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Nicolo G. Torre
Ph.D. CFA
Managing Director
Lloyd Tevis Investments

3658 Mt. Diablo Blvd
Suite # 201, Lafayette
CA 94549

Market Commentary
December 2022

The Russo-Ukrainian War

Ukraine recaptured the city of Kherson. This victory represented the successful completion of a three month campaign which had cut the Russian lines of supply and forced them to withdraw from the west bank of the Dnieper. Currently the Ukrainians are targeting supply lines through the crossroads town of Svatove in the northern sector of the conflict.

It seems likely the Ukrainians will continue their attacks on Russian command and supply points, in the process forcing the Russian field army back without the blood letting of a major frontal assault. Meanwhile, the Russians are mounting repeated attacks on dug in Ukrainian positions in the Donbas. They make little progress despite heavy casualties and suffer steeply declining morale in consequence. In particular, the town of Bakhmut may be becoming this war's Verdun – a point over which far more blood is shed than its strategic position warrants simply because the commanders feel committed to its capture/retention respectively.

The Russians admit to having abducted approximately 40,000 Ukrainian children who they are distributing across Russia. This policy is an attempt to eliminate the Ukrainian political/cultural identity. It is most probably an international crime under the Convention on the Prevention and Punishment of the Crime of Genocide. Until Russia is prepared to return these children it seems that peace talks are futile. Reversal of these extreme nationalist policies on Russia's part seem only likely to result from a more complete military defeat of Russia than we have seen thus far. To bring that defeat about at acceptable human cost, the NATO allies may find it necessary to equip Ukraine with additional war winning weaponry. One possibility is a tactical air force that can hold the airspace over the battlefield. Doing so would be a highly complex and time consuming operation. Not only would equipment need to be supplied and pilots trained to fight it, but the whole crew of ground support personnel would also require training. Perhaps NATO recognized this need and set about the task some months ago. Perhaps they are only just now beginning to see the necessity. In any case, it seems likely this war will continue until Ukraine can deploy a crushing military advantage.

US Elections

The midterm elections were a serious disappointment to the Republicans. The reapportionment resulting from the decennial census was expected to increase their representation in the House of Representatives from 210 to 220. The Republicans completely expected the regular tick-tock of American politics combined with a not very popular president and concerns about inflation and crime would deliver to them another 20-30 seats. Thus, they had every expectation of taking control of the House with a durable majority above the minimum required of 218. In addition, they had hopes of gaining two seats in the Senate, which would give them control of that chamber as well.

Planning an omelet with the eggs not yet laid, the Republicans made no secret of how they intended to use this new power. They would threaten to push the government into default if their demands for spending cuts were not met. They would investigate the President's (nonpolitical) son in an effort to embarrass the President and they would carry out wide ranging investigations of his administration. They even indulged in wild talk of impeaching the President, although no credible cause was ever put forward. In short, they were bent on political mayhem and eagerly looking forward to payback for the Democrat's efforts to hold Trump accountable for his misconduct in office. Busy with these plans, they omitted to prepare any policy positions to champion.

The public, however, proved reluctant to indulge this partisan blow out. The Republicans indeed gained control of the House but with a scant majority of 3 rather than the expected 20. Probing deeper into the numbers shows just how weak this result is. Over 80% of the seats in the House are considered safe seats – meaning the same party wins the seat year after year. Here the Republicans can count on 198 seats from mainly rural counties, while the Democrats have 164 safe seats in mostly urban districts. There remain 73 seats which are somewhat competitive. In this election (see table 1) the Democrats took 70% of the competitive seats. While this fell just short of offsetting the Republicans advantage in safe seats, it meant that the Republicans saw essentially no pickup in seats beyond what they gained from redistricting. Indeed the three extra seats the Republicans gained seem to have been mainly due to the carelessness with which the New York State Democratic party handled the election.

