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Market Commentary

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Major Developments

Worldwide Covid-19 remains the dominant factor. In the US the response has been split along partisan lines. The advice of health experts is that the virus remains at large in the community and that strong quarantine measures should be continued until objective control measures are met. The Democrats have proposed a \$3 trillion dollar relief bill to make adoption of that policy economically possible for the citizenry. The annual cost of financing that measure is about \$30 billion per year – comparatively pocket money for the Federal government. The President has chosen to reject medical advice and he has led his party in rejecting further relief. Instead he has insisted on an early resumption of normal economic activity. This policy appears to have very asymmetric payoffs. If early opening of the economy comes at an acceptable health cost it is not likely the president or his party will be credited with a biological event – the winding down of the epidemic. On the other hand, if the medical advice proves correct the likely outcome is reignition of the epidemic in full force and a more extended period of lock down and economic hardship. To date US deaths from Covid-19 approximate the country's battle field losses in the European theater of World War 2. It is surprising that any political leadership would risk a second such hit. If things turn out badly here, the Republican party could be eliminated as a political force in American life for a generation. We do not like risky bets in the capital markets with small potential profits and large potential losses. Nor do we like such bets in the political realm. At this point the Republican leadership seems to have staked their party's future on the whims of a poorly understood virus. It is a remarkable reversal of fortunes for a party which felt itself to be invincible just a few months ago.

Developments with respect to the virus are generally negative. The disease is proving more dangerous and harder to control than initial assessments. Medical developments, however, are more hopeful. One drug, Remdesivir, has shown some efficacy in speeding recovery. Immunglobin therapies are in initial trials and could provide a degree of biological protection to health workers. A vaccine created at Oxford proved partially effective in monkey trials. A manufacturing process for it has commenced at the world's largest vaccine provider – the Indian Serum Institute. Volunteers have come forward for a human challenge trial of efficacy. If efficacy is established, either by a challenge study or by the more conventional (but slower) process of a test vaccination program, then vaccination of high risk groups could commence in the fourth quarter with mass vaccination beginning in early 2021. Several other teams are preparing vaccines along different lines and are only about one quarter behind the Oxford candidate vaccine. At this point the indications are that this virus is one against which a vaccine program will ultimately prove successful.

Outside the US, the impact of Covid-19 varies by region. In the Asia/Pacific region results are generally favorable. While the initial outbreak in Hubei province got out of control, China was largely able to control the virus in the rest of the country. Japan, South Korea, Taiwan, Singapore,

New Zealand and Australia have also succeeded in either keeping the virus at a low level from the start or at bringing it to a low level. Similar good results have been achieved in Eastern Europe from early imposition of effective control measures. Western Europe, by contrast, was laggard in controlling the virus and is currently struggling to recover from the consequences. Iran has had similar difficulties. Russia, Latin America, the Middle East and Africa are all currently struggling to contain the virus. India has mounted one of the strongest control efforts and is currently experiencing good results, but it has not yet demonstrated that it can sustain those measures for the necessary period of time. Generally, the virus has been better controlled in countries with strong leadership, strong public health systems and recent experience with other epidemic diseases. Countries undergoing a more difficult experience with the disease fall into one of three categories:

- 1) Public policy errors (US, UK, Sweden and Brazil)
- 2) Weaker public health systems (Latin America and Africa)
- 3) Political investment in public medicine rather than public health and little recent experience with epidemics (Western Europe)

Given the high stakes medico-political game being played out in Washington, it is not too soon for investors to consider how a Democratic administration would impact their portfolios. We would expect such a government to be led by its moderates but to reflect the policy divergences within a broad coalition. We would expect a consensus to exist for :

1. Across the board reversal of Trump's policies
2. A focus on reviving the economy
3. Evolutionary efforts to address deficits in public health and medical insurance coverage
4. Modest steps to address climate change

While Democratic administrations often feel a more progressive tax code is a good thing, we would expect the immediate need to revive the economy from the ravages of Covid-19 would hold any major tax increase back until 2022 at the earliest. An increase in the deduction for state taxes might come sooner, however. Industries with cause to regret a Democratic victory would likely be coal, coal fired utilities, pipelines and medical insurers. Beneficiaries could include alternative power producers, electric vehicles and health care providers. The fracking, social media and medical technology industries have been targets of elements of the Democratic coalition in the recent past but would likely benefit from those issues not fitting into the consensus agenda. Overall these industry shifts represent purely incremental influences on the economy. Of greater importance would be any economic stimulus package – likely taking the form of an infrastructure package, credit support and grants to municipal governments.

