STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS AUTUMN, 2014

Lumbard & Kellner INSIGHT

S&P 500 2,008 * Dow Jones Industrials 17,137 * 30 year U.S. Treasury Bond 3.24%

INFINITE POSSIBILITIES

In 1972 the Club of Rome, a think tank formed by "scientists, economists, heads of state, UN bureaucrats ..." caused an international sensation with the publication of The Limits to Growth, which predicted that population and economic growth would exhaust all the world's resources.

That was more than 40 years ago, and it hasn't happened. In that time we've seen any number of scares ("we're running out of oil, water, food, copper, rare earths …") that also failed to come true. When whale oil became scarce we discovered oil that was literally seeping out of the ground; and as demand grew, prices rose enough to justify drilling deeper, on land and in the sea, wringing oil out of rocks that once seemed unyielding.

Your Economics 101 textbook told you exactly what would happen to the supply and demand for oil and gas. The price of natural gas spiked in 2005, kicking off a new round of experimentation in our massive shale reserves. Oil prices spiked to $135 in 2008; and in response our gasoline consumption declined sharply. Oil production began to soar.

The food shortages of the 1800s gave way to an endless string of achievements in mechanization, fertilizer, breeding, and other techniques that spectacularly increased both yield per acre and yield per worker. Densely-populated Europe recently surpassed the U.S. to become the world's largest agricultural exporter—although a glut of American wheat and corn could change that in a hurry. Water? The world used *half* as much water in 2000 as experts had predicted in the 1960s and 1970s. Scarcity caused farmers to use it more efficiently, and now we can look forward to desalinization. 44% of the world's population lives within 150 km. of the sea.

Even the threat of population growth has faded. The World Bank says that there are fewer nations with rapid population growth than there are whose populations are actually *shrinking*.

"Almost every global environmental scare of the past half century proved exaggerated, including the population "bomb," pesticides, acid rain, the ozone hole, falling sperm counts, genetically engineered crops and killer bees. In every case, institutional scientists gained a lot of funding from the scare and then quietly converged on the view that the problem was much more moderate than the extreme voices had argued."

– Matt Ridley, author of The Rational Optimist, and a member of the House of Lords

Yes, there's plenty to worry about in the world. Terrorism is growing in Iraq and Syria, and there's trouble in Ukraine (which sounded a lot more dignified when it was ***The*** Ukraine). China's territorial disputes with Japan and Vietnam have been sharpened by a massive buildup of naval forces across the region. Many of Europe's economies are in trouble again. "Italy, the third-largest Eurozone economy, has returned to recession and

Continued on page 2

Infinite Possibilities

Continued from Page 1

remains saddled with a debt equal to 136 percent of GDP" says The NY Times.

Our Goldilocks economy is just fine, thank you.

We still believe that this economic cycle will last another two years, and probably three. There's little inflation, despite a binge of money-printing (soon to end), and little reckless lending or borrowing. We don't have too many homes, cars, or factories, so there's more building ahead. The oil and gas boom is quietly filling the pockets of dirt-poor farmers and ranchers, and causing a boom in industries that benefit from low gas prices. Anybody who heats a home or office with natural gas has extra cash to spend on cars, boats, and granite countertops.

Stocks are still cheap. It's still easy to find good companies that sell at 12 times their earnings. That's an "earnings yield" of more than 8%, at a time when U.S. Treasury bonds sell at 3% or less. The dividend yield on the S&P 500 is still almost 2%! We're not giving up our suggestion that this long bull market—from 2009 to 2016, or even longer—might eventually become a bubble. ■

Five out of the top six wealthiest counties, as measured by household income, are suburbs of Washington, DC.

CYA

There aren't many guarantees in investing, but we've got one for you today. Keeping your funds in cash right now will guarantee losses, at least after adjusting for inflation. Interest rates are lower than the inflation rate, so everything you have in CDs or a money-market fund is shrinking, slowly but steadily.

