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Market Commentary

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The Russo-Ukrainian War

In a three day offensive (Sept 9-12) Ukrainian armor punched through the Russian line east of Kharkov. A panicky partial collapse of the Russian front followed and the Ukrainians were able to advance about 50 miles before pausing to consolidate their gains along the line of the Oskil river. After a three month grinding Russian offensive in which the Russians had pushed the Ukrainians only 10 miles, this was a stunningly dynamic counter punch.



Since September 12 the Ukrainians advance has continued albeit facing greater resistance. At the same time, the Ukrainians have been advancing in the northern approaches to Kherson. Here the Russians have 30,000 men trapped on the west bank of the Dnieper with no easy way to supply them or withdraw them. In heavy fighting some important Russian units seem to have been nearly wiped out, and it seems that here also the Russian front must ultimately collapse.

Russia's fundamental problem is an inadequacy of resources – manpower, supplies and logistic capability. The Russians invaded the Ukraine with a professional military of some 160,000. To put that number in perspective, we note that this force is about the same size as the force landed on D-Day in Normandy. However that first day the Normandy force was reinforced over the next month by 800,000 troops and a month later allied operations were still confined to the Cotentin peninsula. The liberation of France, fully supported by the local population, was to require over a million men. Yet Moscow tasked its force of 160,000 with the conquest of the Ukraine – a country as large as France – and united in opposition to the would be conqueror. By this point, half of the professional military force is a casualty and Russia is scraping the bottom of the barrel to rebuild its force. The Russians have been reported as recruiting men from prisons and insane asylums. They are also reported as buying supplies from North Korea. The Ukrainians report captured depots of Russian artillery shells to contain WW2 vintage munitions rendered unreliable by corrosion of firing elements. Russia has been paying induction bonuses to volunteers as old as 65. After a month of training, its recruits are dispatched to hold the front line trenches while Russia conserves its professional forces in the rear and directs these reserves to stiffen the line where it is under pressure. That such a defense, pressed hard enough, should collapse abruptly and that the retreat should be panicky is almost to be expected. Losses of troops and equipment are likely to be substantial, so even withdrawal to a smaller perimeter may not materially strengthen the Russian line.

To address the manpower problem, Putin has decreed a general mobilization – the first time Russia has mobilized since WW2. The Ministry of Defense indicates the initial call up will be limited to 300,000 men in the active reserve. In response more than 200,000 Russians have fled the country. Despite the intention to call up only reservists, recruiting officers seem to be grabbing whoever they can lay a hand on, regardless of qualifications or the economic disruption created. Technically the Russians have not fought a foreign war since 1905 and legally its reserve force cannot be deployed

abroad. To finesse this restriction, Putin is moving forward with an annexation of the occupied Ukrainian territories. As no foreign government is likely to recognize the annexations, they are simply an internal Russian legalism. As the newly recruited forces are supposedly already trained, they are being outfitted with a rifle and dispatched directly to the front line. Actually, a significant fraction of the force is either pure civilians or men whose initial training was a short training course delivered years ago. This influx of unwilling raw recruits to the trench zone that makes up the front line is going to further stress Russian logistic and command capacity while adding very marginally to combat power. As a war leader, Putin is comparing unfavorably to Tsar Nicholas II. The Tsar mobilized massive willing, indeed enthusiastic troops, kept them in the field for three years and won major victories before a coup in the capital city triggered a collapse of the front.

Putin continues to make references to red lines that, if crossed, would lead him to unleash nuclear weapons. These comments generate considerable chatter in the Western press. The NATO command, however, seems reasonably confident that any level of nuclear escalation by Russia would meet with a crushing response and that, therefore, no escalation will occur. It is possible, however, that noisy chatter could provoke a stock market swoon at some point.

The Ukrainian success has largely terminated the threat of further Russian advances in the Donbas. Russia is likely to be struggling to hold its current position through the fall and winter. The combination of bad weather, inadequate logistics, and demoralized troops is a poor start. Add to that a determined enemy enraged by Russian atrocities and ever better supplied with superior equipment and the task before the Russian commanders begins to look bleak indeed.

With prospects of victory elusive, a negotiated solution must be considered. Putin would probably accept a settlement leaving each side in possession of what they currently hold. Such a result would be a clear Russian victory. However, the Ukraine will demand restoration of its 2014 borders, acceptance of its membership in the EU and NATO, and perhaps reparations. Putin would find it difficult to concede so much and so the fighting is likely to continue.

