STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS Summer 2008

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,448 * Dow Jones Industrials 12,601 * 30 year U.S. Treasury Bond 4.64%

THE LESSONS OF HISTORY

One of the great mysteries of education in America is our profound reluctance to teach our children any useful history. The adults around them all have a shared body of knowledge that relates to the events of the last several decades, yet our children know nothing about it. Did Russia and China fight in World War II? With us or against us? How did we get into Vietnam, and what happened when we got out? Why were we all driving sub-compact cars in the 1980s?

Many of today's investors lived through the 1970s, and have been comparing recent events with the challenges of that difficult decade. Inflation actually hit 10% in 1974, and hit that level again in 1981. The average unemployment rate hit 10% soon after.

In those years the Fed was printing too much money, and commodity prices of all kinds were rising---just as they are today. Wall Street thrilled to tales of shortage; Paine Webber published a series of research pieces (featuring world-renowned experts), which explained how you could profit from the misery of others. We were running out of oil, copper, food, water . . . .

Most of the bubbles burst quickly. Gold crashed in the early eighties, and silver crashed spectacularly after the Hunt brothers failed to corner the silver market. The demand for every high-flying commodity shrank, while supply grew rapidly.

The same forces of supply and demand caused oil to crash, but the time spans were far longer. Oil prices ran up after the Iranian revolution, and briefly spiked to $50 during the Iran/Iraq war. But from there they declined for 18 years, to $11 a barrel in 1999. Oil-industry executives were reluctant to invest in new oil exploration and new technologies until they felt sure that prices would stay high; and consumers took just as long to send all the nation's gas-guzzlers to the junkyard.

Let's return to the 80s. The bursting of the commodity bubble of the early eighties was soon followed by a real estate bubble that raged on the East and West coasts of the United States. Supply grew, demand shrank. Here in New Hampshire the bubble peaked in late 1988 and then burst with such a fury that it brought down three big banks and sent home prices down 30%.

The tech-stock bubble followed, pushing the Nasdaq 100 index from ***400*** in 1995 to ***5000*** in March of 2000, as we argued against the mania in lonely and futile fashion . . . . And as that bubble burst the nation

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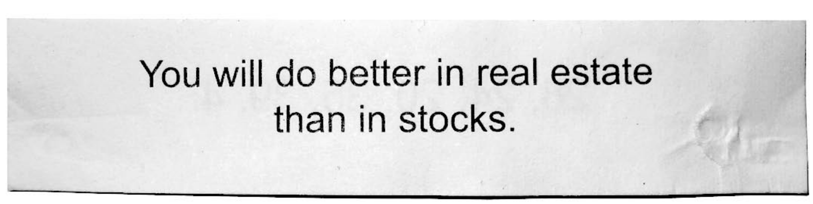


The "fortune" from a fortune cookie that your editor received in March.

FORECASTING YESTERDAY'S NEWS

"Inflation fears are spreading . . . . We're debasing the currency!" These statements are true, but they are remarkably unhelpful. The era of easy money, inflation, and dollar devaluation is mostly behind us.

The dollar fell steadily against its main rival, the euro, for more than six years. In that time the euro *almost doubled*. The fact that Wall Street pundits have just noticed the trend—in time to catch the last 10%—is all the more reason to think that it is nearing an end.

Inflation? We experienced massive inflation in land prices, housing, and other forms of real estate between 1996 (the year of Alan Greenspan's famed "irrational exuberance" comment) and 2006. Interest rates were too low, and easy money was extended by the Federal Reserve, the banking system, and Wall Street. The result was rampant inflation in a huge sector of the economy. The value of owner-occupied homes reached *$22 trillion* at the peak of the bubble. Similar booms were occurring around the globe.

Real-estate inflation doesn't get picked by the CPI. Not much, anyway. Even so, the CPI has slowed noticeably in recent months, in the face of this great infatuation with inflation in the nation. Our crude oil consumption is still just 0.8 trillion dollars a year . . . . When the oil bubble bursts, food and energy prices will fall—and it will be hard to find rising prices anywhere.