Even greater dangers are lurking in "safe" bonds, because the Fed has been holding their prices at artificially-high levels. Those "Target Date" funds that have elbowed their way into most 401K retirement plans tend to be chock full of bonds.... Be wary of the word "guaranteed".

Electric utility stocks will also be harmed by rising interest rates. Right now they're expensive, and dearly-beloved as "safe" income investments—even as dark clouds gather over the business of generating power. Take a look across The Pond, and you'll see that the 20 largest European energy utilities have lost $650 billion in market value since 2008—Germany's largest have fallen more than 50% since 2010—mostly because of legislation which mandated that utilities buy expensive power from wind towers and solar panels no matter what.

Cloudy Germany is at the same latitude as Labrador, but it has more solar panels than any other country on the globe. That's because the poor folks who do not have solar panels are forced to give money to those who do. Electric rates in Germany, now some of the *highest in the world*, are taking a big bite out of household income and driving German corporations to build new plants in other countries. Exporting jobs! Their carbon-trading market, like all artificial schemes, is vulnerable to unintended consequences. Germany is now burning more brown coal—the worst and dirtiest kind—and cutting down forests to fuel wood-fired furnaces. Carbon dioxide output has been *rising* since 2010.

These troubles could arrive on our shores soon. Hundreds of additional wind towers will be built in New England in the next two years. Nationwide the cost of our electricity is already up 33%, despite a sharp drop in natural gas prices. Utility-stock investors beware. ■

DEMOGRAPHICS AND DESTINY

Some worrywarts say that robots and automation are going to create future unemployment. Others point out that the birth rate in China, Denmark, and the Netherlands is just 1.7 children per woman; so low that their populations will soon begin to shrink. In Germany, Japan, and Italy the birthrate is just 1.4. Maybe there won't be enough workers to care for the retirees of the future.

Or maybe it will all work out perfectly!

THE FED IS YOUR FRIEND

How cold was it last winter? *Shoppers didn't shop!* In response the Federal Reserve continued buying $85 billion worth of bonds (mostly mortgages and U.S. Treasury bonds) every month, using dollars that it conjured up from thin air. $85 billion a month is *a trillion dollars a year* .... Many thought that inflation would erupt, but it didn't. And the Fed has been winding down the program ever since.

Next month it will end completely, but short-term interest rates will still be at zero. Monetary policy probably won't return to "normal", with short-term rates higher than the inflation rate, for at least another year. Still, we don't believe that inflation will accelerate past the Fed's target rate of 2%.

The low mortgage rates that resulted from this unprecedented monetary stimulus had a profoundly positive impact on housing, primarily by allowing mortgage holders to refinance at very cheap borrowing rates. The housing sector was so damaged by the past recession that extraordinary efforts to heal it were the right policy choice.

The Great Recession, which officially lasted from December of 2007 to June of 2009, was also followed by unprecedented *fiscal* stimulus that temporarily boosted employment. As the spending programs ended their employees were laid off, depressing employment and slowing the recovery. That fiscal drag is largely behind us, but we won't be able to say that fiscal policy is "normal" until the federal government's budget is balanced. Actually, at this stage of the economic cycle we should be running a surplus, to pay down some of the heavy debt that resulted.

Paul K. Wright, CFA

At the top of the real estate bubble inflation was pushed higher by tight labor markets, rising wages, and a frenzy of consumer borrowing and spending. None of those things are true today. We continue to expect moderate growth and declining unemployment in the next two years, and beyond. ■

THE MARKETS ARE NOT RIGGED!

Flash Boys, by Michael Lewis, caused a media sensation by revealing that traders can get rich by setting up phone lines that allow them to buy and sell faster than others—and thus make a penny on every trade.

So what? If the bid on a stock is $40, the offer might be $40.02. Any hanky panky has to take place in the two-cent spread. If you feel that somebody's getting an unfair advantage by purchasing shares at 40.01, you can put in a limit order to buy at that price. Much of the time you'll get an execution.

