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Market Commentary

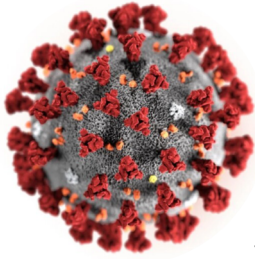
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American Politics

The pandemic has altered American life in several subtle ways. Willingness to engage in remote educational and business relationships is much increased. Parents are paying more than usual attention to what happens in school and are not particularly happy with what they see. Shoplifting gangs have become far more active, ambitious and visible.

These shifting currents wrong footed several senior politicians, who suffered either out right defeat or narrow escapes during the November off year election. The election provided a necessary reminder to America's progressive politicians that their political faction is the most disliked component of the American political scene. After the election they meekly acquiesced to a halving of the Build Back Better bill. It remains to be seen if even that reduced measure can pass moderate scrutiny in the Senate. Republicans meanwhile are cock-a-hoop. They are convinced that the electoral tick-tock and their own eager efforts at gerrymandering will deliver them a decade long run at controlling Congress. So sure are they of success that they are already fighting over the spoils. The Republican party itself is so firmly under the control of former president Trump that party funds are being used to pay for the legal defense of Trump's private business against the (strongly supported) charge that it engaged in a multi-decade scheme of tax evasion.

We think this is all a little over blown. To our eye the senior politician located closest to the fulcrum point of American politics remains President Biden. This means that, while he will endure continuing attacks from left and right, it is his views which are likely to prevail in the long run. Currently it is in the court house where the most current read on politics is being delivered. In Wisconsin a minor who brought a long gun to a riot was excused from legal consequences of using the gun to kill two and wound a third. However in North Carolina the organizers of a violent race riot were held civilly culpable, and in Georgia a nearly all white jury convicted three white men of first degree murder for hunting down and killing a black jogger. Still pending before the courts are the President's efforts to manage the pandemic and to control the border. Also pending is the question as to whether private gun rights should be expanded and whether abortion rights should be curtailed. The radical right position is that Constitutional rights to guns should be expanded and that abortion should be returned to control by the States. We expect the courts to move incrementally. The President's powers are likely to be sustained as there is no other home for public health and border responsibilities. With law and order an increasing public concern, the tide is not running in favor of weakening police powers over guns. Dialing back the fairly arbitrary viability test of Roe v Wade to something like a first trimester test offers the Supreme Court a more attractive resolution than abandoning Constitutional regulation of abortion altogether. Finally the efforts to try the January 6 insurgents and to document the organizers's role in that event grind along. Sentences have been growing harsher as ring leaders move through the court room and Congressional oversight is growing more muscular. We think for those on the wrong side of this issue the experience is likely to resemble the nightmare of being chased by a steam roller – you can run but you cannot escape.



The Pandemic

A serious surge in the epidemic is underway in Central Europe with 70,000 new cases per day being reported from Germany. The underlying problem is vaccine reluctance. That reluctance is approximately the same level as in the United States. While associated with the right wing (as in the United States) the vaccine hesitancy in Central Europe (Germany, Austria and Switzerland) is actually quite different. Vaccine hesitancy seems to be rooted in distrust of the State (in former East Germany), in dedication to nature cures and homeopathy (Switzerland/Austria) and in skepticism about pharmaceutical companies (parts of North Italy.) The vaccine hesitancy thus emerges out of the long term history of the region. In the United States, by contrast, there is a fairly glorious history of public health controlling infectious diseases and today's vaccine hesitancy is in opposition to that history rather than a development from it.