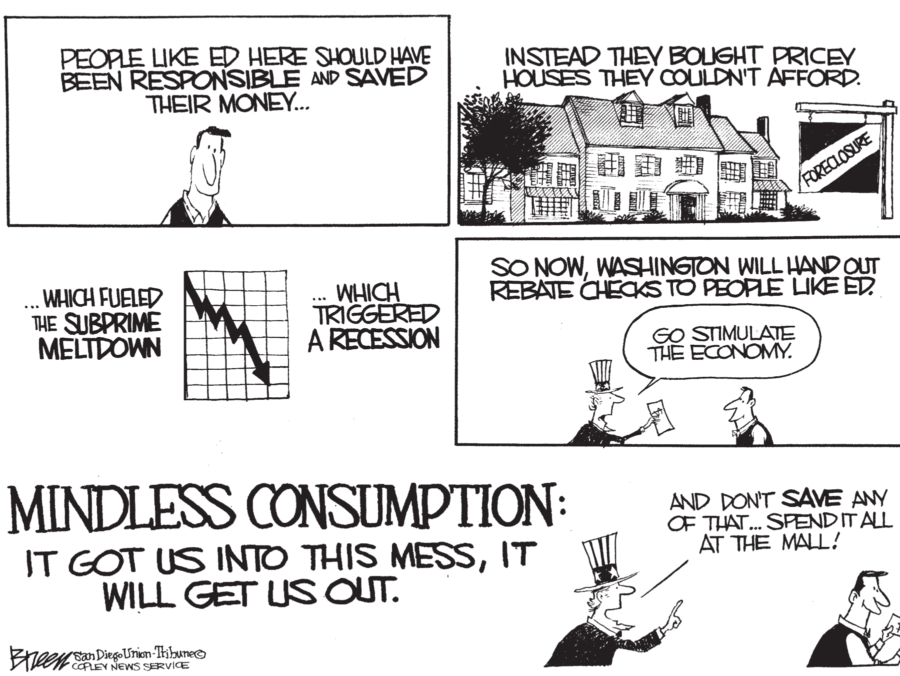
We've long argued that the Federal Reserve fueled the tech-stock and real-estate bubbles by printing far too much money. Today our biggest problem is that money is being *destroyed* on a huge scale.

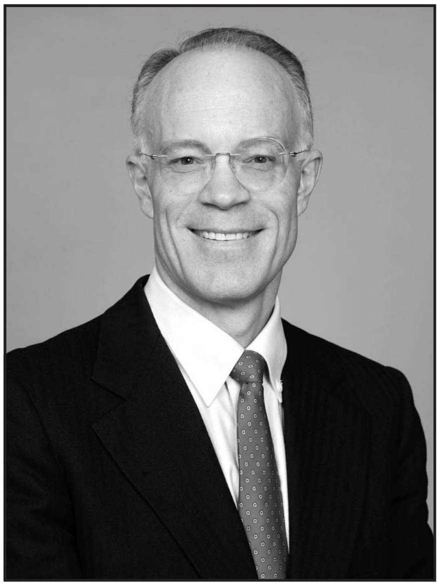
That destruction is mostly taking place in mortgages, where homeowners are defaulting by the millions. Lenders are booking huge losses, and responding by tightening credit across the board. The five million "sub-prime" homeowners who were never able to afford a home will never get a mortgage again. 20 or 30 million "prime" homeowners are cutting back their spending, because they can no longer pay off their credit-card balances by taking out a home-equity-loan or doing a cash-out refi.

Private equity funds are finding it difficult to borrow, and hedge funds that had grown used to borrowing billions to bet big on mortgages are being forced to give it all back to the bank. In this environment the Fed can print all the money it wants, because the amount of money circulating in the economy is not going to grow.

Why, then, are commodity prices rising? Because investors love bubbles, and they're easy to create. Anybody can push up the price of gold, by purchasing shares of GLD—an exchange-traded fund that is now owned by millions. The same can be said about the hedge funds pushing up the price of oil, copper, and soybeans, and it's all going to come to a bad end.

Inflation never coexists with a recession for long.





John Lumbard, CFA

TAKING PROFITS

In recent months we've been reducing our holdings of foreign bonds. The euro has appreciated enough—our once-large European holdings have all been sold at a profit—and we'd rather not invest in the currencies of the commodity-exporting countries such as Australia, Canada, Russia, New Zealand, Indonesia, Brazil, other Latin American countries, African countries . . . . . We still have (reduced) holdings of the Templeton Global Income Fund and the Japanese yen, along with a big investment in a European Investment Bank bond, denominated in Turkish lira, which carries a yield of more than 14%.