Table 1: House of Representatives Election in 2022

Outcome of Competitive Races

Type of Seat	**Number**	**Democrat**	**Republican**
Leans Democrat	27	26	1
Tossup	28	21	7
Leans Republican	18	3	15
Totals	**73**	**50**	**23**

Final Result

Party	**Safe Seats**	**Competitive**	**Total**
Democrat	164	50	214
Republican	198	23	221
Totals	**362**	**73**	**435**

Looking beyond the House, results darkened further for the Republicans. They lost a seat in the Senate and lost two state governorships. It is considered a norm of American politics that the President's party does poorly in the midterm after the President's first election. However, this year's midterm delivered the best result for a Democratic president since Franklin Roosevelt's first midterm in 1934 (table 2.)

Table 2: Comparison of Past Midterm Results to 2022 Results

Part of Government	**Past Result**	**2022 Result**	**Swing**	**Percentage**
Senate	5	-1	-6	-18%
House	50	11	-39	-9%
State Governors	5	-1	-6	-17%

Past result shows average gain by Republicans in first midterm faced by Clinton and Obama. Units are seats except for percentage which is seat swing as a percentage of seats available.

Pundits were caught by surprise by the 2022 result and are scrambling to understand it. However, in our October commentary we noted that Biden's conduct of his office is more successful than most give him credit for, and we opined that the midterms would be decided by a host of local issues rather than by sweeping national reassessments. Here the Republicans shot themselves in the foot by nominating, at Trump's behest, a host of weak ideologically charged candidates selected for their loyalty to Trump rather than their electability. Compounding the party's difficulties, many of the party's major donors belong to the moderate wing of the party which Trump has tried to drive into exile. They declined to back Trump's nominees, and – taking the long view – may have been quite satisfied with the outcome of the election. In short, the election was the Republican's to lose and lose it they did. Less kindly, Karl Rove delivered a postmortem on the election as "we [the Republicans] nominated too many crazies and wierdos."

After a stinging disappointment the political knives are out. It seems many will end up in Trump's back. In our September commentary we noted that Trump, beset by critical legal problems, appears to be a waning force. This election result is likely to accelerate that trend. If this election had one clear message, it is that the public is unlikely to trust the Republicans with real power until the party disassociates from Trump.

Ron De Santis, the Republican incumbent Governor of Florida, had a good election in which he soundly trounced a Democratic has been. His victory margin was strongly buoyed by support from the Latin community to which De Santis belongs. De Santis makes no secret of his national aspirations. Here he is positioning himself to the right of Trump. In effect he offers a "Trump without the baggage candidacy." The next two years should sort out the potential for a Latin Trump version 2. De Santis could either develop into a formidable national candidate or prove to be just a favorite son with limited appeal beyond Florida. In particular, Trump has very much made himself the candidate of white voters who feel their socioeconomic status to be under threat. It remains to be determined if a Latin candidate can plausibly position himself as the champion of this demographic.

In addition, Trump is likely to fight fiercely to hold his base, and that opposition definitely complicates the career of a would be successor. Trump himself rushed to battle with an announcement of his candidacy for president immediately after the election. This move was undoubtedly more to forestall Republican aspirants than to engage with the Democrats.

Meanwhile, back to the gentle art of governing. The Republican House and the Supreme Court will continue to blockade Biden at every opportunity, but they lack the power to make policy. With Democratic control in the Senate, appointments of government and judicial officials should be safe from political hostage taking. Dramatic partisan confrontations such as threatened defaults or government shutdowns are unlikely to be sustainable in a House with such a slim majority. In short, the wheels of government should continue to turn relatively smoothly. The likelihood is that the Republican House will consume itself with investigations which ultimately prove as profitless as John Durham's investigations. Trying to attack Biden through his son could in fact recoil on the Republicans as a distasteful partisan excess. For investors the preferred outcome is that Congress not generate financial crises and that it focus on organizing a national response to China. Possibly the Republicans will realize their planned omelet is cold, and they will in due course rethink their agenda. In that case, Biden may well be able to marshal real bipartisan support for his foreign policy.

Abroad, America's friends and allies will take heart that the Trump fever appears to be breaking and the US is proving once again a force for stability. America's enemies may make similar assessments, but that is unlikely to change their policies.

