LLOYD TEVIS
INVESTMENTS, LLC

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Nicolo G. Torre
Ph.D. CFA
Managing Director
Lloyd Tevis Investments

Archan Basu
CFA

3658 Mt. Diablo Blvd
Suite # 201, Lafayette
CA 94549

Market Commentary

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Recent Developments

We wish to begin by wishing our readers a Happy and Prosperous New Year! The coming year is likely to be different from the past year and we express the hope that for our readers it will prove a better year.

An important development on the Covid front was the emergence of a new strain of the virus in the UK. This strain is apparently more contagious than the dominant strain. Worrisomely, the new strain contains genetic material which could indicate greater virulence. The EC responded to this development by erecting quarantine barriers to the UK. The US CDC expressed the view that the new strain was probably already circulating at large in the US but admitted that they did not know because their disease surveillance efforts are inadequate. It is discouraging that almost a year in to this epidemic the government's ability to protect the public from imported diseases is apparently unimproved.

The other notable Covid development is some research out of Singapore. Singapore's intense testing regime sheds some light on the infectiousness of asymptomatic carriers. Asymptomatic carriers appear to have only one third the infectiousness of symptomatic carriers. This result may partially resolve the tension between high levels of infection suggested by antigen testing and the observed rate of spread measured from symptomatic cases. As fundamental knowledge about the disease increases, we would expect to see some narrowing of policy differences over how to handle the pandemic.

Finally mass vaccination has begun in the UK, US and Europe. So far the process is uneventful but in the US it is running substantially behind schedule. We think this is a heavy blow for the nation's small business community. Their reserves are exhausted and their capacity to absorb further economic disappointments is nonexistent. They need this pandemic resolved without further delay.

In political developments, President elect Biden has nominated most of his cabinet. He chose to draw heavily from the pool of people he had worked with previously and in the process has assembled a strong team for his presidency. To that backbone he has added a selection drawn more broadly from the Democratic party as a whole. In the process of ensuring depth, breadth and diversity he has also successfully diluted ideology.

Outgoing President Trump has fought an aggressive but futile campaign to overthrow the election. Conservative televangelist Pat Robertson kindly described him as living in an alternate reality. Once Trump exhausted legal efforts to reverse the election, he was taped asking Georgia's Secretary of State to fix the election. The Secretary was moved neither by appeals to party loyalty nor by political threats. On January 6 Congress met in joint session to count the Electoral College votes. Trumpters organized a demonstration and a portion of the demonstrators came prepared with an action plan. They forced their way into the Capitol building where every elected official other than Trump was present. They rampaged though the building searching for Vice President Pence and Speaker Pelosi, the presiding officers of the joint session. The insurgent's apparent object was to lynch Pence and Pelosi on the gallows they had erected in front of Congress and to the coerce the remaining

legislators into electing Trump. However the protective officers succeeded in evacuating the legislators without loss of life and the insurgents were forced out of the building, having accomplished nothing. Congress reconvened and proceeded with the certification of Biden's victory. The dollar exchange rate took a modest dip during this uproar but quickly returned to par.

Overall one can assess this affair as an American version of the Beer Hall Putsch - a poorly conceived and executed coup attempt revealing the deadly ambitions of its authors. The US has a long history of its security services being caught asleep at the switch and this event adds to that inglorious record. The fundamental cause appears to be the usual one - too many cooks in the kitchen. However, the US does have a strong record of meting out justice to those who attack it, and we regard insurgency against the US as an activity without a sustained future. At this point it is unclear how deeply Trump is implicated in the plotting. His moral responsibility is indisputable, but his degree of legal liability is not yet defined. However, when the charge is a violent overthrow of the government, the President really does need to be Caesar's wife - innocent beyond a doubt. The Senate will hold a trial early in the Biden administration to determine if Trump should be banned for life from holding Federal office. Given that the jury had to flee for their lives, we rate Trump's chances of acquittal as poor.

Whatever is the outcome of the Senate proceedings, it is evident that disassembling the Trump power structure will be an important item on the Biden agenda. We expect this will be accomplished mainly through lawsuits. Trump and his politically active children are likely to face numerous criminal investigations and civil suits. We expect these to terminate them as players in public life and to strip them of the means of political patronage and intimidation. It is settled law that the first amendment does not protect the deliberate making of false statements which endanger the public. Important media allies of Trump are vulnerable from the disinformation they have published, as for instance the story Fox News put about Covid-19, that it was a Democratic hoax. They may lose their operating licenses and face class action liability from victims. Local Republican officials and local governmental units which engaged in blatant voter suppression activities are likely to face civil rights enforcement actions. The Supreme Court had been expected to broaden gun rights, but we now think that project will be shelved and that instead the Court will approve restrictions on use of guns for purposes of political intimidation (e.g. armed demonstrations) and will allow the creation of security zones around government buildings. The Republican party is likely to fracture into its anti-Federalist and Traditional Liberal components. The anti-Federalists will cling to the myth of the stolen election, while the Traditional Liberals will seek to move on. The business community has already spoken. Key donors to the Republican party want no association with efforts to disenfranchise their customers.