Back in the Good Old Days the brokerage commission on a $40 stock was ***40 cents***, or 1% of the transaction. And that's just the commission; if the bid was $40, the offer was $40 ¼. If you paid an extra 1/8th you forfeited 12 ½ cents! And it was easy to pay an extra eighth, because all your orders could be viewed by a Specialist who was permitted to buy and sell for his own account! ■

"Successful people do all the things that unsuccessful people don't want to do."

– The founder of Patron Tequila, on the importance of preparing yourself for rejection. Now a billionaire, he used to be homeless—living in his car with a 2 ½ year old son.

"Bao Bao should fit in well in Washington; she costs a fortune, has no useful skills, and is always on TV."

– The Economist, describing a new Panda at the Smithsonian Nat'l Zoo

GRANDSTANDING

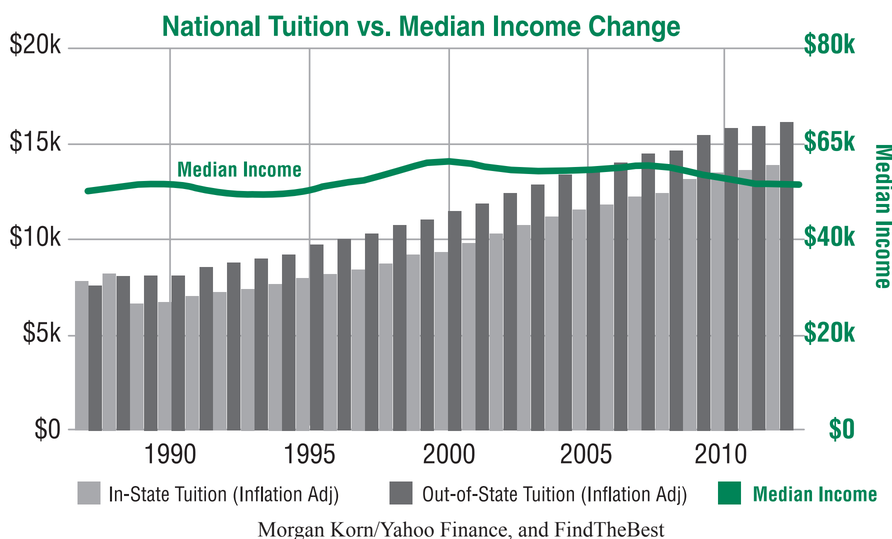
In August, Bank of America agreed to pay yet another $17 billion in fines and restitution related to the mortgage debacle. Most of it related to Countrywide and Merrill Lynch, which it purchased in the middle of the financial crisis; we're not big fans of Bank of America, but it bought Merrill Lynch because the government *asked* it to.

And it's bankers, not banks, who make the decisions that cause harm. If you want to deter bad behavior in the future, punish the people responsible. Give them a reason to pause, and a sense of personal responsibility.

So why aren't they going after the bankers? The Justice Dept. also extracted $7 billion from Citigroup ($4 billion of which went right into the coffers of "Justice"), but there wasn't any clawback of the $1.1 million salary of the COO of Citi's Alternative Investments unit. "Massive losses in that unit helped drive Citigroup into the arms of the federal government", says the Washington Post .... There was also no clawback of the $944,518 bonus that the COO received in 2009, the year that Citigroup got a $45 billion bailout. The bonus wasn't to be paid if he left the bank, unless it was "as a result of your acceptance of a full-time high level position with the United States government or regulatory body."

That's awfully close to "we'll pay you a million dollars if you can get a job as a regulator, overseeing us."

Justice says that it's, umm, er, "complicated". The bonus was paid to Jack Lew, the current Secretary of the Treasury of the United States. ■



Morgan Korn/Yahoo Finance, and FindTheBest

In 1999 the average "out of state" tuition was $11,012, and median household income was $55,390. By 2012 tuition—adjusted for inflation!—had risen to $16,116, while median income had fallen to $51,058. Tuition at elitist schools is 2 ½ times that, but here's a bright spot; in the last three years the income earned by the median household has risen to $53,891.