Turmoil Abroad

Demonstrations against the regime continue in Iran and have been joined by similar protests in China. Neither protest movement yet appears a credible threat to the entrenched governments, but both governments appear likely to be focused on the home front and slow walking their foreign ambitions for the moment.

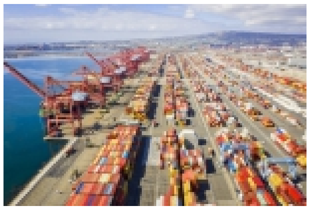
Crypto Collapses – Again

The Bahamas based cryptocurrency exchange FTX has collapsed. The primary cause of collapse seems to have been embezzlement of client deposits to fund market speculation. A lack of accounting controls and outright looting by employees seems also to have played a part. Among those who might have known better but are now totting up losses honorable mention goes to Sequoia Capital ($200 million), Ontario Teachers ($100 million) and BlackRock (undisclosed.) This is an opportune moment to reprint our advice, first published in 2021, that investors avoid cryptocurrency. Cryptocurrency lacks a sound investment case, an adequate regulatory framework and a natural constituency of legitimate investors. What cryptocurrency does not lack is all the indicia of bubbles, market manipulation and outright fraud.

The US Economy in 2022

As the books close on the year this is a good moment for an annual assessment.

Covid – The year opened with a severe spike in Covid. Weekly hospital admissions were at the 150,00 level for most of January. Deaths from Covid were at at the 3500/week level hospitalizations in early February. The primary variant of the virus was Omicron which was more contagious but less lethal than the previous Delta variant. In the rest of 2022 infections decreased rapidly. Hospitalization have been steady at 25,000/week and deaths at 2500/week, i. e. at about 10% of those hospitalized. Fortunately significant new variants of the virus have not yet evolved. A vaccine tuned to the Omicron variant has been produced and appears efficacious, but so far only 12% of the population has chosen to use it. These leaves the population as a whole vulnerable to another seasonal spike. Hopefully it will not be as bad as the January 2022 spike.

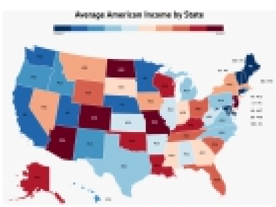


GDP – Real GDP was impacted by Covid in the first quarter and it decreased by 1.6%. In the second quarter improvement was exhibited in the form of a smaller decrease of 0.6%. In the third quarter GDP increased by 2.4%. Estimates for the fourth quarter range from 1% to 4%. Assuming 2.5% for the fourth quarter (i. e. steady with Q3) the result for the year will be 2.6%. This result is inline with long term expectations.

Inflation – Easy monetary conditions, supply chains snarled by Covid and commodity price rises caused by the Russo-Ukraine war all fueled sharply higher inflation in 2022. Measured by the all inclusive CPI measure inflation ran at a 7.7% annual rate in the year. Measured by the index of personal consumption expenditure ex food and energy the inflation rate is 5.1%. This measure, because it removes the volatile food and energy categories, is sometimes thought to give a better measure of the core inflation rate. However, in the present instance food and energy are directly impacted by the war and we are skeptical that their price increases should be excluded from the analysis.

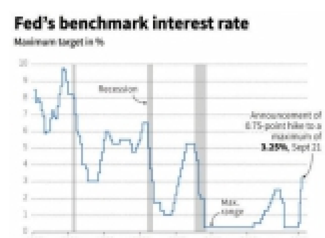
Monetary ease has given way to Federal Reserve tightening. This tightening has buoyed the dollar, which causes the costs of certain imports to decrease or at least not increase rapidly. Supply chains have to some degree sorted themselves out. Energy and commodity prices have relaxed from their initial panic levels and may decrease further. In the broad (CPI) measure of inflation a slowing of inflationary forces can be seen, but so far there is no slowing in the narrower “core” rate.

