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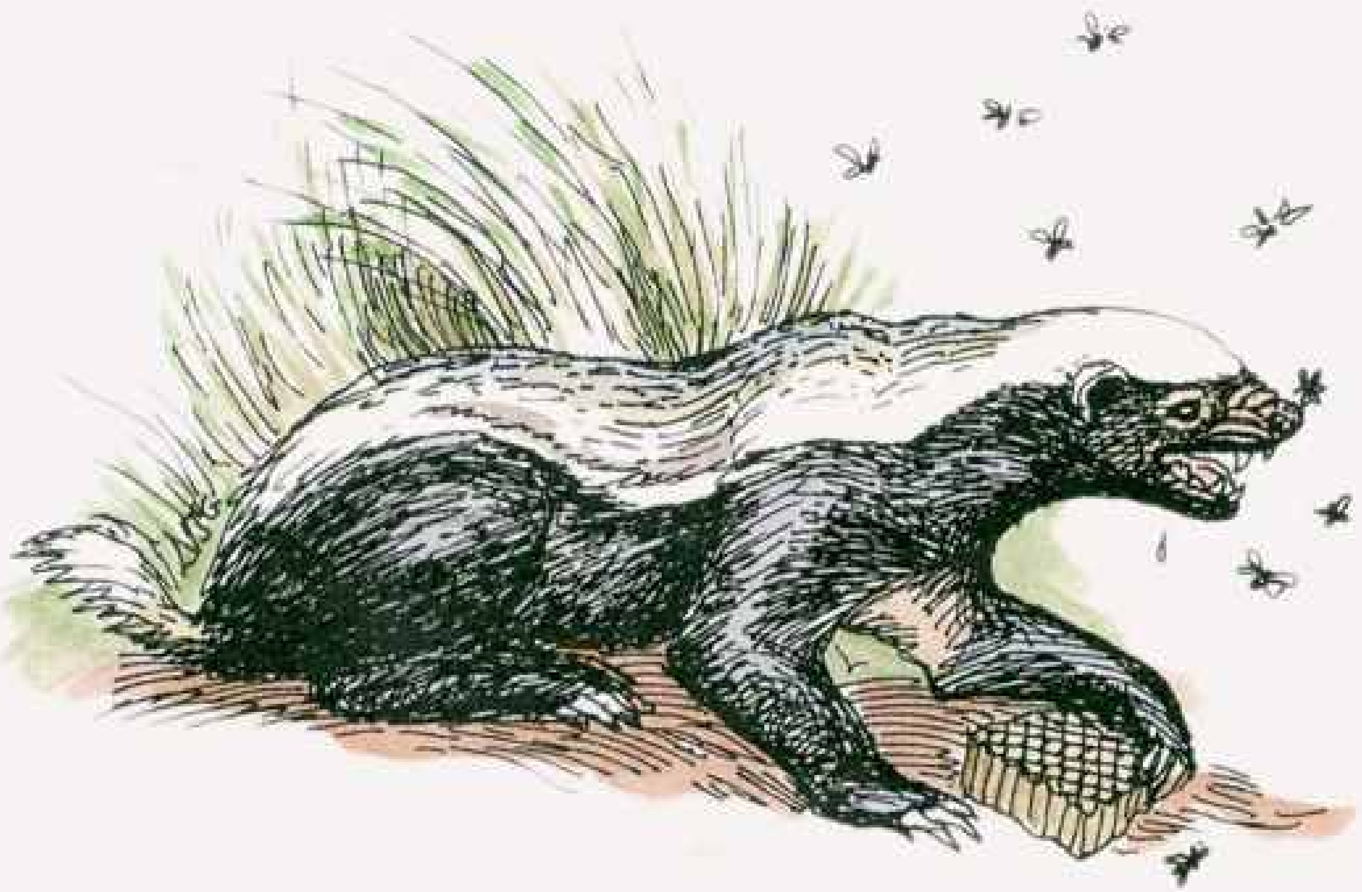

Market Commentary
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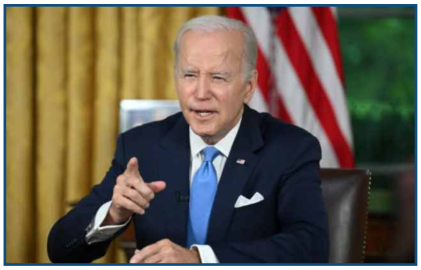


Domestic Politics

Budgetary brinksmanship between President Biden and House Speaker McCarthy has called attention to the US budget. With political spin being deployed from every possible angle it is worthwhile trying to assess what this was actually all about. We look first at the budgetary realities before probing the political kabbuki.