FINELY TUNED

Not long ago MetLife and Microsoft were our two favorite stocks. They sold at very low prices (low PE multiples, that is), despite the fact that there was nothing really wrong with either company. We put 3% or 4% of each investment portfolio into each name (our normal weighting is 2%), and as the stocks went up—they went up a lot—they grew to 4% and 5% of portfolios, even in a rising market.

In August we cut both holdings back to 3%. This kind of trimming is an important factor in our investment performance, and you can say the same thing about our predilection for adding to stock positions when share prices decline.

This process of adding and subtracting is greatly aided by the fact that we own stocks that sell at bargain prices. When a cheap stock gets cheaper, you know it's really cheap. That can't be said about popular stocks with higher-than-average prices, because a slide toward bargain levels might be the beginning of a permanent change in sentiment and a new price range. ■

On Sept. 1 our "Benchmark" account stood at $968,132, up from $216,635 on December 31, 1999, just before the bursting of the tech-stock bubble. The account was at $461,319 on 12/31/07, just before the bursting of the real estate and mortgage bubbles . . . If you'd like further information, please visit www.lumbard.com, or call us at (800) LUMBARD.

THE PRICE OF AFFECTION

Argentina just defaulted on some of its bonds, again. It's their *seventh* default since declaring independence from Spain. Investors kept buying Argentine bonds … *What were they thinking???*

In the early 1900s the people of this bountiful land were the *seventh richest in the world*. Their decline accelerated in the 40s and 50s under President Juan Peron and his wife Evita, populists who nationalized (a very nice word for theft) corporations and property, and stacked the deck in favor of their labor-union supporters. Inflation soared to 40%, the economy collapsed, and Peron was sent into exile—only to return, 20 years later! He soon died of heart failure, bequeathing the nation to his third wife, a nightclub dancer he met in Panama. You can't make this stuff up!

Under her populist leadership inflation surpassed 600%, and in 1976 the military staged a coup…. Democracy returned in 1983. Under populist Raul Alfonsin public payrolls swelled, and taxes were only collected from the 1%. Inflation rose so fast—5,000%, according to Business Insider—that some supermarkets read prices out over intercoms rather than try to update price tags.

Whether it's Argentina, Greece, Portugal, Italy, Ireland, Venezuela, or dozens of other nations, the story is always the same. Populist politicians buy votes; causing the nation's debt to quietly build, until suddenly—surprise!—a financial crisis erupts.

And let's draw an important distinction, before we go any further. People get mad when they hear about a politician buying votes with cash that comes from his own pocket. But honestly, it's far worse when a politician buys votes with other people's money!

"The IMF extended a nearly $17 billion bailout to Ukraine on the condition that it would work toward balancing its budgets. The Fund froze the payments a year later after [President] Yanukovych increased wages and pension benefits for workers during an election campaign, violating the balanced budget pledge attached to the money …. Ukrainians pay just 20 percent of their fuel bills, with the government financing the other four fifths."

– Alan Pyke, Thinkprogress.org

Even the Ukraine crisis was the result of populism and debt. ***The*** Ukraine's separatists want to secede to avoid the coming tax increases and austerity ….

In Thailand the Prime Minister bought her way into office by promising to give cash to rice farmers, and a free tablet computer to every household. The intelligentsia rioted for months. Oil-rich Venezuela is still reeling from the "redistribution" imposed by Hugo Chávez, because businesspeople and the intelligentsia fled. You can still buy gasoline in

Drew D. Kellner, CFA

Caracas for 6 cents a gallon, but you'd better get your tank filled soon.

Populism sounds so friendly. Rock-star politicians, telling their devoted followers that they've been treated unfairly—and that they'll be showered with gifts. Since the dawn of charity the gratitude for gifts of food and medical care flowed to the donors; but today the gratitude flows to the politician—who then denounces the donors for their lack of generosity.