"It is hard to think of any greater geopolitical imperative today than to demonstrate that Islam and democracy can be bound successfully together. Turkey is well on the way to proving this, in an experiment that is resonating far beyond its borders."
– David Gardner, Financial Times

MUDDLING ALONG

We can't claim to have torn up the track in 2008. Our benchmark account (the one that started with $100,000 in the fall of 1990) stands at $446,391, down 3.34% for the year. We've been wrong in our bets against oil, and we've had a rough time with some drug stocks that should have flourished in this weak economy.

You don't have to look far to find investment firms that have fared far worse. Diversification doesn't seem like a good idea when all of your favorite stocks are soaring, but prudence pays when the markets are against you—and it's always comforting to earn a stream of dividends and interest that can slowly pull you out of a hole. Many investors seem to agree, because we've opened several new accounts in the last few months.

It's always pleasing to see growth in our assets under management, but we know that we'll struggle to maintain a high level of service to clients if we establish too many new relationships.

Our solution is to raise our minimum to a million dollars. We know that it's a big jump, and we'll honor any commitments (or even vague expectations) that were the result of past discussions. Give us a call, and we'll be happy to talk about your situation and your needs. Further information regarding performance, fees, and other details of our firm can be found at www.Lumbard.com.

On some days the markets seem to be full of cash. Investors shrug off bad news, or they respond to good news with such enthusiasm that you'd think we're in the middle of an economic boom. Where is all that money coming from?

China and the Middle East. It's well known that the Chinese hold a trillion dollars in U.S. treasury bonds, accumulated as they reinvested their export winnings. Their motivation was to keep the renminbi from rising, and it happens that Saudi Arabia does the same thing with its oil revenues to keep the riyal at a fixed rate to the dollar. The difference is that—because Islam forbids the receipt of interest—the Saudis don't buy bonds. When they put money into the U.S. markets, it goes into stocks and commodities. That river of cash into the stock market has been supporting the S&P 500 for some time now.

Lehman Brothers says that investors poured $40 billion into our commodity markets in the first quarter of 2008, and that much of this investment came from the governments of the Middle East (via their sovereign wealth funds). Perhaps we'll eventually learn that OPEC nations had an important role in running up the price of oil . . . .

LESSONS...

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was already—astonishingly—embracing another real estate bubble. We wrote that New Englanders, at least, should have been able to see the reincarnation of the monstrously destructive bubble of the1980s. Supply grew and grew . . . . Demand shrank . . .

The real-estate bubble is still bursting, and yet Wall Street is hard at work, sucking investors into another round of commodity bubbles. Oil, copper, wheat, soybeans, gold, uranium . . . . We're arguing, in lonely and futile fashion, that oil and other commodities are absurdly overvalued. It's long been said that history repeats itself, but why does it have to repeat so quickly?

Warren Buffett, on the exorbitant fees charged by hedge funds:

"For example, a manager who achieves a gross return of 10% in a year will keep 3.6 percentage points – two points off the top plus 20% of the residual 8 points – leaving only 6.4 percentage points for his investors. . . . . "

"Its effects bring to mind the old adage: When someone with experience proposes a deal to someone with money, too often the fellow with money ends up with the experience, and the fellow with experience ends up with the money."

BUBBLING CRUDE

"Oil imports to China, the world's second-biggest consumer, dropped 3.9 percent from a year earlier to 14.24 million metric tons, about 3.5 million barrels a day, the Beijing-based Customs General Administration of China said on its Web site today." – Bloomberg News

That sounds like a pretty big piece of news, for an oil market that's driven by the notion that a rapid increase in Chinese consumption is the reason for a 900% increase in prices. Chinese oil demand has been dropping—it's been falling for a ***year!!***—and next week the I.E.A. predicts that in 7 years we'll need an additional 12.5 *million barrels a day.*

Back on the home front, US gasoline inventories are up 18.4% in the past year. There's a glut of gasoline in the United Sates, so Goldman Sachs puts out a report saying that gasoline doesn't matter any more. "Gasoline, at least in the short-run, has traded more like an annoying by-product of crude than as its core fundamental driver."