The US Federal government budget of $4.9 trillion is currently in deficit by $1.3 trillion which amounts to 5.2% of GDP. The US national debt is $24.26 trillion or 97% of GDP. Interest on that debt is currently low as much of the debt was financed at the ultra low rates of the past five years. That interest amounts to $0.475 trillion. However, inflation is running at about 4%, so a component of that interest should actually be reclassified as principal repayments. In fact this component, $0.97 trillion, is almost twice the interest due. With this correction the real interest cost is actually negative at $0.5 trillion and by implication the actual budget deficit is only $0.8 trillion. Or to put it another way, measured in real terms the national debt is only growing at an annual rate of 3.2%. With real GDP expected to increase 2.4% annual, the burden of debt is only increasing by three quarters of a percentage point (i. e 0.75%) per year. This is a comparative crawl and by no means a crisis situation.

Next let us look at how Federal spending is directed. Most of the productive economy is concentrated in blue states. As a result, blue states receive on average $1.02 in Federal spending for every dollar of Federal tax paid. The red states are, by contrast, concentrated in older less profitable areas of the economy. They receive on average $1.47 in Federal spending for every dollar of Federal taxes paid. Kentucky is a particular stand out and receives $3.90 in Federal spending for every dollar of Federal taxes paid – clear testament to the benefit of having supplied the Republican Senate leader for 16 years. Such figures force one to question the sincerity of Republican efforts to cut spending.

The current budgetary imbroglio began with the House Republicans refusing to increase the Federal debt ceiling. If sustained, that measure would have forced Federal spending to contract by nearly 30% per year in real terms. Additionally, House Republicans sought to preserve untouched the spending programs most important to their states, with the result that spending programs favored by Democrats would need to shrink by approximately 50%. However, there never was any possibility of sustaining such a measure. Treasury credit is the backstop to the many forms of credit insurance provided by Federal agencies such as FDIC, SPIC, FNMA, GNMA etc. These insurances in turn support the banking and mortgage industries which in turn are the sine qua non of the modern economy. Taking Treasury credit out of the system will at some point unleash a bank run that collapses the global economy. No one really knows how quickly that would happen, probably it takes more than a week but perhaps less than a month. No one really wants to find out. Similar to the collapse of the Roman Empire, there would be no real coming back from such a debacle.

So a budget deal was always inevitable. The President and House Speaker McCarthy concluded a deal at the last minute to allow enactment before the Treasury would exhaust its cash reserves. Cosmetic tweaks were made to current spending programs and the Republicans raised the debt ceiling enough so the issue would not reoccur until after the 2024 election. This outcome was so inevitable that we had forecast it in our January and April market commentaries.

So what was the Kabuki all about? Mostly positioning for the 2024 elections we think. Biden has been able to remind the unruly sections of his party that he may be elderly but he is protecting them from the political meat grinder into which the other party would cheerfully stuff them. The MAGA Republicans can parade before their constituents claiming they would have done great things but for the RINOs. And the RINOs can remind their constituents of what would have happened if there had not been any adults in the room. In short, everyone can congratulate themselves even though there was never anything much that needed to be done at the start of the story and nothing much had gotten done by the end of the story.

Meanwhile down at the court house, former President Trump booked a minor win and two minor losses. The win was special prosecutor Durham's final report finding that the FBI improperly expanded a legitimate preliminary investigation of possible collusion between the Trump campaign and the Russian state into an illegitimate and massive full investigation. That finding supported Trump's long standing complaint that he had been targeted by "the deep state" – i.e. by career bureaucrats at the FBI. As such he enters the long list of American politicians, including Malcolm X and Martin Luther King, who have been harassed by the FBI. Somewhat deflating Trump's success, Vladimir Putin took this moment to salute the Proud Boys and other January 6 rioters/seditionists as political prisoners. One wonders why he picked this particular moment.

