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## Market Commentary

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## Major Developments

### Covid-19

The COVID-19 Pandemic remains the dominant factor worldwide. Here the medical news is encouraging. Several vaccines are in or about to begin Phase 3 trials. A success here will provide a long term solution to the problem.

Meanwhile, drugs and therapies are being deployed to better treat the illness and so reduce suffering and death from it. A most important development has been provided by research on face masks. It is now established that wearing a face mask limits spread of illness by asymptomatic carriers to others. A public policy of universal mask use can thus deliver a result similar to the herd immunity established by mass vaccination. This is the first measure that effectively addresses the problem of asymptomatic carriers short of lock down. High mask usage in Asia is now believed to underlie the generally better experience of those countries. Unfortunately, in the United States mask wearing has become a political statement and is rejected by a fraction of the population. Similar to refusing vaccines, the consequence is to defeat herd immunity. One of your authors (NT) is old enough to remember a time when mothers caring for sick children routinely wore masks and he wonders at how mask wearing silently transmuted into a badge of shame. While rejecting masks has something in common with the rebellion against neckties and high heels, those sartorial statements do not have the consequence of spreading a deadly disease.

Currently US deaths from Covid stand at 120,000. The statistical evidence coming in suggests that in large parts of the country lock down was lifted prematurely and/or before adequate alternate control measures were in place. This is the scenario our medical professionals warned us against and they appear to have been correct. The epidemic appears to be reigniting, but so far public authorities are loath to admit they made a mistake and to introduce effective counter measures. This disease gives no quarter to those who fail to take it seriously. We will not be surprised to see deaths climb to 200,000 and at least regional lock downs to be reintroduced. We initially expected the economy to recover quickly post lock down and it has indeed been recovering faster than the consensus estimate. We now, however, fear that mishandling of the epidemic may abort that recovery midcourse and that full recovery will be postponed to spring or summer of next year.

Turning from the United States, let us take a moment to survey the impact of the pandemic abroad (see table next page.) The three continental regions have approximately equal size, but Asia with many more people, has a generally lower per capita income. In Asia, effective government action substantially protected the population from the ravages of Covid-19. In Western Europe and the United States, by contrast, deaths per million are 32x (Canada) to 92x (UK) higher than in Asia. The impact on GNP primarily reflects timing differences. China took nearly the full impact in Q1 with a decrease in first quarter GNP of 8.1% (not annualized.) Europe's impact will straddle Q1 and Q2 while North America will take most of the impact in Q2. The total impact will probably be on the order of 8% in all three regions. Equity markets have fallen across the board and government bond rates also have dropped everywhere. A regression of equity market return on GDP per capita and

Deaths per million explains 54% of the cross-sectional variation. Basically rich and/or low impacted countries have suffered smaller stock market declines than poor and/or heavily impacted countries. Interest rates have moved most in North America, less in Europe (where they were already low) and least in Asia. Outside the continental regions, Arabia reflects the impact of lower oil prices while Brazil exhibits the misery of misgovernance in a middle-income country. Overall India, Australia and Japan demonstrate effective disease control achieved in democratic countries at low economic costs. China's claim that its success in disease control is a function of its autocratic government is not supported. Poor health performance in Europe and North America primarily reflects the lack of recent experience with epidemics and resulting gross ignorance, in both government and populace, about the necessary policy response

Region	Entity	Size		COVID-19		Economic Impact			
		GDP 2019 \$ Trillion	Population Millions	GDP per capita \$000 per person	Deaths total	Deaths per million	GNP 2020Q1 % change	Equity Mkt % change YTD	Chg Bond Rate %age points YOY
North America	US	21.44	331	64.8	123,476	373.0	-1.3	-5.6	-1.30
	Canada	1.73	38	45.9	8,454	224.2	-2.1	-9.2	-0.80
	Mexico	1.27	128	9.9	23,377	182.6	-1.2	-12.9	-1.95
	All	24.44	497	49.2	155,307	312.7	-1.3	-9.2	-1.35
Europe	Europe	19.84	453	43.8	134,722	297.1	-3.6	-14.7	-0.16
	UK	2.83	68	41.7	42,927	633.1	-1.9	-18.8	-0.71
	Russia	1.67	145	11.5	8,359	57.6	n/a	-8.3	-2.29
	All	24.34	666	36.5	186,008	279.2	-3.1	-13.9	-1.05
Asia	China	14.57	1,446	10.1	4,640	3.2	-8.5	-2.3	-0.69
	Japan	5.15	126	40.9	955	7.6	-0.9	-4.8	-0.08
	Indo-Pacific	4.94	565	8.7	4,217	7.5	-2.0	-13.0	-0.89
	India	2.94	1,380	2.1	14,483	10.5	0.3	-15.3	-1.16
	Australia/NZ	1.58	30	52.3	125	4.1	-0.3	-6.3	-0.54
	All	29.18	3,547	8.2	24,420	6.9	-5.6	-8.3	-0.67
Other	Brazil	1.85	212	8.7	52,771	248.9	-1.5	-17.0	-4.20
	Arabia	1.63	58	27.9	2,291	39.2	n/a	-13.0	n/a