Internationally China is and likely will remain the focus for some time. The out break of a bat derived virus a few hundred yards from a Chinese virology lab known for its active research program in bat viruses has naturally sparked the suspicion that the epidemic began as a lab accident. There is little China can do to allay this suspicion. Of greater moment, it is clear that in January 2020 the Chinese government was deliberately misleading international partners about the risk of human transmission of the virus while at the same time it was actively buying up medical protective gear on the international market. This shockingly predatory approach to global engagement has generated dismay and hostility towards China worldwide. Whether this response will crystallize in broad world action or just dissipates into a friction in China's many bilateral relationships is unclear at this moment. If the China's diplomacy can deal successfully with this challenge it will mark an important step in the country's maturation as a global power. Conversely, diplomatic failure could be a major setback in China's global ambitions.

Market Review

Markets climbed further in May, but with growing underlying divergences. The S&P 500 Index closed decisively above 3,000, leaving March lows (and the Q1 bear market) well behind. Forward volatility as estimated by the CBOE Volatility index (VIX) remained under 30, a barely aggravated level. International and Emerging stocks continued to lag. Bonds held up, all as is shown in the below table.

Market Index	May 2020	Jan-May 2020
S&P 500 = US <u>Largecap</u> equity	+4.8%	-5.0%
Russell 2000 = US <u>Smallcap</u> equity	+6.5%	-15.9%
MSCI EAFE = developed international equity	+4.4%	-14.9%
MSCI Emerging Markets = emerging international equity	+0.8%	-16.0%
Bloomberg Barclays US Aggregate = core US bonds	+0.5%	+5.5%
Bloomberg Barclays US High Yield = junk US bonds	+4.4%	-4.7%

Underneath the rosy headline of a market recovery lies a worryingly narrow market leadership: using capitalization weights, five familiar horsemen (AAPL, AMZN, FB, GOOG, MSFT) are up +15% for the year, while the rest of the S&P 500 is down -8%. It is tempting to rationalize this as a natural outcome of economic splintering; our adoption of the tech future has after all clearly accelerated. No wonder AAPL, AMZN, NVDA and TSLA are all trading at all time highs. But with valuation divergences out of all proportion to discountable earnings deltas, there is no escaping the valuation question.

And to underline broader sustained economic pain, the Congressional Budget Office now projects US GDP will be 3% lower a decade out, than they projected five months ago. This is no ordinary recession.

The Valuation Question

To gain a deeper sense of market valuations we look at four aspects of the question:

- 1) The value/growth sector trade off
- 2) The oil industry
- 3) The Volkswagen/Tesla pair trade
- 4) The cost of hedging market volatility

Stock market analysts define the growth and value sectors by ranking companies on their book value to price ratio and splitting the list at the point where half of market cap lies on each side of the split. Applied to the Standard and Poor's 500 stock universe (the US large cap sector) this typically results in 150 growth stocks and 350 value stocks. Thus growth stocks tend to be individually larger cap companies. As one might expect, technology oriented industries such as medical and information technology companies and internet based or enabled businesses tend to fall in the growth sector. More mature and/or cyclical industries such as banking, insurance, retail,

commodities and manufacturing tend to fall in the value sector. The starting assumption of economic theory is that the market will adjust prices to reflect any systematic differentials in growth opportunity and thus the two groups would be expected to generate similar returns for investors. It thus came as a considerable surprise when research by the academics E. Fama and K. French in 1992 demonstrated that value stocks had substantially outperformed growth stocks over the 1962-1990 period. While disconcerting for efficient market theorists, this result was cheered by stock analysts of the Graham & Dodd school who have long valued the effort to understand accounting data. Responding either to the Graham and Dodd tenets or to the more recent Fama and French findings, many investment strategists have introduced greater or lesser tilts towards value into their portfolio constructions.

	Russell 1000 Value	Russell 1000 (Blend)	Russell 1000 Growth
Total Return since market peak 10/07	78.4%	154.5%	254.2%
Total Return since market low 3/09	344.8%	468.7%	622.4%
20-year average P/E	13.6	15.4	18.8x
Current (5/31/20) P/E	18.0	21.7	27.1

Excerpted from JP Morgan, [Guide to the Markets](#)

How have these tilts fared? Not so well over the past decade. Growth has solidly outperformed Value by a handsome margin (see table.) Perhaps reflecting this strong recent record, the earnings of Growth companies are currently capitalized at 1.5x the earnings of value companies, which is a bit above the long term average of 1.38x.

Can one make sense of such data? The recent past has seen broad disruptive technological change. That pattern has generally favored Growth stocks and disfavored Value stocks. Alternately getting a good price (i.e. favoring value) matters more when capital is scarce and money is tight. Recently the world has been awash in liquidity and risk capital has been in plentiful supply. That circumstance also favors Growth stocks, which often rely on issuing high priced equity to fuel their growth. The divergence between the five FANG stocks and the rest of the large cap universe noted above is an expression of the growth/value performance differential. But it is also a warning that the apparent differential rests on just a few companies.