Taking a quick look at the international situation we note a few developments. The UK has negotiated a trade deal with the EC that establishes their trading relationship going forward from the point where the Brexit process ended. It is, however, incomplete and key areas such as financial services and accountancy will be subject to ongoing negotiation. Putin's goons, having failed to assassinate a prominent dissident, suffered the indignity of being profiled by investigative reporters. One of them, apparently woozy from Covid, took humiliation a step further by giving an unintentional interview regarding the operation to the target himself. In India, a protest by farmers against a proposed reform has delivered the first check to Modi's program since Modi won reelection.

Long Term Factors: The Demographic Effect

This month we institute the practice of devoting a section of our commentary to longer term factors. These factors seldom generate news items which would bring them to the notice of the more topical

commentary, but their gradually accumulated effect is just as decisive for shaping the economic environment and the investment climate. As December is the month with the most conceptions it is appropriate that we focus this month on demographic factors. These factors were generally positive influences over the last ten and twenty years, but over the next ten years they are expected to be the cause of a distinct slowdown in the US economic growth rate. Table 1 takes us through the data.

Table 1: Demographic Headwinds Indicate Slowing US Growth

	Average % Change Per Year		
Factor	**2000-2019**	**2010-2019**	**Forecast2021-2030**
Change in Population	0.82	0.68	0.54
Change in Working Age %age of Population	-0.04	-0.24	-0.42
Change in Employment Rate	-0.05	0.72	0
Change in Labor Productivity	1.15	1.03	1.1
Change in Real GDP	1.87	2.19	1.22
Change in Real GDP per Capita	1.05	1.51	0.68

Source: World Bank

As is well known US population growth is coasting to a halt. In the first line of the table we see that it was 0.82% per annum over the last twenty years but is expected to be only 0.54% per year over the next ten years. People are living longer and having fewer children so the percentage of the population which is of working age is declining. Over the past twenty years this was a mostly negligible -0.04 effect but over the next ten years the effect will increase ten fold to a -0.42 effect. The employment rate is the fraction of the working age population which is actually employed. It varies somewhat year to year as the business cycle turns, but the twenty year average change is close to zero. However, over the last ten years the employment rate improved significantly year to year as the economy recovered from the deep recession of 2009. This improvement more than offset the effect of slowing population growth and aging population. However, by 2019 the country was at approximately full employment. Covid has caused a sharp drop from that level. Our view over the next ten years is for a return to the 2019 level of employment but with no additional growth beyond that. This is rather optimistic as it assumes no permanent job losses due to Covid and a quick recovery in employment. Finally the amount of real GDP which each employee succeeds in creating each year is known as labor productivity. It has generally increased at a steady rate as improvements in technology and resource utilization improve the output per worker. Adding up these different factors we get the annual change in GDP. The last ten years saw GDP increase modestly faster by 0.32 percentage points as compared to the last twenty years. However, the improvement felt better than that. The sensation of economic good or bad times depends on how the GDP per person is changing. Because population growth was slowing, the GDP per capita increased by 1.51 percentage points per year as compared to the 1.05% over the twenty year period. In other words, income growth per capita was almost 50% higher per year. It was this change which created the strong impression of improved prosperity. Unfortunately, the forecast is less rosy.

We expect real GDP growth rate to slow from 2.19% to 1.22%. The per capita effect will be even more dramatic – a decrease from 1.51% to 0.68% percentage points per year. Although incomes will still be increasing it is likely that the increase will be so slow that the general feeling is one of stagnation. The average is also likely to contain significant variation between groups. It is likely that

highly skilled technical and professional workers will continue to experience above average income growth while workers who are unskilled or who face displacement due to trade liberalisation or technology progress will suffer income declines. Mass resentment of "elites" and "experts" seems unlikely to decrease. However, the demographic factors are just one influence – they are not fate. The United States could, for instance, allow greater immigration of working age populations so permitting faster increase in real GDP. Or an increase in redistributive social policies could spread the pain more widely across the population and thus keep social resentments from increasing. Or labor productivity might increase more rapidly due to some complex interaction of factors. Overall, however, a forecast of slowing GDP growth suggests that substantial growth will remain concentrated in a few economic sectors and that the broader economy will stagnate.

Looking internationally we find a similar pattern (table 2.) The prevalent demographic effect is for a slowing of GDP growth by 0.3 percentage points per year over the next ten years as compared to the past ten years.