Source: IMF (GDP 2019, Population), WHO (Covid 19), Economist (Economic Impacts)

Malaysia, Singapore and Thailand. Arabia is Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates.

Note: Europe is EU, Norway and Switzerland. China includes Hong Kong and Macau. IndoPacific is S. Korea, Taiwan, Brunei, Philippines, Indonesia

## Social Discord, George Floyd & Police Reform

Stock market investors are familiar with the phenomena where once or twice a generation some little event will occur which triggers a broad collapse in stock prices known as a crash. Skiers know similarly how a small event can trigger a massive avalanche. We seem now to be witnessing a similar phenomena in the social/political realm. Underlying these disparate examples of avalanche type phenomena is a common mechanism. In some system stresses gradually build up over time until large parts of the system have reached the point where no further stress can be absorbed. Once the system is in this critical state any event can trigger movement which rapidly snowballs until the whole landscape is in motion. Just as it seems anything could happen, however, the stresses have been released and the system settles back to its usual state albeit from a new starting point.

The present avalanche was triggered by the death on May 25 of a black American, George Floyd, while being taken into custody by a squad of Minneapolis police officers of white, black and Asian origin. The facts are by now well-known but bear repeating. George Floyd was born into a poor family in a poor neighborhood of Houston. He strove to escape his origins and made his way to college. Here, however, the professional sports career to which he aspired failed to materialize. He left college without a degree and returned home. There he gradually drifted into crime, beginning with a charge for dealing a small quantity of cocaine and going on to theft and armed home

invasion. Apparently in an effort to make a new start, he moved to Minneapolis and took up a job as a nightclub bouncer. On the morning of May 25, after a night of hard partying, he stepped out of home to buy a pack of cigarettes. The shop he patronized called him in for passing a counterfeit \$20 bill and for being publicly intoxicated. The police responded and initially took him into custody peacefully. But while being placed in the police car Mr Floyd appears to have had a panic attack. The police responded with excessive, indeed lethal, force and within 10 minutes Floyd had died - a tragically wasted life. Shocked bystanders called the incident in and one recorded it on a phone. The police department promptly fired the four officers involved and shortly afterward the district attorney charged the lead officer with third degree murder (reckless misconduct resulting in death.) As the phone video circulated, public anger at a brutal and pitiless killing erupted in nationwide protests. These protests quickly interpreted the events through the lens of "white supremacy" (a label normally restricted to the KKK and its ilk.) Under this labeling the protests spread to seven foreign countries - a testament to the power of images to capture and move the public mind. Although many protests were peaceful, some degenerated into rioting, looting and arson. Governors called out 62,000 national guard across 25 jurisdictions to restore order and some 4,400 people have been arrested on charges ranging from curfew violations to rioting and terrorism. In Atlanta a police officer attempted to arrest a DUI suspect. The suspect grabbed the officer's Tazer and attempted to shoot him with it. The officer then shot and killed the suspect while he was fleeing. The officer is now charged with second degree murder and potentially faces the death penalty. Similarly, in Minneapolis the state attorney took over the Floyd case, raised the charge on the principal to second degree murder and charged the other members of the police squad with aiding and abetting. To win conviction on these enhanced charges he will need to show intent and agreement among the policemen to criminally abuse Mr Floyd. At the height of the uproar the President accused the governors of mishandling the situation and threatened to send in the army under the rarely invoked Insurrection Act to restore order. The Secretary of Defense quickly stated that the situation was not an insurrection. The President was, in addition, promptly rebuked by retired Generals Powell (former Secretary of State), Mattis (former Secretary of Defense) and Allen (former chairman of the Joint Chiefs) who declared the President unfit for office and encouraged rejection of any illegal orders he might issue. Not since the retirement of the battleship Iowa has the military fired such a broadside and this is the first time in living memory that their target has been the Commander in Chief. Mr Trump was then treated to the publication of the memoirs of his former National Security Advisor, John Bolton. Bolton reported Trump to be venal, a habitual perverter of justice, gullible and hopelessly out of his depth in the conduct of foreign affairs. Public disparagement being in season, a less exalted section of the public has taken to knocking down statues. While this may relieve frustration, it is magical thinking to believe it will restrain police use of force and the consequent endangerment of American, and in particular, black American lives. Here there are no easy solutions and so a broad-brush solution of reducing police funding and transferring less serious public order responsibilities to social workers has gathered some currency under the moniker of "defund the police." Local politicians, with elections pending, have to a degree embraced the program of decrying white supremacy, removing statues and attacking the police. What is impressive about this moment is its contrast to the aftermath of the Sandy Hook killing (2012.) In that incident a mentally disturbed man gunned down 26 persons, 20 of whom were small children. Despite this sympathetic circumstance and their apparent privilege, the parents of the murdered children were largely unsuccessful in their political campaign to restrict the access of crazy people to assault weapons. The distinction in this case seems to be that regulatory efforts are narrowly focused on public employees rather than the general population.

