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Market Commentary

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The Russo-Ukraine War

In mid May the Ukrainians pushed the Russian troops in front of Kharkov back to the border. This action relieved Ukraine's second largest city from the shelling and threatened ground assault which had been ongoing since February. The Ukrainian advance also began to develop a threat to Russian supply lines to their spearhead in Izyum.



To the east, the Russians completed the capture of Mariupol after a siege of three months. By concentrating their attacking effort in the Donbas, the Russians were able to crumple Ukrainian lines in the extreme east of the country. The Russians are now moving to take Severodonetsk, an industrial city of peacetime population 100,000. Although a point of only modest tactical importance, this success will allow the Russians to claim control of Luhansk oblast, one of the two administrative units making up the Donbas. To the south the Russians mainly stood on the defensive around Kherson and Melitopol, while limited Ukrainian counterattacks and partisan activity contested Russian attempts to consolidate control. Battlefield initiative appears to be passing to the Ukrainians. It is possible they will mount a successful counter-offensive which pushes the Russians out of significant occupied territory. Alternately, the Ukrainians could find the attack as difficult as the Russians have and in that case a stalemate along current lines is the likeliest outcome. Such a result would represent a modest success for the Russians as they would have secured their land communications to the Crimea and would retain a forward base from which to continue applying pressure on the Ukraine. However, a peace treaty would be unlikely to result from such a stalemate and so Western economic sanctions would continue. Ukraine is unlikely to accept this conclusion without first attempting to win back further territory. However it may take them some months to fully prepare for and execute the necessary offensive. The situation will remain indeterminate meanwhile.

The data on Russian losses for May indicate a loss rate 60-70% of April's rate. We think this decrease represents the shrinking size of the Russian forces and the largely defensive stance by the Russians in two out of three sectors. Fewer Russian generals were killed and fewer command posts destroyed in May as compared to earlier. However, anecdotal evidence points to heavy losses among field grade officers. Russian logistics continued to suffer heavily at Ukrainian hands. The spring mud season is coming to a close, potentially opening the door for maneuver warfare by armored forces. Russian armor appears seriously depleted however – recent reports indicate that replacement equipment is either drawn from Belorussian stores or consists of 60 year old equipment. Ukraine's immediate challenge remains deployment of an effective counter battery force to neutralize Russian artillery. The Russians appear to be continuing their offensive to the point of exhaustion rather than maintaining a strategic reserve. We estimate Russia has lost about 45% of its initial combat strength.

Table 1: Russian Losses Measured By Confirmed Equipment Losses

Type of Force	March	April	May	Total	May % April
Strike	1,311	772	462	2,545	60%
Aircraft	35	40	30	105	75%
Support	146	138	64	348	46%
Logistics	657	223	306	1,186	137%
Total	2,149	1,173	862	4,184	73%

Note: Strike refers to armor, mechanized infantry, air cavalry and artillery. Aircraft includes fixed wing manned and drones. Support includes command, communication, radar, anti-aircraft and engineering. Logistics includes road and rail transportation.

Source: Oryxspioenkop.com

As expected, Finland and Sweden have applied to join NATO. Russia has continued trying to gain leverage with gas and wheat but so far has not achieved much. Whatever the final resolution of the Ukraine, Russia's standing as a major power is likely diminished for a generation. Similarly the Western alliance is strengthened and revitalized. By implication, China is left isolated and without important allies with which to confront the Western powers and especially the United States. Nevertheless, China is continuing its initiative to pick up clients among the island nations of the Pacific – a highly confrontational move from a US perspective. For the United States China's isolation is a significant gain, although one which it would be wise to nurture and improve rather than waste on unilateralist adventures or isolationist postures. The US has announced it will raise its continuing force allocation in Europe from 60,000 to 100,000. This step is inline with our analysis of January. Although the costs of the Russo-Ukraine war run into the tens of billions for the US, this expense is only a few percentage points of its baseline defense budget. The war is not an important fiscal or manpower strain on the US.



