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Market Commentary

November 2020

Major Developments

The Pandemic

This month we update our report on the success of different policies for dealing with COVID-19. Initially there were three policy choices on offer: Do Nothing, Containment and Elimination.

The Do Nothing policy argued for letting the disease progress through the population. This policy proved unimplementable – populations rebelled against it. Accordingly it was replaced by a policy of Selective Protection – try to isolate the most vulnerable from the general population but allow or encourage the spread of disease among the less vulnerable. The Containment policy sought to impose sufficient public health measures that the load of serious cases could be kept within the capacity of hospitals to handle. The slogan of this policy's adherents was “flatten the curve.” Finally the Elimination policy imposed whatever public health measures were necessary to clear the virus from the population. The policy debate was mainly between proponents of Selective Protection and Containment. Proponents of Selective Protection argued that it would be cheaper, just as effective and involve less constraint on civil liberties than Containment. Proponents of Containment viewed these claims as speculative benefits while the policy carried clear risks. Countries following Elimination did not much enter into policy debates. They identified COVID-19 early on as a deadly threat and took immediate action. How well did the three groups do? Here we look at a sample of countries for each basic policy orientation. We measure success by two measures: deaths per 100,000 and unemployment rate. These are fairly robust measures of health and economic impact with reasonable comparability across countries.

As expected the Do Nothing/Selective Protection group turns in the highest mortality figure:

Table 1: Results for Selective Protection Countries

Region	Deaths	Population (M)	Deaths per 100k	Unemployment Rate (%)
US	226,604	328	69.04	7.9
UK	45,455	67	68.25	4.5
Brazil	157,946	210	75.39	13.8
Sweden	5,918	10	58.02	8.8
Total	435,923	615	67.68	8.75

Source: John Hopkins University COVID-19 website and The Economist

But the unemployment figure of nearly 9% is not encouraging. In the middle group of Containment we find a much better health figure:

Table 2: Results For Containment Countries

Region	Deaths	Population (M)	Deaths per 100k	Unemployment Rate (%)
Denmark	709	6	12.22	4.9
France	35,575	67	53.10	7.5
Germany	10,121	83	12.19	4.4
Italy	37,700	60	62.52	9.7
Spain	35,298	47	75.26	16.2
India	119,502	1,366	8.75	6.7
	238,196	1,623	37.34	8.9

Source: John Hopkins University Covid website and The Economist

The mortality rate is almost half that in the prior group. The unemployment rate is equal to the prior group. Those who argued that Containment was too expensive or would not work appear to be refuted. Looking more closely at the data we see that its actually made up of two groups. There is a low death rate group and a high death rate group. The low death rate group consists of Denmark, Germany and India while the high death rate group consists of Spain, France and Italy. The average death rate in the low group is 11 with an unemployment rate of 5.3. In the high group the corresponding figures are

64 and 11.1. We would interpret this as saying the high death group either implemented Containment too late or too ineffectually. As a result their death rate is nearly the same as the Selective Protection group but the economic cost is higher. Those countries which successfully implemented Containment, by contrast, enjoyed much lower mortality and better economic outcomes.

Finally we look at countries following a policy of Elimination.

Table 3: Results For Elimination Countries

Region	Deaths	Population (M)	Deaths per 100k	Unemployment Rate (%)
China	4,739	1,400	3.39	3.8
Japan	1,726	126	13.68	3
Australia	907	26	35.57	6.9
New Zealand	27	5	5.40	4
Taiwan	7	24	0.29	3.8
Singapore	28	6	4.91	2.8
	7,434	1,586	10.54	4.05

Source: John Hopkins University Covid website and The Economist

The death rate appears about the same as successful followers of Containment. However that average is pulled up by Australia which transitioned from Containment to Elimination in mid-course. If we eliminate Australia from the sample the average death rate is 5.5 – exactly half the rate of the successful Containment countries. The unemployment rate is also best for the Elimination countries.

The data analysis is impressionistic rather than rigorous, but the conclusions to which it points appear clear enough. The Elimination strategy was the most successful on both health and economic measures. Containment is a difficult policy to succeed with because the virus lingers in the population and resurges whenever vigilance is dropped. When successful Containment produces worthwhile health and economic results, but when it fails it proves the economically least attractive policy. The Selective Protection policy appears to be a complete failure. It has the worst health results and shows no meaningful improvement in economic results. The idea that there was a trade off between health costs and economic costs appears entirely wrong. Instead it appears that the two costs are correlated. The economy cannot be healthy while the population is sick. In terms of human cost, a recent report for the US indicates that on average victims of COVID-19 lose 10 years of life. The idea that the death figures are driven by mortality among those about to die anyway would also appear to be incorrect.

