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Market Commentary

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Major Developments

Covid-19

In the US the daily case rate has dropped to one quarter of its peak rate. The peak occurred around New Years and was driven by the socializing of the holiday season.

The wind-down of the holiday season and renewed government urging for protective behaviors account for most of the fall-off. The administration is putting serious effort into increasing vaccine supply and facilitating vaccine administration. The US is on pace to have about 200m people at least partially vaccinated by the end of March. An additional 28m people have acquired some resistance to the disease from having suffered a known infection. Perhaps twice as many have acquired natural immunity as the result of an undiagnosed infection. These figures suggest that 90% of the population will have some resistance to the infection by mid-April. A significant economic recovery/boom could be underway by late spring.

A recently published paper has documented the high efficacy of the Russian “Sputnik 5” vaccine. This vaccine was actually the first to market. Like some other vaccines, it employs a natural virus to deliver a fragment of Covid DNA to human cells. Here the harmless Covid DNA results in the manufacture of viral protein which primes the human immune system to attack the Covid virus and thus to resist infection by Covid. Several other manufacturers employed this same technology. But in a refinement the Gamaleya Research Institute used two different natural viruses as carriers in the initial and booster shots. This refinement is probably why their vaccine has proved substantially more efficacious than the other DNA based vaccines. Indeed the efficacy of Sputnik 5 is now among the best of all tested vaccines. Considerable respect is due to the Russian team.

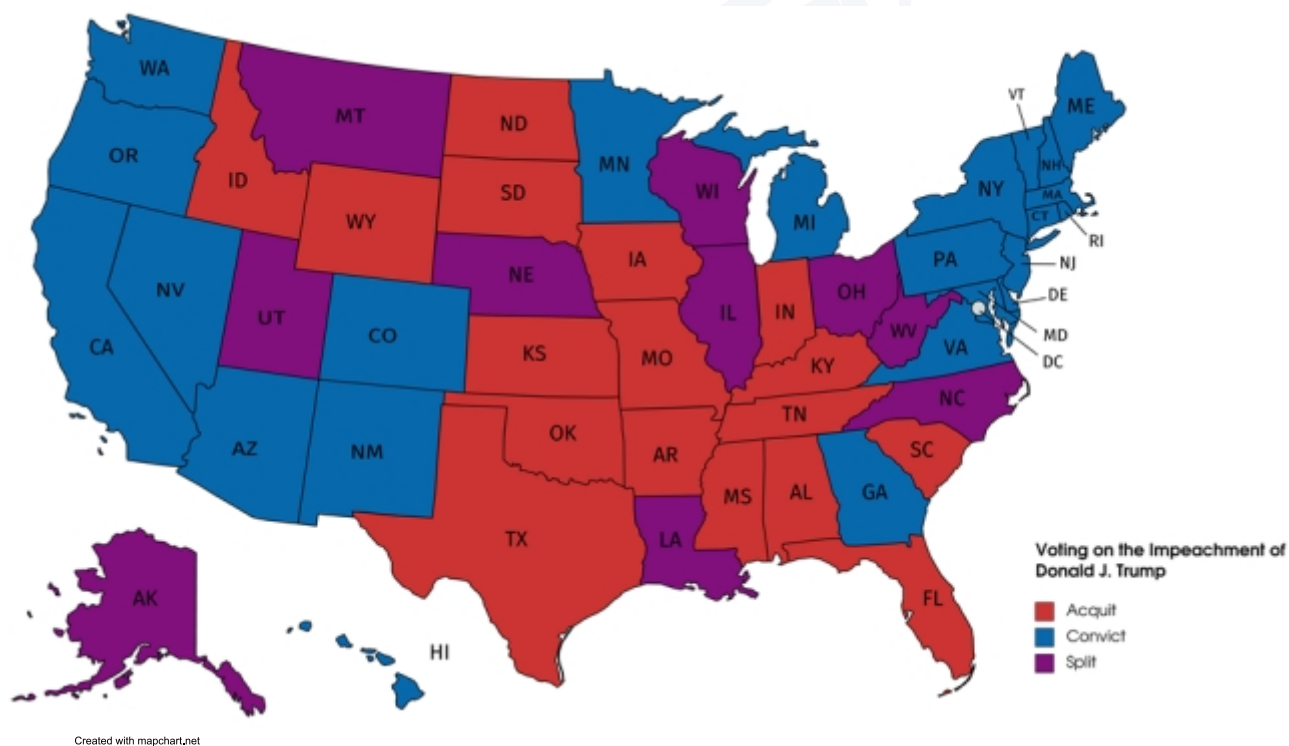
A nagging concern is that a vaccine resistant viral variant could emerge. With the developed world rapidly getting vaccinated, the greatest risk of this development is in the developing world. The US re-engagement with the WHO as well as the efforts of private charities lends some hope that we will not make the mistake of allowing the disease to evolve abroad until it is ready to re-attack the United States.