The unleashing of massive forces by a small trigger is a hallmark of avalanche type phenomena. In the present instance the factors which have contributed to the growth of social tension are fairly easy to identify. To the normal stresses of American life have been added mounting frustration with habitual police mistreatment of black Americans, the fear, ill health and death created by Covid, the economic uncertainty and hardship it has brought, the disorienting effect of breaking usual routines, the splintering of leadership in Washington and frustration at the left end of the political spectrum with the outcome of the Democratic primary. A partial relaxation of these tensions will occur as medicine and public health bring the disease under control, as the economy recovers and as elections restore legitimacy to the political establishment. But these processes will take six months to a year to play out and society is likely to remain on at least a low simmer if not a full boil meanwhile.

On the problem of police reform we do not know what the answer is. We do not believe the answer is defunding. Any real pull back in police presence is likely to create a vacuum that is rapidly filled by the drug cartels. The US does not want to go the way of Mexico. Our research note "Violence in Policing" throws some light on the issue, but it also suggests there are no quick fixes. Similarly, addressing America's racial inequalities is an ongoing massive multi-generational project which over the short term will only exhibit incremental progress at best.

Our final comment on these matters is that we believe they have hardened the political lines in the upcoming presidential campaign. The two contestants, Trump and Biden, are both very known quantities. By this point nearly everyone has formed an opinion about the contestants and we do not foresee developments, other than the death or withdrawal of one of the candidates, which could materially shift opinion. The latest polls indicate that Biden will win the popular vote by a decisive margin and the electoral vote by a smaller but still clear margin.

