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Market Commentary

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The Russo-Ukrainian War



Ukrainian forces have continued their offensives in the Northern and Southern sectors. They are continuing to push the Russians back. The Russian line has been yielding after hard work, but it has avoided a dramatic collapse as happened last month. In part, the fall “mud season” is slowing the pace of war for both combatants.

The ground will freeze in December permitting more active campaigning until the spring mud season begins in February. Meanwhile the front is a meat grinder consuming Russian battalions (1,000 men) at the rate of one per day.

The strategic Kerch strait bridge connecting Crimea to southern Russia was partially destroyed by a truck bomb. Although destruction was only partial and ferry services exist to compensate for reduced capacity on the injured bridge, this blow was both a propaganda victory for the Ukrainians (the attack coincided with Putin's 70th birthday) and another logistical problem for the Russians.

Russia has been conducting an on-off missile campaign against Ukrainian civilian infrastructure. Most of the damage seems to fall on power transmission facilities rather than power plants. By implication, the damage – although initially severe – can be repaired in days to weeks rather than months to years. Western commentators judge the Russians are targeting relatively low value civilian targets rather than higher value military ones because Russia lacks the military intelligence required to target military assets. Russia's stock of precision missiles is estimated adequate to support about ten days of operations at current rate of usage. This dwindling supply likely explains the episodic nature of the campaign. Russia is trying to resupply itself from Iran and North Korea.

Ukraine attacked components of Russia's Black Sea Fleet at its home anchorage in Sevastopol. The attack was carried out by coordinated sea and air drones. The Russians claim – with uncertain veracity - to have successfully neutralized the attack. Nevertheless, the attack is notable both for its boldness and for the increasing use of robots in war. Robotic boats and submersibles have been used in oceanographic research for over a decade.

Under the strain of war the Russian state is beginning to creak. The central government has delegated the task of raising and equipping troops to the regional governments. The result is wide variation in outcome and a feudalization of the military. This high reliance on troops with local identities can create the precondition for the abrupt collapse of central authority when a large enough block of regions decides to withhold their troops. Within the regime a struggle is underway to apportion blame for past failures and to gain influence over future initiatives. Several of the actors are backed by what amount to private armies. If Putin's autocracy were to collapse the next political arrangement could be a Janta made up of players with private military resources. Some of these actors are calling for civilian massacres and total war. Putin probably tolerates this outspokenness to remind the western powers that he is not their worst nightmare.

Russia's original invasion force was approximately 160,000 professional soldiers of whom perhaps 90,000 survive. The Russians are reinforcing this force with between 100,000 and 300,000 reluctant civilian reservists. This influx of men will stretch an already inadequate logistic operation. As the professional component is diluted by the new arrivals, morale may plummet and the line become more unstable. In short, this reinforcement action is not without risk for the Russians. Immediately freshly mobilized troops are reported as under equipped, poorly fed and housed, suffering epidemics of respiratory diseases, undisciplined and suffering high casualty rates on the front line.

Russia's hope is that the reinforced troops will be able to hold the line of the Dnieper through winter until the spring thaw ends active campaigning. By next summer Russia hopes to rebuild its wounded army and either resume the offensive or at least force peace on its terms. Russia also hopes that its pressure on Europe from withholding natural gas during the cold of winter and influence from its political friends in the west will reduce the flow of aid to Ukraine – halting the liberation of its territory and forcing it to accept a disadvantageous peace. Until these hopes are proved chimerical, Russia is unlikely to burn its bridges by escalating the war with nuclear weapons or by a direct attack on NATO. Similarly, Russia has been maintaining a token offensive in the Donbas but is unlikely to risk unhinging its military position by engaging in a major offensive until its army is substantially recuperated.

Ukraine's goal, by contrast, is to push hard at this point in a hope of liberating additional parts of its homeland and perhaps breaking the Russian lines. The Ukrainians have advanced to within 20 miles of the suburbs of Kherson, which puts the city in range of their heavy artillery. The Russians have been preparing to defend the city, but their hopes of doing so are belied by an ongoing evacuation of their government and military assets from the city. The Ukrainian recapture of Kherson will end the threat of a Russian advance along the Black Sea coast. This may provide the necessary impetus for Russia's satellite in Transnistria to come to terms with the Moldavian government. Such a development would strengthen Ukraine's strategic position and continue the rollback of Russia's proto-empire.

Numerous reports indicate that Russia is, as a matter of policy, fighting a dirty war in Ukraine. The Ukrainians report finding 22 torture chambers in liberated areas. The UN reports systematic rapes being carried out as a means of intimidation. The Red Cross reports difficulties accessing POWs. Exchanged POWs report systematic abuse. Mass kidnapping and deportations of children have been reported on multiple occasions. Efforts to depopulate entire regions are underway. While the worst excesses are probably due to the state security police rather than the army, the high command is unlikely to escape command responsibility for grave international crimes. Putin's rhetoric borders on the genocidal – denying the existence of a Ukrainian people. Russia's military and political leadership is likely to emerge from the war as indicted international criminals.