Table 2: International Comparison of Demographic Effects

Years 2010-2019	**Developed Economies**				**Developing Economies**	
Region	EU	Japan	UK	US	China	India
Change Population	0.20	-0.18	0.70	0.68	0.49	1.18
Change Working Age Population	-0.23	-0.49	-0.22	-0.24	-0.30	0.32
Net Demographic Effect	-0.03	-0.67	0.48	0.44	0.19	1.50
Change Employment Rate	0.15	0.33	0.33	0.72	-0.29	-0.43
Change Productivity	0.94	0.66	0.95	1.03	8.83	6.38
Change GDP	1.22	0.89	1.80	2.19	8.95	7.55
Change GDP per capita	1.01	0.80	1.10	1.51	8.13	5.85

Forecast 2021-2030	**Developed Economies**				**Developing Economies**	
Region	EU	Japan	UK	US	China	India
Change Population	-0.09	-0.52	0.36	0.54	0.20	0.90
Change Working Age Population	-0.29	-0.12	-0.18	-0.42	-0.29	0.11
Net Demographic Effect	-0.38	-0.64	0.18	0.12	-0.09	1.01
Change Productivity	1.16	0.66	0.95	1.10	7.00	6.00
Change GDP	0.78	0.02	1.13	1.22	6.91	7.01
Change GDP per capita	0.87	0.54	0.77	0.68	6.71	6.11
Impact Change Demographic Effect	-0.35	0.03	-0.30	-0.32	-0.28	-0.49
Change GDP per capita	-0.14	-0.26	-0.33	-0.83	-1.42	0.26

For the developed economies this is likely to be the dominant influence on GDP growth with a loss of a boost from increasing employment rate as the second influence. In the developing world the key factor is change in labor productivity and demographic and employment factors are secondary effects.

Market Review

Markets reached new highs by year end and have remained buoyant since. The S&P 500 rose +13% from Election Day through Inauguration: a new record, with Kennedy's +8.8% a distant second. This apparent vote of confidence in the Biden administration is unsurprising given the helpful backdrop of an early-cycle economic recovery; affluent consumers' confidence from newly padded savings; vaccines within sight; plus, market-trusted veterans like (incoming Treasury Secretary) Janet Yellen and (climate envoy) John Kerry retaking charge. Further afield, international and emerging stocks rose as well (MSCI EAFE +4.6% and MSCI EMG +7.4% in December), and oil climbed past $50/barrel. Consistent with this bullish picture, the bond bellwether rose as well, from a 10-year yield of 0.88% at Thanksgiving up to 0.93% at year-end and 1.10% on Inauguration Day. While rate rises have been long and widely feared, these were sufficiently gentle – and were sufficiently offset by falling credit spreads – that most investors avoided material resulting losses. In short, investors have much to celebrate in their year-end reports.

Market Index	December 2020	Jan-Dec 2020
S&P 500	+3.8%	+18.4%
Russell 2000	+8.6%	+20.0%
MSCI EAFE	+4.6%	+8.3%
MSCI Emerging Markets	+7.4%	+18.7%
Bloomberg Barclays US Aggregate	+0.1%	+7.5%
Bloomberg Barclays US High Yield	+1.7%	+7.0%
BofA Merrill Lynch European Non-Financial High Yield	+0.8%	+2.7%
JP Morgan EMBIG	+1.8%	+5.3%

There's much talk of a cyclical rotation. Recall that, from March lows through late summer, US large- and mega cap growth equities had risen fastest, leading us to warn of bubble risks concentrated in a handful of familiar names. Since then, however, neglected equity subclasses like US large cap value, US small cap, developed international, and emerging have all risen at a relatively faster pace. At the sector level too, we've seen a steady leadership migration from innovation leaders in technology, healthcare and consumer toward established businesses in energy, financials and industrials. All these rotations seemed overdue, and now that we've gotten a down payment, it is tempting to call for far larger, sustained movement in the same direction. The prospect of infrastructure-focused fiscal stimulus in '21, generating demand for "old economy" assets, provides additional support for this narrative. However, valuation swings remain hard to precisely time, as evidenced by the many prominent value investors who capitulated or retired by midyear. So, the likely future of the apparent bubble in US, large/mega cap, growth, and technology – as well as the relative fate of assets furthest way – remain open questions.