An annoying by-product? Gasoline is more than half of our consumption of finished products, and gasoline conservation was an important factor in the bursting of the last oil bubble. From 1977 to 1985 America's oil consumption **fell 17%** even as GDP rose 27%. Imports from the Persian Gulf fell an outsized 87%, according to Amory Lovins, author of <u>Winning the Oil Endgame.</u>

Next thing you know we'll hear that crude oil production—up *two million barrels per day* in the past year—doesn't matter either. New oil fields have been discovered in Iraq, in Cuban waters, and in two locations off Brazil. Saudi Arabia just increased production by 300,000 barrels per day, and they're about to open two massive new oil fields. Matthew Simmons, who achieved fame by forecasting an imminent decline in Saudi production, unhelpfully offers that something could go horribly wrong.

The former head of reservoir management for Saudi Aramco recently wrote about world oil supplies in the Wall Street Journal. He pointed out that the world holds 12 to 16 trillion barrels of oil, and that there is wide agreement that mankind has burned one trillion barrels in all of human history. It is expected that we will burn another trillion in the next 30 years . . . .

"World oil production can probably keep going up for another six or eight years. But some time in the 1980s it can't go up much more. Demand will overtake production."

-- President Jimmy Carter,
April 18, 1977

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IT'S YOUR MONEY

Recently a client—mindful of the Bear Stearns bailout—asked what would happen in the unlikely event that our custodian US Bank were to go bankrupt. The answer is that your assets are legally yours, and cannot be seized by creditors. Eventually your U.S. Treasury bonds, stocks, and other securities would be sent to you or to a custodian designated by you.

Assets held at a brokerage firm are technically the property of the brokerage firm. That's why these firms maintain such large "SIPC" insurance policies. In either event you would be protected, but we prefer that our clients actually own the assets in their accounts.

The hedge-fund lunacy we outlined in our Autumn 2007 issue (on line at www.lumbard.com) has unfolded according to the script. Citigroup's Falcon Strategies fund is down 75%, and Peloton, a hedge fund launched by two former Goldman Sachs partners in 2005, has gone belly-up by borrowing and betting big on risky mortgage-backed securities.

Carlyle Capital, a fund launched by the famed Carlyle Group, didn't even last a year. The fund raised $670 million from the (hapless) public, borrowed *$21 billion dollars,* and went bust—the shares declined 100%—in less than 8 months.

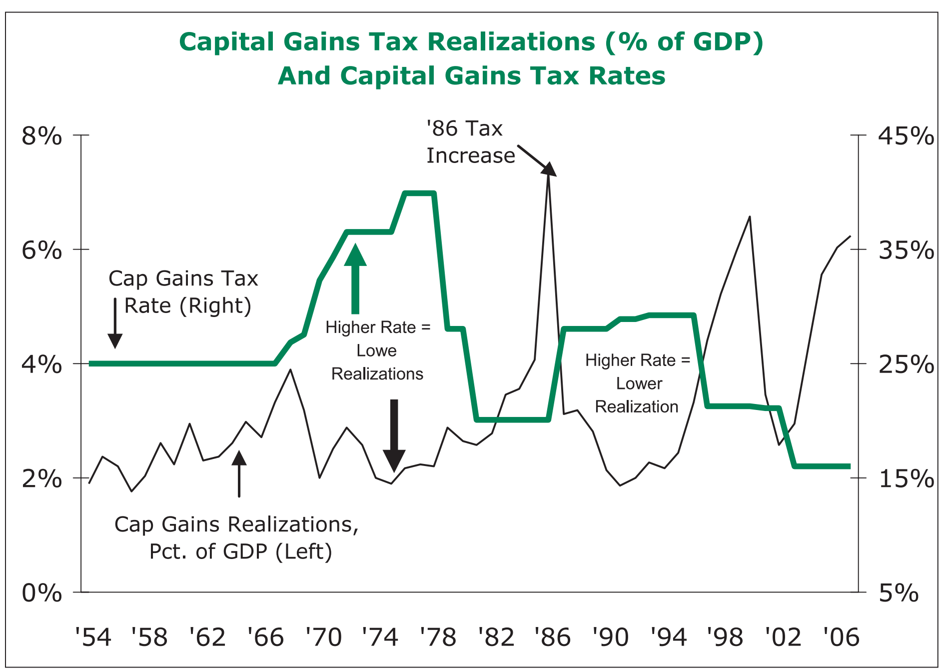
TAX REVENUE

The maximum federal tax rate on long-term capital gains is 15%. It will return to the old 20% rate, automatically, if Congress does not act prior to the end of 2008. Even more troubling is the potential for Congress to push this rate higher than 20%.