A new Covid variant labeled Omicron has developed in South Africa and spread rapidly there. Its high level of mutations raises the possibility that that it will be more resistant to antibodies, whether derived from vaccination or from past infection, than the currently dominant delta strain. The United States and European governments have reacted promptly with travel bans. This is a notable increase in prudence from their prior posture of acting only in response to well developed threats. While they are learning prudence, they are probably still behind the curve in controlling the spread of this new variant. In general all developed countries need to increase their testing, increase their strain monitoring and increase their vaccination rates to near universal levels. Until these steps are taken new variants and surge outbreaks are highly likely to continue. In the US the virus appears to be taking up residence in white tailed deer– a possibility about which we raised concern many months ago. If this animal reservoir becomes a source of human infections, border controls will lose much of their effectiveness as a control technique.

International Politics

The Chinese and Russians sailed a joint naval force around Japan. Russia's interest in entangling the US and China in a confrontation in the Far East is clear, as it would likely give Russia more liberty to maneuver. The immediate consequence of the cruise, however, was to speed a hefty increase in Japan's defense spending through the legislature. How that outcome benefits China is less clear. To China's troubling level of aggression we should perhaps now add a troubling degree of inexperience with great power politics. In fact, President Xi found it necessary to assure the ASEAN countries that China was not aiming for regional hegemony. In diplomatic speak this is roughly an admission that your ambitions have become so apparent that you must provide your friends with cover for denying them. China's probing of Taiwan's defense perimeter continues at a high level of activity.



At the other end of Eurasia, Russia has massed troops on the Ukrainian border and allegedly sought to bring about a coupe attempt in Kiev – perhaps so it can intervene militarily to “restore order” (i. e. to seat a Russian puppet government.) Not since Stalin was blockading Berlin and Mao Tse-Tung was sending the Chinese army to battle the Americans in Korea have we seen such willingness to play footsie with a world war.

There is, however, a significant difference today. Stalin and Mao knew they could risk a failed foreign adventure with no risk of personally losing power in the aftermath. Putin and Xi, however, can have no assurance that they would personally survive a major failed foreign adventure. This consideration will make them slower to commit to conflict but more ready to go “all in” should things get to that point.

Both Russia and China have significant internal issues. Russia is struggling badly with the epidemic as the public so distrusts its government that it will not use Russia's technically advanced vaccine. China faces a severe cyclical downturn in its property development sector which accounts for 30% of GDP. China also faces a potential Covid bomb as much of its population has not yet received an effective vaccine. Sabre rattling to distract the local populace from these issues seems likely to continue.

Actually launching what could become a world war seems less likely. We regard both Putin and Xi as dangerously ambitious leaders but also as smart highly calculating statesmen. Unfortunately they sit a top large bureaucracies which mirror their ambitions without necessarily embodying their intelligence.

The Green Economy

The climate summit in Glasgow opened to disparaging comments by such different voices as Greta Thunberg and Queen Elizabeth II as to the event being all talk and no action. Indeed the final agreements were modest and the volume of speechifying generous. Such is the nature of multilateral diplomacy. To focus on these qualities, however, is to miss an important development. What is clear is that carbon control has moved from the aspirational stage of earlier conferences to the implementation phase. We are at a point where real progress is more likely to be made by technical working groups than by head of state summitry. No issue better illustrated this point than coal. The US is well along the path to phasing out coal and Europe also is broadly committed to this program. The major remaining coal users are China and India. They were unwilling to commit to hard deadlines for phasing out coal. However, in both cases it is clear that the technical road map for this step is not yet worked out in the context of their specific economies. Their willingness to develop such road maps will be highly informative as to the reality and the urgency of their commitment to carbon control. The decision to hold annual review meetings in addition to the five year summit meetings is a definite recognition that policy making has moved into an implementation phase.



Inflation

US dollar inflation is running at about 5% per year. A variety of labor strikes have broken out during the summer months. Some strikes seek pay raises which points to the possible beginning of a wage-price spiral. However, work practices are also a common reason for strikes and appear focused more on addressing onerous employer behavior than in responding to rising price levels. The cause of the inflation is obvious—a highly accommodative

monetary policy that has successfully carried the economy through the pandemic without the deep depression that otherwise would have resulted. However, this monetary stimulus is inflating capital asset balloons – especially in the area of cryptocurrency and block chain startups, but also in real estate prices, precious metals and consumer debt. Investors should begin to factor in an inevitable hard landing.