Fiscal Outlook

The Biden presidency launched about as energetically as expected, reentering the WHO and the Paris Accord before even unpacking its bags. It has announced a $2 trillion stimulus package, on the heels of a recently enacted $900 billion relief program, and an even larger infrastructure bill may follow in spring. Of course, Biden's stimulus packages will have to make their way through Congress. Given Democrats' recent Senate wins in Georgia, we can expect normal legislative

examination there, rather than implacable opposition. So, it is worthwhile to consider the potential impact. By (former Treasury Secretary) Larry Summers' calculation, $2 trillion represents 300% of the current output gap, in other words, it is thrice the degree of slack in today's recessionary economy. This is an outsize boost; for comparison, Summers figures that Obama's 2009 programs amounted to only 40% of the output gap then prevailing. So much stimulus would jolt the economy and markets and could easily ignite inflation – in turn causing the Fed to raise rates sooner than its 2023 schedule, an outcome no one wants. Inflation recently ticked up to +1.4%; recall that Fed chairman Powell plans to act once it stays above +2% for a while. All of which explains why many seem to doubt the Biden stimulus will emerge from Congress intact.

Where the Biden stimulus is likelier to resemble current plans is in its character. Unlike Obama's stimulus that was notably disbursed to banks, carmakers and the markets, Biden appears steadfast in wanting to directly reach disadvantaged communities, via education, housing, vaccine distribution and municipalities. This is a sensible way to stimulate an economy, since needy recipients generally spend stimulus checks, unlike the relatively well-off who end up saving more. Considering America's runaway inequality (our top 10% of earners now collect 50.5% of all income, the highest ever recorded) a progressive turn appears timely. However, that remains blasphemy among investors and the broader business community. Our nation is 40 years deep into laissez-faire capitalism; attitudes are so entrenched that even a slight move toward redistribution brings forth angry references to Venezuela. As investors we strive to maximize after-tax returns and don't look kindly upon increases in government spending or taxes. But good investing also requires a keen eye for cyclical turns. (Apropos, the top marginal income tax rate peaked way back in 1953, at 92%; currently it's 37%. Rest assured no one expects higher tax rates for at least another year.) Leading investors like Buffett and Dalio have called for policies that favor sustainable equitable growth. Indeed there's ample case for stronger centralized healthcare (do not leave a pandemic fight to states or companies) and for addressing current gaps in education and infrastructure. So this is no time for spending restraint; following a lengthy fiscal drought in new programs favoring the have-nots, Biden's program could achieve a lasting stimulative effect. Since the government can still borrow at historically low rates, this is a proverbial fat pitch: while the government's debt service burden remains manageable, even those inevitable inefficiencies that business people abhor can be taken in stride. In Yellen's words to Congress on Inauguration eve, "the smartest thing we can do is act big." Just maybe not $2 trillion big.

Investment Outlook and Guidance

So, with steadier policy hands, plus the promise of sustained monetary and fiscal support, our market outlook is relatively sanguine. As widening vaccination causes the pandemic to recede through summer, economic growth ought to enliven battered sectors like travel and sports. Some tech-enabled lockdown habits will likely persist, hence so will those glowing earnings in mega cap growth tech. Nosebleed valuations suggest gradually rotating away from that part of the market, though for now, the bubble may yet grow. (Buffett's largest position is 48% in Apple.) It will likely pay to carefully differentiate among stocks and sectors. Overall, large US stocks remain relatively attractive, followed by small value and emerging. Value stocks and smaller-cap stocks trading at low multiples who stand to benefit from fiscal stimulus seem a natural place to build positions. Conversely highly appreciated stocks, as well as high yield bonds, appear good candidates for trimming.

Risk mitigation still matters. Volatility (VIX@ 23%) will likely fade further as the economy transitions from early recovery toward mid-cycle expansion. In that environment, typical risk mitigators like

hedge funds and gold that performed strongly in 2020 now face a weaker investment case. Never forget that the only true risk mitigant are treasuries and hence the familiar Barclays Aggregate. Although this asset class remains much hated, elementary bond math shows that modest interest-rate rises will not materially impair it. For those who refuse to consider owning high-quality bonds at current yields, if they can forego liquidity, apartment complexes newly provide intriguing levels of yield and upside potential alongside their traditional modest correlation to stocks.

Bonus Section: How Not to Write an Annual Outlook

While the new year remains young, we are seeing voluminous investment outlooks through the rest of the calendar year. Such forecasts from last year were quickly belied by the spiraling pandemic, yet their practitioners' self-assurance appears to have recovered fully. Readers may want to filter out other classic mistakes like: writing in the present tense ("the great rotation is underway") thereby confounding past fact with future speculation; ignoring valuations (to focus just on rosy fundamentals of the post-Covid rebound); recycling canned histories (saying the 2020's will resemble a specific past decade makes for entertaining television but lazy investing); and of course vanilla projections (typical for most banks is an S&P 500 target that's 5-7% above the Dec 2020 level). More useful by far to focus on a new, timeless investing habit or two, or perhaps identify a topic or sector to which to dedicate some study; along those lines, we'll report on decarbonization next month. Finally the new year is also a great time to revisit and update one's financial plan.