$100,000 per fatality. The typical Covid victim loses 10 years of life they would otherwise have had. Valuing a year of life at \$50,000 (a typical figure used in wrongful death litigation) results in a cost of \$500,000. Thus each Covid death ends up costing about \$600,000. That is approximately 66x the cost of prevention. These estimates of cost are, in fact, a gross underestimate as we ignore all costs incurred by Covid survivors and all secondary costs engendered by social and economic disruption. In the same group of 100 there is about a 1 in 5,000 chance of a significant adverse vaccine reaction. This is less than a pedestrian's risk of being struck and killed by a bicyclist – a risk which does not keep many people off the sidewalk. There is simply no rational basis for opposing masking or vaccination. Indeed, parents who withhold masks and vaccines from their children might be exposed to charges of reckless endangerment.

Turning our eyes away from the United States to consider the wider world, we turn to examining vaccine progress abroad. In the first half of this year, the US vaccination effort was impressively ahead of the rest of the world. Surveying vaccination rates in benchmark international peers, the US effort is no longer impressive either in terms of absolute scale or of percentage of the population reached. In fact, the United States is now something of a laggard:

Doses Administered By July 31

| Country | Total (M) | % Population |
|---------|-----------|--------------|
| Canada | 48 | 64% |
| UK | 86 | 64% |
| China | 1,652 | 59% |
| Europe | 491 | 50% |
| USA | 345 | 50% |

Source: John Hopkins Covid Map, percent of population is calculated on the assumption of two doses per person. Europe in this case means countries west of Belarus.

None of these countries has yet achieved a vaccination rate which confers effective population protection in the face of Delta. Because China has relied on its less efficacious domestic vaccines, its protection factor, in particular, is less than these numbers suggest.

Looking beyond this group, vaccination results are even less encouraging.

Doses Administered By July 31

| Country | Total (M) | % Population |
|---------------|-----------|--------------|
| Turkey | 73 | 45% |
| Japan | 84 | 33% |
| Brazil | 135 | 32% |
| Russia | 62 | 21% |
| India | 470 | 17% |
| Indonesia | 68 | 13% |
| Rest of World | 586 | 12% |

These results have various causes. Turkey suffers from government maladministration. In Japan the population has high vaccine skepticism as the result of now long ago industrial accidents. In Brazil the President has indulged in running Covid folly. In Russia scientists have produced an excellent vaccine but the government is struggling to manufacture it and the population has high distrust of the government. India has a large domestic vaccine manufacturing capacity but it has an even larger population. Indonesia and the Rest of the World generally lack domestic vaccine manufacturing capability and are forced to the end of the vaccine delivery queue.

Countries which have succeeded in vaccinating most of their older population will be somewhat protected against high mortality from Delta. But the working age and younger population remains very exposed in most of the world. With vaccine manufacturing capability running well behind demand, masks, lock downs and other public health measures will remain important nearly everywhere. One infers that world economic recovery will be a halting and long drawn out affair. We believe that the road out of this epidemic consists of a concerted whole of society effort which eradicates Covid locally and which gradually expands the virus free zone into a larger and larger fraction of the globe. In the United States a consensus in favor of such an approach may be slowly emerging, but there is still considerable misplaced optimism, denial and political resistance which saps the US effort of efficacy.

For the moment we expect that the pandemic will continue to run its course faster than the US's capacity to form a consensus and take effective action.

Domestic Politics

Against the odds, moderates of both parties in the US Senates have negotiated an infrastructure bill which appears likely to pass into law. It provides for \$1.2 trillion in spending over ten years to repair and improve the nation's physical infrastructure. Funding of this expenditure is by Congress's favored mechanisms – fiscal shell games and optimistic projections of economic growth. The bill will be significant for industries directly involved in the spending – notably civil construction, broad band and electric power distribution. We do not think the spending on its own will dispel the economic headwinds the epidemic has produced. A larger partisan social spending bill is working its way through the Congressional process. What the outcome of this bill will be is not yet clear. We think the large canvas of social spending which the president has put forward is likely to be cherry picked for a collection of broadly supported individually compact projects. The bill is likely to be financed by tax raises on capital incomes and high wage earners coupled to continued deficit spending.

President Biden and the auto industry appear to be reaching a consensus on the phaseout schedule for the internal combustion engine. Currently electric vehicles constitute 3% of sales. The emerging target appears to be raising that to 50% by 2030 and to nearly 100% by 2040. With a typical road life of ten years, that implies extinction of gasoline and diesel sales by about 2050. At current prices, full life time costs of electric and gas cars are about the same. However, electric vehicles give auto manufacturer's a larger slice of that value chain. It is unsurprising that the auto manufacturer's have shifted to being electric vehicle advocates.

