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Market Commentary

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Major Developments

Global Economic Results

We begin this month with a survey of the global economy (table 1.) At this point all the results for the second quarter are in and we can see the strongly contrasting effects of the pandemic on the global economy.

In Asia the pandemic has basically been a nonevent. The death rate in Asia as a fraction of the population is low at 34 per million. The Asian economy has decreased only 2.6% cumulatively since the start of the year and the decline primarily reflects the spillover of the virus's impact on Europe and North America rather than direct damage from the virus in Asia. China's economy is a point of particular strength. It grew 13.65% in the second quarter – the only country to experience economic growth in that quarter. For the year to date its economy is up 4%. By contrast, Europe is heavily impacted by the pandemic with a death rate 9 times higher than Asia. Its economy has shrunk by 13.26% year to date. North America is also heavily impacted. Its death rate is about twice that of Europe or 17 times worse than Asia. Its economy has shrunk by 9.5% year to date. The spread in outcomes is particularly stark if we compare the US and China. The US death rate is 189 times worse than China and the Chinese economy has outperformed the US economy by 13 percentage points. To put it another way, during a period in which the US gross domestic product decreased by 2 trillion dollars, the Chinese GDP increased by 0.6 trillion dollars. Equity markets have proven fairly resilient. Asian equity markets are down 3%, North American markets are down 5% and Europe is down 16.5% year to date. The China market (Shanghai) is up 7%, while the US market is up 4.8%. The relative strength of the US market versus Europe appears to derive from the US's strong tech sector which is a comparative beneficiary of the dislocations COVID-19 has brought. Globally interest rates continue to trend lower, but the major move occurred in Q1 and rate changes in Q2 have been purely incremental.

Consequences for Commercial Real Estate

In our April commentary, we highlighted possible long-term changes that could result from the pandemic and we drew particular attention to business offices. We hypothesized that an enforced period of working at home would result in a partial adoption of work from home as a standard business practice. There is an obvious economic inefficiency in workers maintaining spacious homes which they leave standing empty during the day while they spend hours commuting to spacious offices which they leave standing empty during the night. The potential efficiency gains from working at home derive from eliminating the commute and shrinking the corporate office footprint. These gains are most significant in highly congested expensive metropolitan centers. After six months' experience with most employees working from home, some of the differences in firms are emerging. Work from home is proving difficult for two types of firms to adapt to: 1) hierarchical control-oriented firms such as banks and 2) creative firms that thrive on social interaction such as advertising. However firms where workers spend most of the day processing phone calls and electronic documents with little direct interaction with colleagues, work from home is proving highly viable. In truth, the ability to remotely locate workers is probably more a function

of department than the overall firm. We expect work from home to be a permanent practice going forward. The impact will probably be greater in San Francisco than in Manhattan, given that tech firms are more aligned to work from home than are banks or advertising agencies. The other lasting impact of COVID-19 on real estate markets is likely to be in malls. Here it has caused a likely permanent shrinkage in retail and thus in foot traffic. The decline in foot traffic argues for a decline in food establishments or at least their relocation out of malls to more local shopping zones. We believe these changes in business and shopping practices will drive significant net productivity gains for the economy as a whole, but commercial real estate is likely to endure years of adjustment pain.

Table 1: Comparison of Regions With Respect To Economic and Pandemic Factors

Region	Component	2019 GDP (T\$)	Population (M)	GDP/capita (\$000)	Total Covid Deaths	Deaths per Million	Percent Change in GDP			Equity Return (% YTD)	Bond Rates (ppt change YTD)
							q1	q2	q1+q2		
North America	US	21.44	331	64.8	205,072	620	-1.3	-7.9	-9.1	4.8	-1.15
	Canada	1.73	38	45.9	9,328	245	-2.1	-9.7	-11.6	-4.5	-0.91
	Mexico	1.27	128	9.9	76,603	598	-1.2	-13.2	-14.2	-15.6	-1.58
	All	24.44	497	49.2	291,003	586	-1.3	-8.3	-9.5	-5.1	-1.21
Europe	Europe	19.84	453	43.8	149,225	329	-3.6	-9.9	-13.1	-10.8	0
	UK	2.83	68	41.7	42,090	619	-1.9	-15.0	-16.6	-19.4	-0.5
	Russia	1.67	145	11.5	20,299	140	n/a	n/a	n/a	-19.2	-0.8
	All	24.34	666	36.5	211,614	318	-3.1	-10.5	-13.3	-16.46	-0.43
Asia	China	14.57	1446	10.1	4,739	3	-8.5	13.7	4.0	7.7	0.03
	Japan	5.15	126	40.9	1,561	12	-0.9	-7.0	-7.9	-0.8	-0.08
	Indo-Pacific	4.94	565	8.7	16,491	29	-2.0	-1.8	-3.7	-7.45	-0.65
	India	2.94	1380	2.1	96,318	70	0.3	-17.4	-17.1	-4.7	-0.72
	Australia/NZ	1.58	30	52.3	907	30	-0.3	-6.3	-6.6	-9.6	-0.27
	All	29.18	3547	8.2	120,016	34	-5.6	3.2	-2.6	-2.97	-0.338
Other	Brazil	1.85	212	8.7	142,058	670	-1.5	-8.4	-9.7	-13.8	-3.39
	Arabia	1.63	58	27.9	4,712	81	n/a	n/a	n/a	-0.9	n/a