The war has been a major negative for the US/EU economy and for investors. The Ukrainian success does not bring immediate relief, but it is an important positive development. Worse case scenarios have improved greatly. We think it unlikely that China will fully commit to supporting Russia or make an opportunistic grab for Taiwan. We expect economic pressures on the EU and to some extent on the US to gradually moderate without generating further major political upheaval. Putin's grand strategy is foundering on the fundamental limitations of Russian power and that is a good thing for peace and profit loving democracies.

Requiescant In-Pace

With moving solemnities and storied pageantry Queen Elizabeth II was laid to rest. For the United Kingdom the abiding connection of Crown and Country was reaffirmed, while abroad perhaps a billion television viewers watched the funeral. In some of the Commonwealth countries which adhere to the monarch as head of state, politicians may seize this moment to push for republics. But they could well face skeptical publics who could see this push as simple self serving ambition on the part of local pols. The Commonwealth shows no signs of dissolution. That outcome is generally favorable for English remaining the lingua franca of international business and finance.





The Green Economic Transition

The Northern summer has closed with record heat waves, droughts and warnings about possibly collapsing ice sheets. We now move on to the hurricane season. The long forecast massive costs attached to global warming are beginning to appear. Holdouts continue trying to dismiss the science and to interpret away the painful reality, but this is an exercise in

futility – the climate does not negotiate with industrialists. California has adopted 2035 as the phaseout date for gasoline cars.

New York quickly followed suit and there are an additional 10 states which usually follow California's lead in this matter.

Domestic Politics

The midterm elections are a month away. These elections are their own unique mix of a referendum on the president and a host of local contests. This year Trump has sharpened the conflict by strongly shaping the Republican slate to represent the anti-Federalists. In our February 2020 number we listed out the challenges facing the incoming President. Let us score that card and see how he is doing



Table 1: Biden's Scorecard		
Domestic Issue	Comment	Grade
Covid	Moved strongly to deal with problem but could not persuade conservatives to embrace his policy and met opposition from the Supreme Court. The disease has greatly diminished.	A-
Economy	Covid relief kept economy from cratering but coupled to loose monetary policy and the Russo-Ukrainine war sparked a surge of inflation.	B
Trump's Insurrection	Let justice take its course and left Trump to inflict more wounds on himself and his party. This is a long game play and the jury is still out.	B
Spending Priorities	Inherited a highly progressive party platform from the primaries which he pulled back to the center and then bargained with conservative Democrats and liberal Republicans to partially enact.	B+
Infrastructure	Passed a strong bill after many predecessors failed	A
Green Transition	Got the framework of a coherent national policy in place despite interference by the Supreme Court	A-
Social Programs	Made modest improvements to Medicare and other programs, but had no progress on education reform or support for children/parents	B-
Border Control	Did little or nothing	C
Abortion	Mostly uninvolved in this battle	C
Environment	Actively reversed Trump's policies	B+
Partisanship	Modestly cooled the fires of interracial and cultural conflict	B
Overall	We give significant credit for Covid	B+

International Issue	Comment	Grade
Russia	Successfully leading the western alliance to what promises to be a major victory.	A
China	Deterred Chinese aggression and organized the Quad into a credible counterbalance to Chinese power	A-
Iran	Sought to reverse Trump's policy but had no apparent success	C
Afghanistan	Messy implementation of Trump's policy got US out of a costly and pointless war	C-
Mideast	Injected Wilsonian diplomacy into the real politic of US-Saudi relations for no real purpose or gain	C-
Global Climate Accords	Returned US to position of influence	B
Rest of World	Mostly benign neglect	C
State Department	Trying to restore competence after Trump's wrecking ball	B
Overall	We heavily weight first two issues	A-

The record shows a few strong wins on critical issues, a weaker showing on a host of secondary issues and no huge flubs. Overall, we rate him a weak B+ on the domestic side and a firm A- on the international side for a B+/A- overall. In the midterms this should qualify as a passing grade. Our forecast is that local issues will shape the outcome of the midterms and that the country is likely to remain balanced between the two parties.

The New York Attorney General has brought a civil suit against Trump and three of his children. The suit alleges a pattern of fraud in real estate operations. Allegedly property valuations were inflated by nearly a billion dollars in multiple loan and insurance transactions. In addition, alleged understatement of values in tax transactions has caused the Attorney General to make a referral to the tax authorities for potential criminal charges. We previously discussed this legal hazard for Trump in our March 2022 issue. Meanwhile, the FBI investigation under the Espionage Act has resumed. A district court judge had imposed a two-month procedural delay, but the appeals court removed the critical portion of this lower court order. Trump appears to be cratering like Madoff.