The US Economy

For businessmen the current economy is excellent. Real GDP is above its prepandemic peak and expanded at a 2% rate in the third quarter, down from the 6.5% rate of the first half. The stock market has been rising steadily and equity capital is readily available. Real interest rates are negative and debt capital is correspondingly cheap for the credit worthy. Proposed tax changes are at worst incremental negatives. Federal infrastructure spending promises long term fiscal stimulus to the capital goods sector and eventually productivity improvements for the economy as a whole. Many self defeating tariffs and trade wars have been wound down. Certain sectors remain disrupted by the epidemic and its consequent labor shortages, tangled supply lines and shifts in consumer spending. Outside of these areas, however, the economic climate is favorable.

For workers the economy is more of a mixed bag. Total employment is about 4 million below its prepandemic peak and about 6 million below trend line. The unemployment rate is low, however, at 4.4%. The discrepancy between these two figures indicates that significant numbers of workers have withdrawn from the labor market at least temporarily. Wages have been rising, but so has the cost of living. Real wage gains by the employed are at most modest. Eventual passage of the Build Back Better Act will be supportive for certain parts of the labor force – most prominently working women with family care responsibilities. However, it will be the ending of the pandemic and control of inflation which will provide the greatest benefit for workers and retirees.



The Markets

For the most part markets have been flat over the six month time frame. Areas of strength have been in the safe haven sectors of US Large Cap, Long Term Treasury Bonds and the Dollar (in the three month perspective.) But trends have not been compelling and the reversal driven by the advent of

the Omicron strain of Covid-19 have driven most markets into negative territory over the one month time frame. This reversal is particularly sharp for Oil. Only the dollar and Treasury bonds have continued to show strength.

Sector	Returns 3 Month	1 Month	Trend 6 Month
Equity			
US Large Cap	5.03%	-1.71%	rising
US Mid Cap	-2.18%	-4.05%	weakly rising
US Small Cap	-4.15%	-1.93%	flat
US Preferred	-2.64%	-2.47%	flat
Foreign Developed	-5.80%	-5.68%	flat
Foreign Emerging	-8.10%	-4.95%	falling
US Bonds			
Treasury Medium Term	-1.15%	1.09%	flat
Treasury Long Term	1.98%	3.69%	rising
Treasury Index Linked	0.91%	1.47%	weakly rising
Corporate Investment Grade	-1.61%	0.06%	flat
Corporate Medium Grade	-2.53%	-1.03%	weakly falling
Municipal	-0.32%	0.80%	falling
Commodities			
US Dollar/Euro	4.23%	1.99%	rising
Gold	-2.09%	-1.11%	flat
Oil	-3.09%	-20.92%	rising



Investment Advice

Until the pandemic is under better control financial markets are likely to remain in the current holding pattern. Continuance of the epidemic offset by monetary stimulus will maintain or accelerate the current level of inflation. If inflation further accelerates performance of TIPS relative to Treasury long bonds would likely improve. Necessary for control of Covid are increased manufacture, improvement and distribution of vaccines (ongoing) combined with formation of a social consensus that the disease must be defeated (currently absent) and translation of that consensus into vigorous government policy (halting at present.) The epidemic currently seems unlikely to end as an economic force before midyear 2022 at earliest. Once the pandemic is clearly dying out we would expect a shift in financial markets as performance of more speculative asset classes improves relative to current leadership. The primary challenge to this recovery scenario is increased political turmoil, either domestically or internationally. In particular, launching of a military adventure by China, Russia or one of their clients (North Korea, Pakistan, Iran) could unleash considerable volatility. We think that possibility unlikely, however. Significantly more likely is that capital markets continue to grind out positive results for investors that in the long term prove highly meaningful.