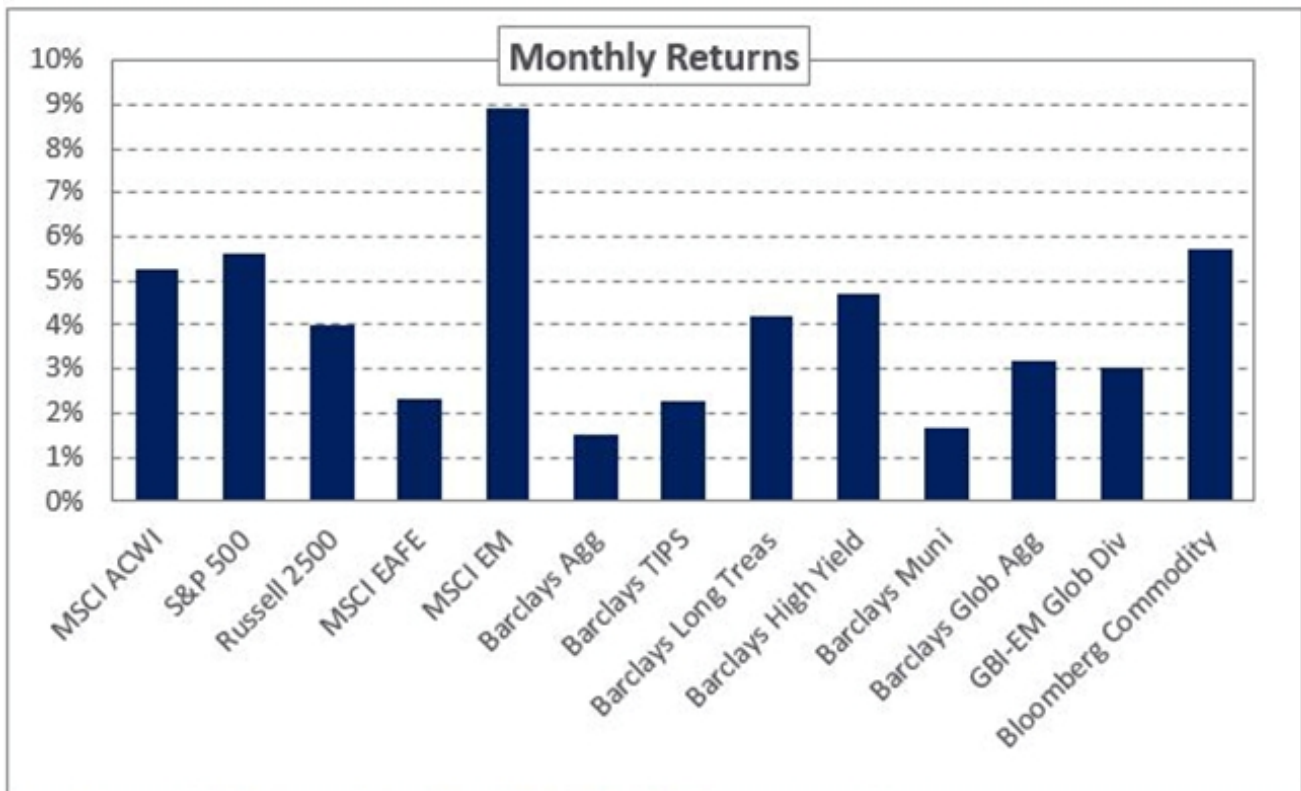
## **China**

In previous commentaries we have noted that China is also impacted by Covid and we ventured the opinion that China would dial back its assertiveness in the world for some time. We could not have been more wrong. China has struck out in every direction at once. It has ended Hong Kong's autonomy, applied naval pressure in the South China sea, heated up a territorial dispute with Japan, attempted to expand its incursion into India and even gotten into a kerfuffle with Russia over the Arctic. The US has responded by sending three aircraft carrier task groups - two forwarded deployed to the Western Pacific and one held in reserve in the Eastern Pacific - approximately 36 ships and 15 squadrons of attack aircraft. China has responded with some brave talk about how its anti-ship missiles could sink this fleet in an afternoon. China appears to regard a renewed cold war as inevitable and to be probing for potential weaknesses among its bordering states. Of critical importance is China's decision to end Hong Kong's autonomy in violation of the treaty which ended British rule in Hong Kong. Britain has responded to this violation by extending residency rights in Britain and potential citizenship to half of Hong Kong's population - some 3 million people. The ending of the treaty regime ends the formula of "one country, two systems." As such it also terminates any political road map whereby Taiwan could be peacefully drawn into the mainland's system. The Taiwan Question, silent for now, may come to the fore. China insists that Taiwan is its sovereign territory and has engaged in a long diplomatic and military campaign to bring Taiwan under its control. The US has never recognized China's claim and has quietly neutralized China's military threat to Taiwan's independence. Behind the Taiwan question lies a much graver potential conflict. Since 1948 the US has recognized China as the Asian power, but it sees itself as the Pacific power. That is a position which it has purchased and sustained at a blood price in three wars. China

does not accept this formulation. It regards the US as an interloper in the Western Pacific. Since President Xi came to power, China has seemed to be engaged in a campaign of slowly increasing pressure which has as its terminus pushing the US back to Hawaii and drawing the countries of the Western Pacific and Indochina into a Chinese centered economic system as dependent powers. This is simply a revival of Tojo's ideas for Asia or Stalin's ideas for Europe. At some point the US will resist rather than accept this vision. With international politics apparently moving in such an unfavorable direction, we would recommend investors to carefully reassess investments in China or Hong Kong.

### Market Review

July was the market's fourth straight positive month; the S&P 500's +5.6% rise brought its year-to-date tally back in the black at +2.4%. Other markets too moved positively, as the chart indicates. In large part these bullish moves reflected continued falls in interest rates that are used to discount all assets: the 10-year Treasury yield of 0.55% on July 30 was another new, unprecedented low. The magnitude of these returns also reflects declines in the US dollar, which is now down some 4% year-to-date after wild swings in Feb-March. Some who sought ultimate safety in gold have seen rich reward as that shiny metal reattained its prior all-time high from mid-2011. When asset values reach such historical extremes, reversion is a distinct and easily overlooked possibility. Overall, volatility remains elevated (VIX at 25 vs. 72 on March 19 and teens throughout 2019) so caution remains warranted.



As of 7/31/2020, Source: S&P, Russell, MSCI, JPM, Bloomberg, Factset

Source: NEPC