Domestic Politics

The impeachment trial of Donald Trump ran a mixed course. On a positive note, the Senate succeeded in maintaining order and decorum in the face of high partisan feeling. Senatorial practice in impeachment trials does not establish fixed rules of evidence, but rather leaves it up to the jurors to assess the credibility of evidence as part of their total decision. This practice is normal for legislative investigations, but it departs sharply from judicial practice. Consequently, it is difficult to triangulate from a case presented in a Senate impeachment to what the same case would resemble if presented in a law court. In another departure from judicial practice, several jurors openly coached the defense. Such behavior would not pass in Little League, let alone in court – a fact obvious to every watching American who has ever served on a jury.

The House managers presented a strong case that Donald Trump sought to overturn the results of the national election by applying pressure on Congress to throw the election into Trump friendly state legislatures. For this purpose he organized a march by his most militant supporters on Congress timed to coincide with the constitutionally mandated joint session. As is well known, that march resulted in the invasion of the Capitol building by Trump supporters of whom some had apparently homicidal intent. The House managers had not alleged that Trump intended that result and their evidence did not address how cognizant he was of his supporters' exact plans. However, the managers established that his tweets alone directly supported the charge of incitement under which he was impeached.

Curiously, Trump presented no substantive defense at trial. His attorneys followed the maxim: "If you do not have a defense, talk vigorously about tangential issues and sit down quickly." Trump avoided conviction by a margin of ten votes. Immediately after the trial concluded, Republican Senate Leader Mitch McConnell delivered a scathing attack on Trump calling for his criminal prosecution. McConnell explained his vote to acquit as driven by qualms about the constitutionality of impeaching Trump once he was out of office rather than by doubts as to his responsibility. And so the problem of Trump was passed on to Biden to deal with.



Since the trial's end, Trump has moved quickly to consolidate his power within the Republican party. While his support among Congressional officials is shaky, support at the state level is strong. Many Republican-led legislatures are introducing strong measures to change voting procedures under the guise of preventing the repetition of a fraud which did not occur in the first place. The political careers of Representatives and Senators who stand against Trump are being threatened. Trump himself declares an intent to run for president in 2024.

Where is all this activity leading the party? Above we show a map of the United States color coded by whether a state's senators voted for conviction, acquittal or split their votes. Here the states marked

in red constitute the core of Trump's support. They are 17 in number, but being thinly populated they only dispose of 169 electoral votes. The Split verdict states are 9 in number and dispose of 73 electoral votes. In terms of demographics and economy they are more similar to the acquit states than to the convict states. The conviction states are 24 in number and dispose of 293 electoral votes. This map suggests Trump would have a difficult time winning the 2024 election should he be the Republican candidate. If we allocate the electoral votes of Split states equally to the red and blue camps the map suggests Trump would lose the 2024 election by 206 to 329 electoral votes. Impeachment provided the Republican party with an opportunity to disassociate itself from Trump. Instead he seems likely to remain the party leader and to lead it from a Hard Right stance to a Militant Right stance.

President Biden had hoped for a Republican party with which he could negotiate, at least in the Senate. Possibly ten or so Republican senators will break from the party ranks sufficiently to negotiate some key issues. But it seems more likely Biden will govern by executive order and budget reconciliation measures. How long will this last? Many Republicans seem to hope the tick-tock of the political pendulum will be beneficial to them in 2022. Actually they have more vulnerable seats in play in 2022 than the Democrats. Countering the tick-tock narrative, Karl Rove has suggested that Biden's popularity is likely to increase over 2021 as the epidemic comes under control, the economy recovers and the Republican's electioneering narrative of what a Biden administration would be like proves inaccurate. Democrats can defeat scorched-earth opposition from the Republicans by granting statehood to Puerto Rico and Washington DC. Republican efforts to change state voting laws are sure to invite Federal lawsuits to enforce voting rights. Trump and his close associates will likely be the subject of continuing inquiries, investigations and prosecutions for years. We are skeptical that Trump will successfully lead the Republicans to renewed political power. Instead his continuing involvement will likely stymie the emergence of new leadership.

International Politics

The Biden administration has made a strong initial showing on the international stage – moving forcefully and with confidence to signal a return to the United States' traditional diplomatic posture.

A coup has occurred in Burma. The long ruling military dropped their experiment of collaborating with the democratic opposition and returned to direct rule. China has been supportive of this move by the Burmese military. China is building a rail link from Kunming to Kyauk Pyu via Mandalay. When completed the line will approximately reopen the Burma Road transportation corridor of World War II fame. The reader may be forgiven for not immediately recognizing the name of Kyauk Pyu, which today is a sleepy town of 20,000. The Chinese, however, plan on transforming it into a deep-water port with a transit capacity comparable to the Port of New York. This rail line will give China improved access to the Indian Ocean. Biden's ability to balance Chinese influence in the world will very much depend on his ability to consolidate power at home.