Next we consider the major integrated oil stocks. Historically these stocks have offered investors a rare combination of three highly desirable qualities: good dividend yields, strong balance sheets and participation in the growth of the world economy. The only downside has been the inherently cyclical nature of the oil industry and its exposure to occasional political squalls. However, the strong balance sheets and comfortable dividends have generally carried investors through these periods. Where do the companies stand today? The next table ranks the five majors by yield and provides the ratio of earnings to dividends per share.

Company	Price	Yield (%)	EPS	DIV	EPS/DIV
Royal Dutch Shell	32.25	3.87	1.28	2.45	52.24%
Chevron	94.03	5.49	2.06	5.16	39.92%
Exxon	46.60	7.22	2.66	3.48	76.44%
Total SA	39.97	7.64	3.04	3.07	99.02%
British Petroleum	23.70	10.26	-0.97	2.52	-38.49%
Average		6.90			45.83%

At an average yield of 6.9% the group is a stand out income producer in an era when Treasury bonds yield below 1%. But with earnings only covering 45% of the dividend, cuts must be anticipated if oil prices are sustained below \$35/barrel. Currently oil (North Sea Brent) is at 40.70 having traded down to 19.33 in April. Our primary caution about the group is not the sustainability of dividends, however. Rather we are concerned that this group may be providing ever less participation in world growth. Both cars and electric utilities are clearly shifting away from hydrocarbon fuels. We do not expect this decrease in demand to occur so rapidly as to crater these stocks, but we do anticipate a long plateau of slow or no growth. Investors in oil stocks have traditionally thought of them as income plus growth, but at the current juncture it may be wiser to assess them as just income. But then it is difficult to see much growth potential in government bonds either.

Our third approach to valuations is the Volkswagen/Tesla pair. The very comparison will seem whimsical to some and we ask the reader to accept it in a somewhat lighter spirit than some of our other comments. Volkswagen is Germany's stolid national champion, churning out a full range of motor vehicles for the world market. Tesla is America's upstart pure electric auto company struggling to expand its production capacity to meet order backlogs. Volkswagen is slowly trying to shake free of the massive scandal created by the fraud around emissions testing in the diesel powered portion of its product line. Tesla is led by the brilliant but mercurial Elon Musk. To compare the two companies we have had the unorthodox idea of dividing their market caps by their annual vehicle production.

Company	Price (\$/sh)	Capitalization (B\$)	Production (M units)	Capitalization / unit (\$/unit)
Volkswagen	151.58	79.5	10.875	7,310
Tesla	991.79	183.95	0.396	464,520

At first glance one might conclude that investors in the US and in Germany pay no attention to how the other values its car company. Then one might consider what could justify such a difference. Perhaps the future really does belong to Tesla and Volkswagen is hopelessly emeshed in a dying technology. In this regard one might want to take note of a recent announcement by the German government, to help the economy recover from the pandemic generated recession and to fight global warming, the government will be subsidizing the purchase of electric cars. That stimulus to the marketplace should help Germany's automakers, and especially Volkswagen, retool for the next technology. Germany's center-right governments are not known for allowing national champions to collapse. Today Tesla and Volkswagen may look like companies in very different technologies, but by 2030 they will likely just look like two car companies. In the meantime, perhaps Tesla should take advantage of its relative valuation difference and buy Volkswagen. That would probably be the simplest way for it to expand its manufacturing capacity.

Lastly, we consider hedges. Anyone who rode the markets down and back up this year - along with accompanying job and health stress - would gladly shift to a smoother ride. And those few who bought and held such insurance are surely now glad. But as insurance is dearer following a crash, an identical market ride over the balance of this year, with a hedge purchased today, would produce

an inferior outcome. See the below table for a sense of the recent trade offs in a buy-write strategy. Hedging may still make sense, as March-like volatility spikes typically draw aftershocks for months; an investor who lacks adequate intestinal fortitude would cause greater self-harm by selling into a bottom than by rolling insurance. Remain clear however on the trade off: smoothing your ride makes the journey more expensive, hence detracts from precious longer-term returns.

For a maximum monthly loss of..	..you have to relinquish monthly gains above..	..and also pay an annualized fee of..
15%	5%	0% (self funding)
15%	7%	1.20%
15%	10%	2.76%

Indicative pricing from Acruence Capital using EOD SPX CBOE data as of June 4 2020
Does not reflect trading costs, management fees, or taxes

Guidance

This market presents no obvious, no brainer bargains. While macro themes will dominate for a while, superior investment opportunity likelier lies in relatively inaccessible niches: entrepreneurial businesses that capitalize upon the newly normalized modes of work, school, healthcare and socializing; distressed private debtors who lack access to government or bank facilities; owners of neglected or beaten down assets who successfully repurpose them. For the majority of investors however, what matters now is timeless: peace of mind in an uncertain time; confidence to re-engage during periods of market uncertainty, even if that means sitting longer on the sidelines or buying some insurance; and as always, the ability to focus on and achieve life defining goals.