Covid

Despite extreme attempts at self isolation, North Korea has failed to exclude the Covid virus. The virus is now exploding in the population and mass casualties are likely to result. China is having somewhat better success at controlling her recent outbreak, although lock downs and diminished economic performance are continuing. The US passed the one million casualty point this month. Possibly exaggerated projections from the White House suggest there could be 100 million cases this winter, which could lead to several hundred thousand to a million more casualties. Re-vaccination of the population and widespread mask use could substantially reduce fatalities and economic damage. However, Covid policy remains a point of partisan contention and the necessary steps are unlikely to be taken as long as that remains the case.

Domestic Politics

The mid-term elections are heating up the partisan environment. Pending Supreme Court decisions on abortion and gun rights are likely to further increase tensions. A troubled economy is likely to make this a difficult election for the incumbent Democrats. Further partisan gridlock in Washington will restore the political system to



its chronic state of frustrated paralysis. Fortunately, support for Ukraine enjoys broad bipartisan support so one may hope that domestic dysfunction will not extend to foreign policy. As measured by recent votes, isolationist Republicans command only 59 votes in the House (out of 435) and 11 in the Senate (out of 100.)

In late May an 18 year old in Texas donned body armor, collected his AR-15 rifles and went to school where he murdered 18 ten year olds and two adults. It is probably common experience that for many people the late teens/early twenties are a time of unusual emotional stress and poor decision making. It is also an observation that this age group commits murders at three times the rate of the general population. A fairly moderate proposal in response to these observations would be to limit the purchase of assault rifles to persons of age at least 25. In fact, the State of California adopted a watered down version of this idea and limited purchase of assault rifles to persons of age 21 or older. Unfortunately the Federal Ninth Circuit Court of Appeals ruled the law unconstitutional. The court reasoned that as persons under age 21 had served in the Revolutionary War, persons of at least age 18 must be considered as proper members of militias and so could not be debarred from exercising their Second Amendment right to purchase assault rifles. This decision would seem to raise three immediate questions. First, it certainly raises a constitutional cloud over Texas's "Constitutional Carry" law recently signed by Governor Abbot. That law dispenses Texans from the necessity of getting a permit to carry a weapon, but only if they are of age 21 or greater. Second, it must be noted that in Revolutionary times (and indeed much later) midshipmen were substantially younger than 18. By the Court's reasoning the age limit might need to be dropped to twelve. Indeed, if we were to consider cabin boys perhaps the limit should drop to five. Third, revolutionary teenagers could not carry AR-15s for the simple reason that they had not been invented yet. But to the extent these youngsters were participating in militias they were certainly carrying military equipment. One may wonder if bans on teenagers purchasing machine guns, flamethrowers or stinger missiles may be constitutionally maintained under the Court's reasoning. There is nothing particularly surprising in the Appellate Court's action. After all in the midst of a pandemic which has (so far) killed a million Americans, courts found that mask wearing could not be mandated on public transportation. There is no reason, therefore, to think that killing even a few thousand school graders would move the legal system into new thought patterns. But we would like to call attention to the process by which this decision was arrived at. A school of constitutional scholars developed a theory of constitutional interpretation based on the idea that the meanings of words in Constitutional documents should be interpreted based on their meaning at the time the documents were drafted. One could draw a parallel between this Original Meaning school and the musicological theory which argues that musical pieces should be performed on original instruments according to historical performance practice. But as Original Meaning is being adopted by the Courts it is slowly drifting simply from trying to understand the historic meaning of words to privileging historic legal practice. This is a very definite break from the traditional understanding of Constitutional law. Historically the Constitution was seen as enacting a permanent structure by which the community could govern itself, but it left up to each generation how to turn those wheels of government to solve the problems of their own day. Here, however, judges are constraining the gears of government by reference to the historical practices of 1776. In the process, they disempower the legislatures of Texas and California from governing. Linguists would perhaps have advised us of the inevitability of this development. It has long been a fundamental insights of linguistics that words exist in a social and historical milieu and not in a Platonic empyrean. Whatever position one may hold on gun regulation or constitutional interpretation, one has to agree that what is happening here is unelected judges applying the

theories of a group of unelected constitutional scholars. It is certainly a reaffirmation of the continuing power of elites in the American system of government. But of what interest is this to investors? We think the inevitable result of gumming up the wheels of government is to generate mounting social tension which finally explodes in reform movement. Investors are best served by a social context with stable structures, predictable outcomes and continuous incremental adaptation



to change. Social explosions are not beneficial for investors. Accordingly, a gumming up of the gears of government is nothing for investors to celebrate.