Sources: Economist, WHO, World Bank

International Politics

China's international stance continues to be highly belligerent. It has made a substantial military incursion into India and has launched military demonstrations in force against Taiwan. It has made verbal threats against the European Union, Japan and the United States. It has made economic reprisals against Australia. Once the US national election is settled, China is likely to find itself isolated diplomatically and tending towards economic isolation. In anticipation of that, the Chinese government is emphasizing growth in domestic consumption over export-oriented growth. China's strong line is not without a foundation. Measured by tonnage its naval fleet is three times larger than the US Pacific fleet and comfortably larger than the combination of the US Pacific fleet and the Japanese navy.

Domestic Politics

The run up to the US national election is sure to promote a flood of political commentary. Pre-election discussion will center on personalities, campaign posturing and polls. Afterwards it will focus on offices distributed by the winner and the future direction of the losing party. Stepping away from this cacophony, we offer our own analysis - which focuses on political forces rather than personalities.

In American political life there are many axes along which players may be sorted. We identify the controlling axis at this juncture as being attitude towards the Federal government. We identify three

distinct groups. Because political terminology is freighted with associations and often applied pejoratively, we have created three new labels with which to identify these groups rather than seeking to apply labels already in common use.

Our three groups are:

Anti-Federalists – This group identifies the Federal government as the greatest threat to their well-being. They regard the Federal government as a threat to their personal freedom, economic livelihood, and cultural values. They feel it is dominated by an elite class which deeply disrespects them on a personal basis. They fear that the foreign engagements of the Federal government will result in a blood tax on their children. They fear that open immigration policies will swamp and ultimately disenfranchise their social group. The primary political agenda of this group is to weaken the Federal government. This group sees itself as highly patriotic despite its opposition to the Federal government.

Members of this group resolve the seeming tension in these two positions by seeing the United States as a product of its people rather than its government. Despite the fear which animates much of the Anti-Federalist program, the core insight of this group is an optimism as to the ability of the American people to form and carry out more creative solutions than any centralized decision-making process can arrive at.

Traditional Liberals – This group wants a Federal government which is strong enough to protect them but not strong enough to constrain their liberties. On defense they favor a forward defense posture involving alliances and foreign bases. On the economy they see government as using its police powers to ensure fair and orderly markets and to address market failures. They want these powers to be deployed by the Federal government to preempt State governments and thus to prevent the fragmentation of the economy which would result from state regulation. This group is pro-choice on nearly every issue – reproductive rights, gender orientation, health insurance, education and economic freedoms. On social justice this group emphasizes economic growth and jobs as the primary mechanism of social uplift, but it is willing to deploy Federal power to address situations of historic injustice, present hardship or other special circumstances. Overall it is committed to equality of opportunity but not outcome. This group favors selective immigration based on family linkages or the need of the economy for workers. The core insight of this group is that the American government is one of the creative works of the American people and that properly employed it can achieve ends which are otherwise unattainable.

Social Democrats – The Anti-Federalists and Traditional Liberals are agreed in holding a positive view of the United States. The Anti-Federalists stress the need to preserve it, while the Traditional Liberals seek to perfect it. But both groups view it as a good and fundamentally honorable country which they are proud of. The Social Democrats have a darker view. They regard the United States as deeply flawed and in need of far reaching reform. They would use the Federal government as their tool to bring this reform about. They would limit choice to achieve faster progress with their reform program, especially in the area of economic freedom, but also in healthcare, education and political speech. Like the Anti-Federalists, this group is distrustful of elites, skeptical of the existing defense posture and prone to feel personally disrespected. On immigration, however, this group favors broad immigration to dilute the white element in society. On social justice this group's commitment is to outcomes rather than opportunities and it sees redistribution as important as economic growth. The core insight of this group is that the suffering of the poor and oppressed is now and that solutions which arrive someday are not solutions.