The rationale is to increase tax revenue, but history has shown that revenues actually **decrease** when the capital-gains tax rate is raised. The graph below shows clearly that when tax rates have been increased in past decades, tax revenue decreased. When the rate was lowered, revenue collections increased.

At lower tax rates investors are more willing to sell long-held common stocks and other assets, and when they do so they unlock capital that becomes available for reinvestment. Usually this capital will be reinvested in more-productive ways, either in the market or in the broader economy, and create further tax revenues. It's not often that you see a win-win relationship with the government and taxation . . . .

Drew D. Kellner



Source: Strategas Research Partners, LLC

HOW TO LAUNCH AN ECONOMIC RECOVERY

"Real Estate prices are falling!" Those words put fear in the hearts of investors and lenders. Buyers wait on the sidelines, afraid to buy too soon; and nobody wants to make a mortgage loan unless it's guaranteed by the federal government.

Prices won't stop falling until the boldest investors see bargains that they find irresistible. There is a level at which prices will naturally stabilize, and the sooner we reach that level the better off we'll be. When it's clear to everyone that we've reached bottom the timid will begin to buy, the mortgage companies will begin to lend, and the real estate market will finally thaw out.

Let prices fall until buyers emerge. In economic terms this is called "letting the markets clear", and it's an essential approach to economic problems.

Or we can help the wounds to fester. We can intervene in the markets, bail out homeowners and lenders, and work furiously to keep prices from falling quickly. The declines will go on and on, slowly but relentlessly, until every American believes that real estate is the worst investment he's ever seen. One by one we'll all sell our second homes and investment properties, and the single-family construction market will disappear.

That's what happened in Japan. That nation's 1990 recession was triggered by the bursting of its stock-market and real-estate bubbles, but it was prolonged—for a decade—by government meddling in the economy. Failing Japanese banks were kept on life support, sucking up financial resources and preventing solid companies from borrowing. Agricultural subsidies and protectionist tariffs blossomed. Construction companies were bailed out by awarding massive construction projects—such as bridges to nowhere—that provided little benefit to anyone.

If all this sounds familiar, it should. The Federal Reserve has already bailed out a failing investment bank, and the Congress has started to meddle with Fannie Mae and the rest of the mortgage market. We've enlarged the already-enormous subsidies and tariffs that protect farmers, and we're diverting hundreds of billions of dollars each year from taxpayer pockets to "earmarks" (such as bridges to nowhere) and the entitlements that are fast overwhelming the federal budget and our entire economy.

Consumers and voters yearn for the boom times of 1999 and 2005, and they are all too susceptible to politically-motivated promises that government action can help us to bounce right back. It cannot. There is a serious risk that government action will push us to the brink of economic disaster.

Given time our economy is capable of mending itself. Rising productivity, ever-improving technology, a rising population, and the consumer's never-ending hunger to consume mean that the economy *wants* to grow. But it needs time to repair itself. We have to work our way through an enormous excess inventory of unsold homes, and write off millions of mortgages. We have to pay off (or write off) hundreds of billions of dollars of credit-card debt, and reorganize great swaths of the markets in which companies raise capital.

Patience is the key.

John Lumbard, CFA

WE DON'T NEED NO STINKIN' OIL

This year the U.S. Air Force will buy 300,000 gallons of jet fuel derived from coal, on its way to 400,000,000 gallons 8 years from now . . . . . Next year Nissan and NEC will begin mass-producing lithium-ion batteries for cars, and in two years Nissan will start selling cars that can run on wind, solar, or nuclear power . . . . The latest idea in liquid fuels is to grow algae in pools, fed by the carbon dioxide exhaled from a coal plant. Cleaning up coal-plant emissions and making fuel at the same time!!

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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