The Economy

The Federal Reserve has begun raising interest rates to choke off inflation which is currently running at 8% per annum – well above the Federal Reserve target of 2% on average. The Fed has signaled that rate rises of a half percent should be expected at quarterly intervals. In this

case the tightening cycle may extend over two or more years. The immediate consequence has been the collapse of the highly speculative cryptocurrency area and of VC funded activity in general. In cryptocurrency, the supposedly stable value Luna coin collapsed from \$85 per coin to essentially zero, in the process wiping out \$40 billion in wealth. We advised back in February that investors should avoid the then hot cryptocurrency area. In the more consequential VC world it is stated that 50% of projects have seen valuations decline by 50% and 25% of projects have declined by 75%. The area of electric vehicle startups has seen a near complete wipe out of value. In April 2021 we advised that such startups were unlikely to succeed in the face of competition from established vehicle manufacturers. Despite the significant repricings, valuations were quite high to begin with so VC backed firms are not necessarily at bargain prices currently. However, price declines imply freezes on new capital infusions and firms with negative cash flows (as most VC backed firms are) will need to react quickly to avoid collapse. Cut backs in staffing, marketing spend and consulting services are commencing. Eventually we will see contractions in activity, forced mergers and recapitalizations. Secondary consequences for real estate pricing may begin to show up in the next quarter. All of this contraction, however, will cool inflation faster than the half point rate rise might have led one to expect. Slowing in the wider mature economy will likely take several quarters to show up.

Financial Markets

Equity and bond markets continue their falling trend. Relative strength remains in defensive stocks (utilities, consumer staples, medical, military and government services), and short term government bonds. The euro had a modest recovery and gold a modest sell off – both counter trend moves. Oil continues to rally on war shortages although we believe the secular trend is downward. US Large Cap Growth, REIT and – to a lesser degree – long term bonds all continued to feel pressure. Rising interest rates and large uncertainties about the medium term are likely to continue to weigh on investments with longer term cash flows. Additionally, individual firms may experience important declines if negative firm developments coincide with a general bear market. Bear markets in general are more volatile than bull markets and so we expect heightened volatility to be ongoing.



Table 2: Market Performance in May 2022

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	falling	-14.24%	-9.62%
	US Large Cap Growth	falling	-22.43%	-14.61%
	US Large Cap Value	range trading	-5.17%	-4.46%
	Growth – Value	falling	-17.25%	-10.15%
	US Mid/Small Cap	falling	-13.26%	-9.23%
	Intl Developed	falling	-12.53%	-6.46%
	Intl Emerging	falling	-13.94%	-7.98%
Fixed Income	3-7 Year Treasury	falling	-6.59%	-1.30%
	7-10 Year Treasury	falling	-9.94%	-3.48%
	TIPS	falling	-8.85%	-4.61%
	Muni	falling	-7.08%	-1.24%
	Investment Grade	falling	-9.21%	-3.64%
	Medium Grade	falling	-9.28%	-3.58%
Commodity	Preferred	falling	-11.93%	-4.78%
	REIT	rising	-14.23%	-10.87%
	Euro	falling	-6.38%	4.91%
	Gold	rising	2.81%	-3.83%
	Oil	rising	49.21%	14.18%

Advice

The Covid Pandemic is a huge natural disaster which the world economy is still processing the consequences of. The Russo-Ukraine war is one of broad geostrategic consequence with meaningful impacts on the world economy. China's confrontational politics and uneven economic performance is a net source of instability. The US is not immune from these strains. Easy to overlook amidst the hubbub is that the US is under less strain than other nations and so its relative position is strengthening. A foundation is being laid for its further growth in prosperity. Investors should generally maintain their long term strategies.