The Domestic Economy

The Federal Reserve raised its short rate to 3.25%. The Treasury yield curve is approaching an inversion (short rates above long rates.) Curve inversions are considered a key harbinger of recession. Inflation remains high at 8.5% (cpi) or 6% (core cpi.) We think short rates may need to rise another point or two before the inflation rate starts trending down with any conviction. The dollar has risen substantially. It is buoyed both by rising interest rates and by its status as a safe haven currency during international turmoil. This appreciation benefits US consumers but is a negative for US business.

The International Economy

The United Kingdom is in disarray. Its new prime minister hopes to offset the economic decline brought by Brexit by stimulating growth with expensive tax cuts. Financial markets feel the policy is out of step with the need to control inflation, and they have bid down the Pound Sterling



accordingly. To prevent a full-blown currency/bond crisis, the Bank of England has intervened with heavy bond purchases and interest rate increases.

The central bank of Japan also is raising rates to protect its currency. Japan is a massive importer of dollar denominated oil and protecting the Yen's dollar exchange rate is critical to restraining domestic inflation.

Europe continues heavily impacted by the war and by inflation. China continues working through its real estate lending mess and through the episodic disruptions of Covid lock downs. Unfounded rumors even briefly swirled around that Xi had been deposed – no doubt to Xi's intense irritation.

Even relative bright spots are not especially bright. In the recovery from Covid, the Indian Stock Market rose about 50% from its pre-Covid value to its opening point this year. Since then, it has range traded despite the misfortunes happening elsewhere in the world. Arab oil exporters have benefited from the disruptions caused by Putin's war. However, the price of oil has decreased from its peak of \$120 to \$87 currently (Brent spot crude.) Still the price is above last year's low of \$70.

Financial Markets

Assets fell across the board in September. The best performing asset class was Gold at -1.69%. Gold would normally be expected to do better given inflationary trends and political turbulence. Possibly the Russians are unloading reserves to fund their war and evade sanctions and this circumstance accounts for gold's weakness.

Table 2: Recent Market Performance

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	falling	-12.85%	-10.01%
	US Large Cap Growth	falling	-11.56%	-10.38%
	US Large Cap Value	falling	-13.88%	-9.44%
	Growth – Value	falling	2.32%	-0.94%
	US Mid/Small Cap	falling	-12.08%	-9.19%
	Intl Developed	falling	-19.14%	-7.98%
	Intl Emerging	falling	-17.62%	-10.84%
Fixed Income	3-7 Year Treasury	falling	-4.51%	-2.60%
	7-10 Year Treasury	falling	-6.45%	-3.97%
	TIPS	falling	-10.41%	-6.02%
	Muni	falling	-4.97%	-2.35%
	Investment Grade	falling	-6.34%	-3.73%
	Medium Grade	falling	-9.52%	-3.99%
	Preferred	falling	-8.12%	-3.56%
Commodity	REIT	rising	-16.93%	-13.60%
	Euro	falling	-7.95%	-2.37%
	Gold	falling	-9.83%	-1.69%
	Oil	falling	-29.76%	-7.93%

The p/e ratio on the S&P500 is currently 16.35. For approximately 20 years, a PE ratio of 15 has been considered fair value. This observation suggests that the market may begin to find some

valuation support at about this level. However the fair value norm of 15 applied in a period of established disinflation. During the high inflation period of the 1970s a PE more like 8 would have been considered fair value and capital intensive value stocks sometimes carried PE ratios of 5. Were the market to lose confidence in the Federal Reserve's ability to control inflation, the market would likely move to a new – significantly lower – valuation level. Our expectation, however, is that the Fed will succeed at controlling inflation and stocks will not reprice significantly from their current norms. By implication, there is little incentive to move out of stocks at this juncture. To be sure, stocks may decrease somewhat from the current level but this is likely to be a cyclical rather than secular move. Timing exits and entrances on cyclical moves is challenging and seldom rewarded. By the same token, however, a PE of 16 does not represent a great bargain and so there is little incentive to overweight equity positions at the current valuation.

The current high yield in the US Treasury market is the two year note (4.28%) while the long bond is 0.5% lower at 3.78%. Treasury bills are lower again at 3.25%. A further rise in the bill rate to 4% is nearly inevitable in this cycle of Fed tightening and a rise to 5% would not be hugely surprising. Similar to stocks, bonds look as if they are approaching fair value but are not quite there yet. The constant dollar (TIPS) yield curve is much flatter with 5 year notes offering 1.96% and 30 years offering 1.72%. Again these rates are possibly approaching fair value but do not yet seem compelling bargains.



Advice

A combination of structural and cyclical factors (Russian and Chinese aggression, domestic political turmoil, climate change, inflation) has cast a shadow over American life and economy recently. Slowly slowly, however, these issues are being resolved in favorable directions. Accordingly we feel the future is promising and investors should sustain their long term strategies.