Trump's losses were of equal magnitude to his win. In a civil proceeding a Manhattan jury found him guilty of thirty years ago having sexually harassed a woman who he could have credibly mistaken for his then wife and subsequently defaming her. Trump's unbridled tendency to insult opponents cost him a $5 million adverse judgment. In a New York criminal proceeding Trump appears to be facing conviction for hiding a hush money payment to a porn star in the books of his business. However, it remains doubtful that the prosecution can sustain the theory that would raise this from a misdemeanor to a felony charge. More serious concerns are possible criminal indictment for obstruction of justice in the Mar Lago papers case and possibly RICO charges in connection with apparent corrupt influence on the Georgia 2020 election. While Trump's supporters will sympathize with him over his recent legal difficulties, the emerging charges are more hard core. Former FBI Director Commey's characterization of him as a mob boss may yet stick.

Russo-Ukraine War

On May 20 Yevgeny Prigozhin, head of the Wagner mercenary group, announced his troops had completed the conquest of Bakhmut after a campaign of eight months. He further stated that Wagner would transfer control to conventional Russian forces on May 25 and retire to training camps to regroup. Prigozhin's claim appears technically correct, however the Ukrainians continue to hold positions just beyond city limits from which they contest the road lines westward out of Bakhmut. Additionally they have made flank attacks which have pushed the Russians back and forced the Russians to rush new units to the fray to stabilize the front. From this perspective the wider Bahkmut area seems still in play and Prigozhin's decision to claim a victory and withdraw appears to be an effort to make the best of a likely Pyrrhic victory. It is believed the Russians have paid a 5-1 loss ratio over the course of the Bakhmut campaign.

The United States has finally consented to supply the Ukraine with F-16 fighter jets and accompanying support operations. Immediately the jets will be drawn from NATO arsenals and not directly from the US. The F-16 comes in many variants depending on installed radars and weapon systems and combat capability varies widely across the different types. Thus, it is not immediately clear how capable the supplied jets will be. It will also take many months to transition Ukrainian pilots to the new platform and likely a year or more to stand up the full set of sustainment operations (i. e. restock and repair of planes and training a continuing pipeline of pilots.) Nevertheless this is a highly significant move in upgrading the Ukraine forces. We have long called attention to the inadequacy of NATO support in this area. We regard NATO investment in this program as indicating an expectation that the Ukraine is on track to NATO membership and that its forces will need to be integrated with the alliance's core technologies.

The battlefield dynamic appears to be transferring the initiative to the Ukraine. The summer campaign season should show whether the Ukraine can liberate significant occupied territory and deliver to the Russians at least a tactical defeat, or whether the Russian hold on the occupied territory is resilient and not to be shaken. A major tactical defeat of the Russians could force them to withdraw from Ukraine and accept the restoration of the Ukraine's full territory. Conversely, a successful defense by the Russians would suggest that the conflict is headed for a "frozen conflict", similar to the situation in Korea and many other war zones around the world. In such a situation, neither side accepts the other's legal position and so there is no formal peace settlement, but rather a continuing set of cease-fires wind down efforts to change the situation on the ground.

The attempt by NATO/EU to choke off Russia's oil revenues appears to have failed. In part this is because China, India and some Arab states have been willing to purchase Russian oil. Also Saudi Arabia refused to increase production to make up for embargoed Russian oil and so the EU was forced to tolerate sanction evasions to stabilize the oil market. More broadly European and US diplomacy has not been able to form a strong front against Russia outside Europe. The countries of the global south continue concerned about Western power and happy to see it balanced by the Russians and Chinese.