In Europe a second wave of COVID-19 infection has begun. This is a well known phenomena with pandemics. Why it happens is unknown. Hypothesized causes are seasonal variation in contagiousness, waning of immunity acquired in the first wave, genetic drift on the part of the virus and relaxation of protective measures in the afflicted population. Probably all factors contribute to some degree. As the causes are not understood, it is impossible to predict the severity of the second wave. Sometimes it is worse than the first wave and sometimes it is less severe. A priori, the best assumption is that it will be about as bad as the first wave. A doubling of mortality figures, therefore, must be considered as a possibility.

Sidebar: The Chinese Navy

Last month we commented that the Chinese navy was larger than the US Pacific fleet. That statement is incorrect as it stands and we now delve in to the matter in more detail. The US Pacific fleet is divided into two components: the Seventh Fleet home ported in Asian waters, and the Third Fleet mostly home ported in San Diego. The US Pacific fleet is allied with other fleets in Asian waters of which the Japanese is the most significant force. The comparison of the fleets in terms of number of ships and total displacement is shown in table 4. The China fleet is far larger than the Seventh fleet and is 60% larger than the combination of the Seventh fleet and the Japan fleet. These

Table 4: Comparison of Fleet Sizes

Fleet	Ships	Displacement (tons)
China	231	1,181,820
US 7 th Fleet	20	355,300
US 3 rd Fleet	92	1,172,100
US Pacific Fleet	112	1,527,400
Japan Fleet	45	355,500
US 7 th + Japan	65	710,800
Pacific Fleet + Japan	157	1,882,900

Source: Wikipedia

forces, however, are backstopped by the massive Third Fleet whose displacement nearly equals the China Fleet. The combined Pacific and Japan fleet is 60% larger than the China fleet. Displacement

alone, however, does not tell the full story. The China fleet is a green water navy designed to dominate its littoral seas but lacking the organic air arm required for operations away from land-based air cover. The Pacific fleet by contrast is a blue water navy designed to command the high seas. Its air power, however, is based on just five ships and this makes it a fragile force which its admirals would be loath to bring within reach of land-based air power. At present the two navies may press upon each other's sphere of operations, but cannot truly challenge one another. That situation is changing, however. The China fleet is continuing a rapid build-up and has begun acquiring a significant carrier force. It is on course to present a challenge to the Pacific fleet on the high seas. The US has not faced such a challenge since 1944 and such a move by China will strike a deep nerve in the US strategic psyche. Assuming China continues building, the US will at some point have to respond. By contrast, we do not see significant challenges to US land or strategic nuclear forces emerging in the near term. Accordingly, we think the medium-term picture for US military procurement may be an incremental shift towards naval forces and away from heavy land or strategic nuclear forces.

Market Developments

Markets appear to have split the difference between the latest economic and pandemic news. On one hand, economic data has continued to signal a rapid cyclical recovery from the sharp recession of the first half. GDP growth rate fell by a third in Q2 then jumped by the same proportion (a substantial recovery, albeit short of its high water mark) in Q3. Unemployment ticked down to 6.7%, another positive outcome. The ISM Purchasing Managers' Index, an index of bullish corporate sentiment, rose to 59, its highest reading since early 2018. Yet inflation remains tame (at 1.2% headline, 1.6% core) – in all, a benign economic setting. On the other hand, we are at best only halfway through a global pandemic. America has entered its fall COVID-19 wave, with record daily incidences and patient counts in some hospitals nearing bed capacity. While field test results for both Pfizer and Moderna's vaccines exceeded expectations with over 90% efficacy, we must await several months' passage before these (or other candidates) achieve mass distribution. More business closures and interim disruption are to be expected. Taken together, all of this amounts to a disjoint backdrop for markets. That disjointedness was only exacerbated around month-end by anxiety toward a more than usually bitter election season. Reflecting all this, the CBOE Volatility index (VIX) duly spiked to 39, up by half in a month. And US stocks (represented by the S&P 500, per below table) declined further in October, shaving their year-to-date gains down to +2.8%.