From the proposed wind down schedule we can begin to estimate residual value in the oil industry. There are a number of uncertainties: will the expansion of market share by electrical vehicles follow an arithmetic or geometric course, how much contraction will there be in oil industry profit margins as revenues contract and what will be the residual value in the oil business after the exit from road vehicle fuels. Cautiously, we assume electric vehicle market share grows at 20% per year, that profit margins contract steadily to 50% of current levels as the oil industry contracts and that residual value is 15% of current value. The assumption of that the market share growth rate will achieve by 2030 only an 18% market share for electric vehicles instead of the 50% targeted. But it does achieve phase out by 2040. Basically technology adoption starts slower but ends faster than the figures being put forward by the President and the auto industry. As a result it increases the value of the oil business above what the value would be under the proposed phaseout schedule. Under these assumptions an 8.5% dividend yield is required simply for capital recovery on oil stocks. We note that Exxon currently yields 6%, so the market appears more optimistic about the prospects for this group. Less contraction in the profit margin and more residual value in natural gas might help to close the gap between model value and market value.

We note, however, that Germany has recently begun testing delivery of electricity to heavy trucks through overhead cables strung along highways. Once this technology is field proven it could lead to a program whereby the Federal government electrifies key portions of the interstate and heavy truckers switch to hybrid powered tractor units. With the Federal government fronting the capital cost of electrification recaptured over 50 years through user fees and the truckers capturing immediate savings in operational costs the economics could result in industry enthusiasm for such a program. This is an example of how emerging technology news is likely to contract rather than enhance values in the oil sector. We advise investors to avoid the sector at current valuations – especially in taxable accounts.

The nation's political battle continues. The Justice Department has charged more than 500 individuals over their role in the January 6 insurgency. It has begun processing plea deals from minor offenders. Typically they plead guilty to a misdemeanor charge, are sentenced to time served and are given a modest fine. Given that the typical offense amounts at a minimum to aggravated breaking and entering, there is significant leniency involved in this approach. Indeed, the judges have criticized the Justice Department for excessive leniency even as they go along with the plea deals. An important point of detail is whether the deals will result in the insurgents losing their gun rights. Under Federal law pleading guilty to an offense for which the maximum sentence exceeds a year, regardless of the actual sentence imposed, results in loss of gun rights. It is unclear whether the Justice Department is structuring deals with this end in view, but one would hope known insurgents are not being turned loose to build personal weapon stacks. The Justice Department has revealed very little regarding how it will proceed with major offenders. Continuing investigation is making it clear that the January 6 insurgency was simply one battle in a broad campaign by Trump to overturn

the results of the national election. At some point Biden will have to confront head on the extraconstitutional agenda of Trump and of his supporters in the Republican party.

International Politics

International politics has been relatively quiet – a fact which we attribute to the ongoing Olympic games. It is unclear whether the world's various troublemakers are avoiding adverse publicity during the games or whether they are simply too busy rooting for their home teams to bother with other forms of international competition. We would hope it is the later. Be that as it may, existing trends remain in place. The Taliban is advancing rapidly in Afghanistan and appears poised to re-establish their Islamic state. That result implies the bloody uprooting of the civil society the United States has labored for 15 years to create in Afghanistan. China, true to its long standing role of the great power sponsor of regimes too unattractive for the Russians or the Europeans to back, has rushed in with pledges of support for the Taliban. This is a considerable change on China's part as, prior to the US invasion, it did not recognize the Taliban government. At home President Xi continues to consolidate power, with Hong Kong and the general business community being the latest targets for oppression. President Biden is extending political refuge status to Afghans and Hong Kongers – a move supported by the Republican party despite its general anti-immigration stance.

The Financial Markets

Overall the markets were quiet in July with major components continuing their recent behavior.

Equities

| | |
|-------------------------|--------|
| US Large Cap | 2.28% |
| US Small Cap | -3.63% |
| Spread | 5.91% |
| International Developed | 0.77% |
| International Emerging | -6.44% |
| Spread | 7.21% |

Other

| | |
|-------------------|--------|
| 10 Treasury Yield | -0.20 |
| Gold | 2.30% |
| Euro | -0.08% |

The realization that the pandemic is not going away quickly generally favored large cap US equity over small cap and developed markets over emerging. Treasury bond yields eased 20 basis points as Fed stimulus looks to be continued somewhat longer. The inflationary concerns engendered by continuing monetary ease were modestly beneficial to gold. The Euro moved towards the bottom of its trading range. But generally the picture is one of stability with no especial volatility.

Assessments and Advice

There is plenty of latent capacity for turmoil in the pandemic, in politics both international and domestic and in relative sector valuations. Investors should expect episodic bouts of turbulence to spill over into the markets. Overall, however, we remain in an economic expansion driven by gradual recession of the pandemic. Portfolios should be reviewed and rebalanced periodically but there is little reason for major realignments at present. On the horizon, shifts in tax policy and the pandemic are the matters which investors should monitor most closely.