Belarus's dictator Alexander Lukashenko attended the May 9th commemoration of victory in WW2 held in Moscow. Immediately on his return he was hospitalized, which fueled speculation about the Russian's poisoning him. Lukashenko is deeply unpopular at home and would likely be swept aside by a popular uprising which would seek to follow Ukraine into the Western camp. Lukashenko is maintained in power by his own military and by the certainty of Russian intervention. On the other hand, Putin makes no secret of his desire to absorb Belarus and of his desire to engage Belarus in the Ukraine war. Lukashenko has proved a canny politician and has successfully postponed both eventualities without giving Putin a hard no. A Russian hand in Lukashenko's poor health could indicate increasing Russian frustration with his resistance and an attempt to either intimidate him or to launch a silent coupe. On the other hand, natural ill health would simply underline to all paries the fragility of Belarus's current internal and external balance. Lukashenko is currently 69 and has been in power for 29 years.

Putin has strengthened his internal security arrangements and has conditioned the populace to expect a long war with tactical setbacks. Even a strategic defeat in Ukraine would not necessarily shake his grip on power. A persistent rumor claims he has a slow moving terminal cancer. His current constitutional successor is Mikhail Mishustin – a nationalist technocrat. Whether Mishustin could maintain a grip on power against challenge from political rivals both within and beyond the Kremlin is unclear. The Russian elite is believed to be of divided minds on the war. One part judges it an inevitable and very costly defeat in the making. The other part believes it is a strategic necessity which must be driven to victory whatever the cost. The general public is under no illusion as to the irrelevancy of its opinion and the considerable personal risk in voicing an opinion outside the bounds sanctioned by the Kremlin.

Our assessment remains unchanged. NATO must either aid Ukraine to a strategic victory which fundamentally discredits Putin's revanchist political program within Russia or else NATO must look forward to an extremely expensive armed peace along its eastern frontier lasting a generation. A Russian victory – not currently expected – would be pregnant with further wars engineered by the Russians and Chinese with the goal of fundamentally breaking Western power.

China

Western firms operating in China have used local subsidiaries of global accounting and consulting firms to do due diligence on business deals in China. This is an utterly routine and necessary business practice. Recently the Chinese government raided the due diligence firms under its espionage acts and forbad Chinese firms to provide them with information. It is difficult seeing western firms continuing normal business in China under these circumstances. China appears to have decided on reversing its economic opening to the West and returning to an closed economy.

In one interpretation the Chinese government apparently believes its economic dealings with external actors can be conducted on a tribute basis. In such a relationship the external party accepts that the Chinese will hold the paramount position in any economic relationship and the external parties gratefully accept this reality in return for being granted access to the Chinese economy.

Or more simply the Chinese have something to hide and do not need pesky foreigners around checking the books. What could it be? Satellites pass over China every night and count how many electric lights are on. Given the economic results reported in China's economic statistics, the satellites should be seeing more lights than they actually observe. The ready explanation is that the Chinese have been cooking the books. Book cooking may be systematic through out the state. It is likely regional governments pad up their local reporting and that the national government then further pad up that result. It is quite possible officials in the central government do not know the true numbers and cannot keep track of just how badly cooked the books are. For years the Chinese have been reporting GDP growth that looked a little too good to be true. Based on light bulb counts it is possible that the cumulated distortion amounts to 30% of GDP. In other words, China's true GDP may not be $18T (closing in on the US at $21T) but rather something like $12T (about on par with the EU.) Adding credibility to this supposition, China has stopped publishing a host of macroeconomic indicators.

China's economy was expected to take off this year and to help rescue the world economy from the recessionary effects of a slow down in the US. Word out of China is that 20% of young people are unemployed – so a robust recovery does not seem to be occurring. If, however, China's books are seriously cooked then China's influence in the global economy was never going to be so strong. By implication, the failure of a robust recovery to appear – while not good news – is also less bad news than it otherwise would be.

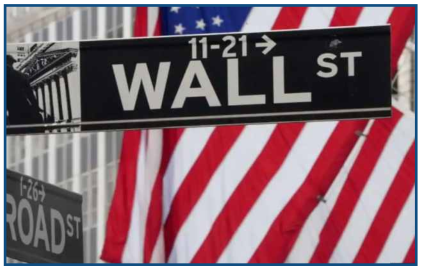
In recent years China has been engaged in a big expansion/modernization of its military. Against the perceived backdrop of a big growing economy that build up looked like simply the natural expression of China's economic progress. If we reassess the economy as actually smaller and not growing so quickly, then the military expansion looks more like deliberate policy choices and the expression of a deeply nationalistic program. That would be disquieting.