The Traditional Liberals and the Social Democrats dislike each other, but they are able to work together tactically to oppose the Anti-Federalists. Although the Social Democrats and Anti-Federalists are both anti-elitists, their strong disagreements on other issues does not permit even tactical alliance between them.

In a cabinet style government, each of these groups would carry on their political life through their own party. In a presidential system, however, only two political parties are viable and so these groups must map on to the Republican and Democratic parties. From Franklin Roosevelt to Barack Obama the Traditional Liberals were the dominant group. Beginning with Dwight Eisenhower they divided into a group emphasizing economic liberty and a group emphasizing personal liberty. The first group allied with the Anti-Federalists to form the Republican party, which they led for most of the period. The second group allied with the Social Democrats to form the Democratic party, which they also led for most of the period. Because both parties were led by Traditional Liberals, the two parties held compatible visions of what the United States should be. They maintained a unified position on foreign affairs and were able to effectively horse trade domestic priorities. In 2016, Donald Trump captured control of the Republican party for the Anti-Federalists. He has since acted to push the Traditional Liberals out of the party, and they have rejoined with the Traditional Liberals in the Democratic Party. As a result, Joseph Biden currently leads a group which ideologically stretches approximately from George Will on the right to Alexandria Ocasio-Cortez on the left. In the language of political commentators "Trump has lost the suburbs." In that statement we take exception only with the verb; "discarded" would better acknowledge the element of deliberate choice in Trump's actions. For his part, Biden's challenge is how to lead a very broad coalition. His novel solution is to campaign for the position of Head of State rather than to present himself as a party leader proposing a specific program of action.

The defining issue which has brought these political alignments into clear light is COVID-19. For the Anti-Federalists it is natural to view illness as not a Federal responsibility. Consistent with that view, Trump has resolutely refused to lead the fight against COVID-19. Instead, by championing protection of personal liberty against the policies of elites, he has adopted policies which promote the spread of the disease. Traditional Liberals, by contrast, regard protecting the public as the primary mission of government. Social Democrats focus on the social justice aspects of the infection. For both groups it is axiomatic that the government should fight the infection and Trump's stance appears to them as a betrayal of the public trust.

The word betrayal is chosen with care. It highlights the fact that the Anti-Federalists and the other two groups hold incompatible views of what the United States should be. Until one or the other group emerges as dominant the Federal government will remain paralyzed. For the Anti-Federalists this would count as a partial victory, while for the opposition, it is a defeat. Domestic paralysis also weakens the United States internationally, to the benefit of our political and economic rivals and enemies. Unsurprisingly, they seek to promote domestic discord in the United States. The coming election will clarify the electoral strength of the three groups. But all three groups have deep roots in the political life of the United States. We expect them to persist for generations more, whatever, may be the outcome of one election season.

Market Developments & Outlook

While much is being made of September's market decline (S&P 500 down -ve 3.8%, shaving its year-to-date tally down to +5.6%) this is a small move given our bubble warning last month. Major trends remain in place: quality growth, mega cap tech, and consumer stocks remain expensive

while high yielding financial and industrial stocks remain undervalued relative to history. The weight of information technology names in the S&P 500 is now 28.2%, a level last seen in 1999; that said, its earnings contribution weight of 23.7% has never been higher. And the broader economy shows continued signs of recovery, with inflation up (to 1.3% headline, 1.7% core), unemployment down (to 7.9%) and capacity utilization up (to 71%).

Table 2: Performance of Major Markets Past Month and Year to Date

Market Index	September 2020	Jan -Sep 2020
S&P 500	-3.8%	5.6%
MSCI EAFE	-2.6%	-6.7%
MSCI Emerging Markets	-1.6%	-0.9%
Bloomberg Barclays US Aggregate	-0.1%	6.8%
Bloomberg Barclays US High Yield	-1.0%	-0.4%

These ingredients promise continued uncertainty in market direction, and in particular, investors should beware of betting on binary political outcomes. Instead invest on longer term themes and consider lightening up on conviction as you approach binary corners.