Table 5: Recent capital market returns

Market Index	October 2020	Jan – Oct 2020
S&P 500	-2.7%	+2.8%
MSCI EAFE	-3.0%	-1.0%
MSCI Emerging Markets	+2.1%	+1.2%
Bloomberg Barclays US Aggregate Government	-0.9%	+7.9%
Bloomberg Barclays US Aggregate	-0.4%	+6.3%
Bloomberg Barclays US High Yield	+0.4%	+0.1%
BofA Merrill Lynch European Non-Financid High Yield	+0.3%	-2.4%
JP Morgan EMBIG	-0.1%	+0.3%

Our September commentary had touched on the high valuations then present. We have since experienced two months' selloff, followed by a +10% rise in the S&P 500 in the first half of November. So valuations today remain pricey. And notwithstanding some sectoral valuation flip-flops, the most expensive sectors remain those (like technology and consumer mega-caps – aka “stay at home stocks”) whose earnings have risen the fastest this year, while laggards include banks, materials, industrials and smaller firms. For the latter group, as before, its best-case scenario remains an infrastructure bill in early 2021.

Considering all that has happened this year, it's worth noting how well conventional assets have held up. 2020 produced the fastest economic meltdown on record, with many sectors simply switching off. For any strategy or investor premised on avoiding large drawdowns, this should have been their year to shine. Yet this time around, unlike in 2008, there's no parade of hedge fund managers who called this right, nor reports of systematic hedges that created fortunes. Where hedge strategies were deployed, they tended to declare early victory in Q1, then lagged in the subsequent V-shaped market recovery. Meanwhile, stock and bond portfolios, in particular those focused domestically, have performed respectably. Active equity managers who focus on technology have been the ones to beat. And that old standby of risk mitigation, the humble Barclays Agg (index of high-quality intermediate duration bonds) is up +6.3% thru October. Does this mean that hedges don't work, or aren't needed? No and not necessarily – while conventional portfolios are far more resilient (for reasonably patient investors) than they get credit for, 2020's zig-zags were also more dramatic – and unfolded quicker – than an ordinary market crisis. Rest assured markets won't see a brand-new pandemic surprise for a while. And if having a hedge in place (suitably sized and sourced of course) helped keep the broader portfolio strategy intact, it likely beat the panicked alternative.

Good time also for an update on US treasury bonds. Our September commentary questioned the consensus distaste for these instruments, pointing to “ample mathematical, empirical and economic evidence to not capitulate.” Since then, 10-year yields rose from 0.72% to 0.88%, a modest rise with a small corresponding erosion in their price. Directionally this was the movement widely feared, but the move was small enough that it caused minimal damage to portfolios. And the resulting steepening of the treasury yield curve implies economic normalization that will help most portfolios. Meanwhile, treasuries still provide cheap, reliable insurance against any broad sell-off in equities.

Outlook

Many asset managers publish long-term capital market assumptions each fall. Institutional clients use them to align portfolios and broadcast risk/return expectations. Firms tend not to precisely specify the time horizon of their forecasts, and they often gloss over other technicalities (like the important distinction between arithmetic and geometric returns). Still, given the widespread popularity of these frameworks, using JP Morgan's as an example, it's instructive to examine what has changed:

- Core bond returns over an intermediate (5 to 10 year) horizon tend to follow their starting yields. So with government bond yields having fallen everywhere over the past year, future returns are assumed lower as well.
- Stock return forecasts have generally ticked higher, consistent with initial economic conditions near a cyclical low plus stimulus to fuel the rebound. Comparing across sectors, styles and countries, those with initially lower valuations (like developed, emerging, value, and smallcap) are favored.

- Dollar is forecast to weaken, given its initial strength – further raising forecast returns of foreign equities for a(n unhedged) US investor.
- Alpha opportunity is forecast higher, on the basis of continued dislocations. However, there is no change in outlook for investors' ability to choose superior managers.

These are reasonable directional indicators to guide strategic portfolio tilts. Of course, to run a large number of customized client portfolios with consistency and scale, a greater degree of numerical precision is required than most current frameworks can support.

In short, long term asset allocations are generally reaffirmed. Forward return expectations over a 5-10 year period are generally lower than was experienced in the past 5-10 years. Equities remain likely to outperform bonds by a greater degree than equilibrium models imply. And there may be attractive investment opportunities for nimble allocations to active managers or alternatives where skill proves effective.

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