The Texas Power Grid

An unusually sharp winter storm nearly caused the collapse of the Texan electricity grid. Millions were without power or tap water for days and dozens died. The specific engineering failure was a drop in gas-fired electric utility capacity in the face of soaring demand driven by the cold snap. Texas has opted for an extreme form of electricity deregulation that is the ultimate cause of this failure. It has long been known that complex systems are subject to cascading failures. Safety engineers, therefore, insist on the establishment of reserves throughout the system to ensure that

under stress the system degrades gradually rather than collapses brutally. The classic example of such a system is the banking system, with each bank required to maintain capital and liquidity reserves and a Central Reserve bank on hand to deal with crises. In banking, this approach is entering its third century of existence and no one seriously believes the system could function without these safety measures. System stability is, however, a global concern and a pure free-market approach has long been known to result in inadequate reserve holding. Accordingly, reserve requirements must be imposed in the public interest rather than expected to flow from commercial self-regulation. Texas's politicians forgot this basic fact in setting up their power market and they show little evidence of having relearned it. Texas' governor was quick to blame windmills for Texas's power problems. In fact, Texas power generation has moved strongly into windmills – which is one reason Texas has low, business-friendly electricity rates. And Texas' windmills were as lacking in weatherization as its gas fields. But windmills provide only 7% of Texas' power during winter months and it was the drop in gas-fired power which created the crisis. Having misidentified the problem, the governor then chose a short-term non-fix with long term costs. Specifically, he blocked – probably illegally – the export of Texas gas to northern Mexico. Any consideration of Texas' strategic economic position would identify northern Mexico as the more likely source of economic growth for Texas than say New Mexico and Oklahoma. Indeed, to the extent there is a national imperative to reduce dependence on Chinese manufacturing, northern Mexico is the obvious beneficiary. Cutting gas flow to a strategic business partner as they struggle through the same storm as yourself is an excellent way to remind them you are an unreliable business partner. Specifically, it hurts the reputation of Texas gas as a reliable supplier in the face of competition from Mexico's national oil company Pemex. One is left with the strong impression that Texas's politicians have opted for simplistic ideological and nationalist solutions rather than engaged with the true complexities of governing.

Market Review

Equities moved up in February, though as was true in January, they had moved even higher before selling off at month-end. The economy and corporate earnings now show solid improvement, which is expected to continue as the pandemic recedes by summer. That anticipation, together with the potential for accompanying inflation, has caused yields to rise: 10-year US Treasuries that yielded 0.93% at year-end, now yield above 1.5%. So markets found themselves in a familiar face-off with the Fed. Two things remain clear, both as previously observed: we are well past last summer's bottom for 10-year yields (0.52% on August 4), and stocks (particularly of the growthy tech variety) remain historically pricey.

| | February 2021 | Jan-Feb 2021 |
|--|---------------|--------------|
| S&P 500 | +2.8% | +1.7% |
| MSCI EAFE | +2.2% | +1.2% |
| MSCI EMG | +0.8% | +3.9% |
| Bloomberg Barclays US Aggregate Government | -1.8% | -2.8% |
| Bloomberg Barclays US Aggregate | -1.4% | -2.1% |
| Bloomberg Barclays US High Yield | +0.3% | +0.7% |
| BofA/ML European High Yield | +0.5% | +0.9% |
| JPM EMBIG | -2.6% | -3.7% |

Outlook and Guidance

The old Wall Street adage “Buy the rumor, sell the news” reminds investors that long-anticipated good news, upon its ultimate arrival, may actually cause a sell-off. Mathematically, since

intermediate Treasury yields are both an economic bellwether and the discounting rate for future stock earnings, their rise in good times induces a downward revaluation of stocks. Don't rush to conclude, however, that rates will necessarily move much higher this year.

For anyone still wondering whether to trim gains after 2020's bull run, or at least to rebalance portfolios that have gotten overweight in US stocks and FAANG names, here's another topical adage: "Ride your gains, cut your losses." Given the elevated volatility still present in markets (VIX down slightly at 27) it's prudent to lock in some gains, though as usual, we wouldn't rush to do so on a down day.

With recovery underway, and the Biden administration's fiscal stimulus package ahead, US inflation concerns (raised in a prior monthly column) now occupy center stage. So it's worth considering how best to inflate portfolios from its corrosive effects. Today's usual candidates include gold, Bitcoin, oil and inflation-protected Treasuries (TIPS). Gold is among humankind's oldest currencies, and Bitcoin arguably among its newest; neither is controlled by a print-happy government, yet neither holds up well on closer inspection. Gold rose dramatically in 2020 then recently slid; it may take an unusual upside spike in inflation to push it up much further. Bitcoin remains volatile and largely institutionally untested. TIPS directly protect from unanticipated inflation shocks, but that insurance doesn't extend to the rest of your portfolio. Oil too has risen (already above \$60 cf. below \$30 last year) and per earlier commentary is hard to recommend. The worthiest candidate is emerging market equities, whose attractive fundamentals (relatively low valuation, dividends, long term growth) solidifies its case.

In short, for most wealth allocators, this is an opportune moment for a portfolio tune-up.