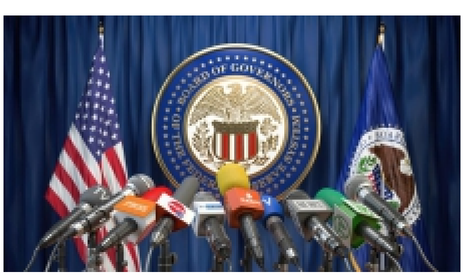
Employment – Employment has been steady all year with an unemployment rate of 3.5-3.7%. This rate is normally referred to as “full employment”, since job switching and temporary leaves usually generate this base level of unemployment. Average hours worked per week has been steady through the year, indicating the employed labor force is neither surging overtime nor enduring furloughs.



Personal Income – Personal disposable income increased 2% in 2022. However, after inflation adjustment, real disposable income fell 2.3%. The burden of inflation was likely felt more strongly in the lower income demographic as food and energy consumption represent a greater fraction of personal budgets for this demographic.

Interest Rates - As the Federal Reserve has tightened, the Federal Funds rate has increased from 0.25% to 4%. The ten year Treasury rate has increased from 1.64% to 3.68%. Thus the change in the average of the two rates is 2.9% and the slope of the yield curve has gone from +1.39 to -0.32 for a total change of 1.71. The prime rate has gone from 3.5% to 7% and the prime mortgage rate from 3.1 to 6.6% for a similar increase of 3.5%.





Assessment – It appears a fairly average year. Fairly large knocks were administered to the economy by Covid, the Russo-Ukraine war, inflation and Federal Reserve tightening. The machine that is the US economy kept on lumbering along, however, and the impacts of these events appeared to have largely dissipated across the economy as a whole.

For much of the year the editorial columns of both the New York Times and the Wall St Journal have been filled with consternation at the Fed's tightening. Contrary to the editorials, the Federal Reserve appears at this moment to be pulling off the most difficult of reserve bank feats – a soft landing for an overheated economy. We are expecting interest rates to continue upwards, but perhaps at a more judicious rate of 0.5% per move rather than the 0.75% heretofore. Once the inflation rate drops below the Federal Funds rate we expect rates to plateau and then gradually relax as inflation drops to its target range.

The Markets

Most equity markets enjoyed a good rally in November. As a result we feel their downward momentum has broken and we now show these asset classes as range trading in the past six month view. Although fixed income markets also showed some strength, we were not persuaded that this was more than a bear market rally. As a result we continue to hold their six month trend as falling. The same remarks apply to most commodities. Gold was the exception and appeared more equity like.

Table 3: Recent Market Performance

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	range trading	-0.21%	2.99%
	US Large Cap Growth	range trading	-5.16%	2.43%
	US Large Cap Value	range trading	4.60%	3.20%
	Growth – Value	range trading	-9.76%	-0.78%
	US Mid/Small Cap	range trading	1.17%	1.38%
	Intl Developed	range trading	8.03%	10.00%
	Intl Emerging	falling	-3.89%	7.95%
Fixed Income	3-7 Year Treasury	falling	-1.72%	1.85%
	7-10 Year Treasury	falling	-2.81%	3.02%
	TIPS	falling	-3.94%	0.60%
	Muni	falling	0.46%	3.81%
	Investment Grade	falling	-2.19%	3.18%
	Medium Grade	falling	-0.19%	0.91%
	Preferred	falling	-3.26%	4.78%
Commodity	REIT	falling	-10.08%	2.55%
	Euro	falling	3.45%	5.14%
	Gold	range trading	3.16%	5.89%
	Oil	falling	-9.31%	-11.31%

We should possibly recognize the Euro also as range trading.

It is expected that Equity markets will be more forward looking while Fixed Income and Commodity markets are more reflective of current conditions. This market picture is consistent with the view that interest rates will continue rising but we may be approaching an inflection point about 6 months further out. Meanwhile markets are likely to remain volatile and prone to turn on a dime until this bear phase is clearly seen to be winding down.

Advice

After twenty years of economic and political uproar, the United States is enjoying a period of competent government, relative peace and a normal economy. As the business cycle turns, some renewed prosperity should arrive next year. An upward turn in real disposable income will sweeten the currently sour public mood. We think the longer term outlook remains strongly encouraging. Investors should stick with their long term strategies.