China

As expected, President Xi assumed a third term as paramount leader at the Chinese Communist Party conference in mid-October. He took this opportunity to send a number of messages. To the Chinese public he announced that the deeply resented zero Covid policy with the accompanying

heavy surveillance state would be continued. To the world he reaffirmed his intent to take Taiwan and to push the United States out of the Western Pacific. The Chinese old guard saw his predecessor Hu Jintao being led off the dais as Hu's proteges were retired from their careers. Finally, the new Politburo has omitted any women officials for the first time in 25 years. There was not much subtlety to the messaging- or to its response. Taiwan's president (a woman) ordered live fire military exercises. The Hong Kong Stock Exchange has dropped 17% in October. US foreign secretary, Blinken commented with studied blandness that China does not accept the status quo.

The United States

As far as the United States goes, President Xi's stance must be seen as a rejection of the formulation of "competition but not confrontation" which Biden offered him. Xi evidently believes confrontation is in his interest. The United States is beginning to face the reality that the Cold War began again over a year ago. The implications for US policy will be significant and far reaching:



1. The United States must prepare to win a war in the Western Pacific while balancing Russia in Europe and Iran in the Middle East. Judging by past history, the military budget could rise from 3% of GDP currently to 5%. This will be beneficial for the defense industry and for the technology sector generally. This buildup will likely see a much increased role for military robots.
2. The ending of the "peace dividend" will foreclose further expansion of the welfare state or tax cuts, probably for a generation.
3. US education, particularly in STEM disciplines, will need to be refocused on excellence rather than social uplift. Currently US college freshman lag international peers by up to four years in terms of their preparation for STEM subjects at a time when STEM subjects are ever more necessary to the economy. Fixing this shocking deficit is a huge social effort and import of foreign students will need to increase meanwhile.
4. In general immigration policy needs to refocus on meeting the needs of the economy rather than catering to political hysteria. Currently the United States imports undocumented workers equal to 0.3% of its population per year (with year to year fluctuations driven by the business cycle.) Most are Spanish speakers who easily assimilate to the mainstream population within two generations. Current border control policies are good enough to have created substantial underemployment (and consequent wage inflation) in the low wage service jobs typically performed by these workers.
5. A massive effort is required to confront China's global military/industrial espionage effort. This will be beneficial to cyber-security firms and data analytic providers. It will be a burden on exporters of high technology goods and services.
6. The political space for domestic right wing insurrectionary politics is likely to continue contracting as external pressure is more strongly felt.

Much of this reorientation is frankly unwelcome to Biden's party. The rest will be anathema for the current Republican party. It will be a test of Biden's leadership to see how effectively he can shape a political consensus. The leader of the progressive caucus in Congress urged him to negotiate with

Putin to end the war in the Ukraine. But she was repudiated by her caucus. On the right, McCarthy – who is expected to assume the House leadership in January – has promised to “end the blank check for Ukraine” and to sustain active opposition to the President in the House. It was unusual to see the Progressive and the Republican leadership singing from the same hymnal. As Putin continues his dirty war and Xi moves forward with his confrontation we expect Republican and Progressive leadership to find a position of “being soft on ugly and dangerous autocracies” increasingly less inviting and to migrate to more mainstream positions. This migration could be beneficial to Biden, who appears positioned closer to the midpoint of American politics than anyone else. In a partisan environment that has been a lonely position, but as rallying around the flag becomes more important it could prove a wise choice.

Putin had built up a sizable clique of friendly western politicians: Le Pen, Schröder, Orbán, Berlusconi, Trump and the CPAC. Some of these players were even on his payroll. Putin probably hopes that a peace push from these forces will assist his war with Ukraine. As the political climate darkens over a difficult winter, however, these friends of Putin are likely to find themselves more focused on their futures than his.

The Cold War environment we foresee will be a difficult one for Western businessmen with large commitments in China. We noted that Elon Musk, who had been a major supporter of the Ukraine, suddenly sought to back off that stance and was advocating for peace on Putin's terms in the Ukraine. We wondered if that change of heart might reflect a friendly word passed from China regarding Tesla's massive Shanghai plant. With his recent acquisition of Twitter Musk has very much made himself a target for influence campaigns.

Under the Presidential succession act, Nancy Pelosi is next in line after the Vice President to succeed to the Presidency in the case of a vacancy. At the end of October her 82 year old husband was bludgeoned in his home by a hammer wielding political nut case from Canada. Currently, family of high ranking officials do not receive protective services. It is clearly only a matter of time before our excessively partisan political environment delivers a tragic result. An urgent extension of protective services is needed.

The Global Economy



In the United States inflation continues out of control. However supply chain issues appear to be improving and dreaded strikes in the freight sector have been avoided so far. Substantial appreciation of the currency should also be removing inflationary pressure from imports. The Federal Reserve is likely to continue tightening measures at a steady pace until inflation is under control. Growth year to date is about flat as strength in the second half has offset weakness earlier in the year. The country remains at full employment although the labor market has cooled significantly from its previous overheated state. House construction is falling and portions of the technology sector are adjusting staffing from high to low growth scenarios.