There does not seem to be enough light on what is actually going on in China.

In an unrelated event the Pope has announced a synod (church governance council) in Rome at which nonbishops will be voting members for the first time and will hold 20% of the votes. Those votes are being divided equally between men and woman, so for the first time woman are directly participating in church governance. We noted in our November 2022 commentary that the Chinese government had dropped the token participation of woman in its governing Politburo. The Vatican and the Chinese state are two of the world's oldest governments, but at this moment they seem to be going in opposite directions with regard to male monopolization of power.

The Economy

The US economy continues surprisingly strong. The Federal Reserve has successfully engineered a banking crisis which should lead to a credit contraction, but job creation rolls on anyway with nearly 10 million open positions (6.25% of the workforce) and employers are bidding up wages in an effort to secure staff. There is considerable concern about a wageprice spiral fueling inflation, but the obvious counter measure of allowing in more foreign workers is not even discussed. The greatest number of job openings are in the hospitality industries – long the domain of less skilled emigrant workers. The second greatest number is in teaching which perhaps reflects an economy with an under supply of knowledge workers – the long time domain of H1B visa workers. Stepping on the brake and the accelerator simultaneously is a good way to overheat an automobile and the same appears to be true for the national economy.



The Markets

Large cap equity, both US and International Developed markets, continued a rising trend. US Large Cap Value took a minor correction and in the process confirmed that Growth's long period of weakness versus Value appears to have run its course. US Mid/Small cap and International Emerging markets continued to range trade. We see adverse credit conditions as holding back the Emerging Markets, the Mid/Small Cap and even perhaps the Large Cap Value, while leaving Large Cap Growth and International Developed relatively untouched. In most Fixed Income sectors recent momentum was not sustained and we now mark these sectors as range trading rather than rising. They will continue to wait on a clearer picture for the US economy.

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	rising	5.73%	1.01%
	US Large Cap Growth	rising	9.58%	2.67%
	US Large Cap Value	rising	0.50%	-1.90%
	Growth – Value	rising	9.07%	4.57%
	US Mid/Small Cap	range trading	-6.07%	-1.99%
	Intl Developed	rising	1.92%	-3.99%
	Intl Emerging	range trading	-0.03%	-2.28%
Fixed Income	3-7 Year Treasury	rising	2.09%	-0.99%
	7-10 Year Treasury	range trading	2.39%	-1.65%
	TIPS	rising	1.05%	-1.72%
	Muni	range trading	0.86%	-0.82%
	Investment Grade	range trading	1.28%	-1.28%
	Medium Grade	range trading	-0.54%	-1.65%
	Preferred	range trading	-6.85%	-2.47%
Commodity	REIT	range trading	-6.07%	-4.21%
	Euro	rising	0.72%	-2.69%
	Gold	rising	5.91%	-2.65%
	Oil	range trading	-8.89%	1.58%

The Euro and Gold continue a modest rising trend, which is another way of saying the dollar is weakening – probably a response to the unimpressive politics on display in the US. Oil had been falling for months from the panic highs seen at the start of the Russo-Ukraine war. It appears to have reached a stable trading level.

Advice

Raucous politicians, uninspired technocracy, unfriendly foreigners, the interest rate cycle – the US economy has seen them all before and like the honey badger it doesn't much care. Its going to do what its going to do and most of the time that is grow. These are normal times and investors should be holding their personal normal portfolio. That portfolio should be based on a careful analysis of their resources, obligations and objectives such as is provided by our Precision Investment ™ service available at www.lloydtevis.com.

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Cover Photo

The honey badger (Mellivora capensis) is a member of the weasel family which ranges across Africa,the Mideast and India. As a midsize predator it faces competition and threats from much larger predators throughout its range. However, its truculent personality allows it to hold its own. Its determined and slightly hyperactive character has been celebrated in several entertaining video shorts, easily available on YouTube, such as The Crazy Nastyass Honey Badger Don't Care which went viral in 2011.