OPEC is attempting to reduce production to keep the price of oil steady in the face of (projected) cyclical decrease in demand. It will be interesting to see if they can maintain that stance if cyclical demand decrease should overlap with a secular decrease in demand.

The Euro block economies continue growing but there is considerable turmoil due to disrupted energy supplies. They are expected to slow and go into recession this winter.

China's economy is growing at a below trend rate – a so-called growth recession. The primary difficulty is turmoil in its real estate development sector. Defaults here are beginning to create credit problems for local governments as well. Secondly the zero Covid policy creates episodic regional shutdowns and government hostility towards the business sector slows business expansion. China's worsening relations with the Western economies is likely to reduce China's secular growth rate.

India's economy is growing strongly as the country successfully navigates among the perils of the world. The UK has dropped prime minister Truss after her budget unleashed chaos in the financial markets and has replaced her with an Indian banker, Rishi Sunak, who is broadly regarded as a safe pair of hands by the financial markets. Whether other British constituencies will warm to his leadership remains to be seen.

Brazil completed a closely contested Presidential election with a return to power by labor leader Luiz Inácio Lula da Silva. Lula da Silva's career had previously seemed to be ended by a corruption conviction which jailed him for 18 months, but the Brazilian Supreme Court reversed his conviction. A considerable shifting of the gears may be expected in Brazil's economy.



Ever marching to its own tune, Iran is convulsed by a popular revolt. The regime had been enjoying strong oil revenues, was making progress on its atomic bomb project and had purged moderates from its ruling theocracy in preparation for the succession to its current octogenarian Supreme Leader. Then its thuggish morality police known as the Gasht-e-Ershad, a crew of men and female members who are tasked with waiting at busy public spaces to police improper behavior and dress code detained a young

22 year old woman, Masha Amini, for having her head scarf out of place and killed her. Leading the country to explode with pent up rage. Some twenty five cities continue to be convulsed by demonstration and rights on a daily basis, for over a month. Most demonstrations involve a hundred people carrying placards and shouting. A few protest have swelled to thousand erecting barricades and fighting with the police. When the regime responds repressively, the inevitable death of protesters simply fuels the public anger. Rumors are circulating of high placed official moving their families out of the country. If true, the regime has deep doubt about its future. Tragically it appears to be preparing for mass trials and executions. Where this revolt will end up is difficult to say. Sadly, the turmoil remains a cautionary example for the unpredictability of human events.

Financial Markets

It was a month of cross currents in the financial markets. US Mid-Small Cap Equity and Oil rose by 10% or more. US Large Cap Equity and Developed Equity were up by about 7%. Emerging equity was flat. In the interest rate sector results were very mixed. Ten year Treasuries were off almost 1.7% while TIPS rose 1.6% for a differential return of 3.3%. Among corporates, medium grades rose 3% while preferreds fell 4.26% for a differential return of 7.26%. REITs rose 0.9% while investment grade corporates fell 1.5% for a differential of 2.4%. The euro rose 0.78% while gold trimmed 0.9%. Both movements occurred



despite the rally in oil which might have been thought good for gold and bad for the euro. Other precious metals are also mixed with Platinum up 4.7% and Silver off 5.4% for a differential of 10.1%. Broadly momentum from the war and inflation stories drove the markets for the past few months. This past month the markets paused for reflection and recalibrated. Overall domestic inflation and the US economy are proving more resilient than expected, which is negative for conventional bonds but moderately bullish for TIPS, equities and credit sensitive bonds.

Table 2: Recent Market Performance

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	falling	-6.49%	7.67%
	US Large Cap Growth	falling	-11.84%	3.32%
	US Large Cap Value	falling	-0.98%	11.92%
	Growth – Value	falling	-10.86%	-8.60%
	US Mid/Small Cap	falling	-3.53%	9.91%
	Intl Developed	falling	-9.16%	6.73%
	Intl Emerging	falling	-12.09%	-0.14%
Fixed Income	3-7 Year Treasury	falling	-6.67%	-0.94%
	7-10 Year Treasury	falling	-10.70%	-1.76%
	TIPS	falling	-9.01%	1.60%
	Muni	falling	-6.30%	-0.90%
	Investment Grade	falling	-8.99%	-1.54%
	Medium Grade	falling	-5.60%	3.03%
Commodity	Preferred	falling	-12.72%	-4.26%
	REIT	falling	-16.41%	1.49%
	Euro	falling	-3.24%	0.78%
	Gold	falling	-6.56%	-0.91%
	Oil	falling	-5.67%	11.07%



Advice

In a turbulent world the US remains a haven of strength and stability. While it has its own causes of excitement, these are comparatively cyclical and superficial. There is no need to revise long term strategies at this juncture.