It's an extraordinarily effective way to gain and consolidate power. Of course, the scam depends heavily on the notion that the donors can't quit the game. They can. ■

Portugal is spending $6.6 B to rescue Banco Espirito Santo. The bank will be split into a "good bank" with good loans, named Novo Banco, and a "bad bank" full of bad loans … which we'll call *Banco Dispirito.*

"Swiss cantons are free to set their own tax rates. For example in Zug, corporate tax is about 16 percent but can fall as low as 9.5 percent for companies that do most of their business outside Switzerland."

– Reuters

John Lumbard, CFA

Switzerland is stealing our lunch money! A firestorm of criticism stopped Walgreens from moving its headquarters to this alpine paradise; but Tyco International, Noble Corp, Transocean, and Foster Wheeler are already there. Weatherford International *was* there, but it just moved from Switzerland to Ireland to get an even better deal.

Chiquita Banana and Perrigo are also moving to Ireland. Applied Materials is moving to The Netherlands, and Abbvie has moved to England. Warren Buffett is going to help Burger King move to Canada! These "corporate deserters" are not moving to Grenada, but to some of the world's wealthiest and most-admired countries. Instead of bashing corporations for disloyalty, we should worry that we've created such an inhospitable environment that we're pushing them—over-regulated and over-taxed—out the door.

Actually this sounds a lot like the bidding wars that break out among our states, as they try to get Hollywood fat cats to make movies—sorry, ***Major Motion Pictures***—within their borders. California isn't taking this lying down; Jerry Brown and the Golden-haired legislature have just agreed to shower *$330 million a year* on movie moguls to keep them out of the clutches of New York and New Mexico.

California, of course, is the state that just raised its taxes to the highest in the nation, saying that tax revenue would go up because hardly anyone would leave. Now they're paying rich people to stay ....

The same thing is happening at the federal level, where we have corporations that pay nothing in tax, and more than a few that pay the highest tax rates in the developed world. Instead of a simple and fair system, we set tax rates at levels that drive corporations away—and then give lots of special deals to those who are politically connected. Yes, GE pays very little, but Whole Foods pays at a 38% rate. Exxon and Chevron (really!) pay 40% of their income in tax.

The Roth IRA is pretty much the Cadillac of accounts for [your heirs] to inherit."

– Wealth planner Aaron Thiel. It's also the best account when you're retired, because the mandatory withdrawals from a plain ol' regular IRA become larger and larger as you age, pushing you into a higher tax bracket.

The simple truth is that states and nations have to compete to attract the investment that creates jobs and wealth. In this new world of globalization they have to compete for employers, innovators, brilliant immigrants, and the wealthy; but that competition should be fought without offering special deals to anyone. The media are raging about the wealth of one-percenters like Kareem Abdul-Jabbar and Oprah, but are shockingly silent about the privileges—a glaring inequality—that are accorded to those who are politically connected. Why is there a special tax rate for hedge fund managers and private-equity tycoons?

The tax system is the foundation for corruption in American politics.

– John Lumbard , CFA

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.

General Disclosures:

Statements in this communication are the opinions of Lumbard & Kellner, LLC and are not to be construed as guarantees, warranties or predictions of future events, portfolio allocations, portfolio results, investment returns, or other outcomes. None of this material is intended as a solicitation or offer to purchase or sell a specific investment. Readers should not assume that all recommendations will be profitable or that future investment and/or portfolio performance will be profitable or favorable.

General Disclosure: The contents of these Insight Newsletters are for General Educational Information and Market Commentary only. Our goal is to provide Educational Communications that are limited to providing general information about investing, such as information about types of investment vehicles, asset classes, strategies, certain geographic regions, or commercial sectors. None of the material contained in our Newsletters should be construed as constituting an offer of our investment advisory services with regard to securities or a recommendation as to any specific security. These Newsletters are only opinion commentary. Similarly, materials that provide our general market commentary are not intended to offer advisory services with regard to securities. Our Market Commentary and Opinions rendered are aimed at informing current and prospective investors of market and regulatory developments in the broader financial ecosystem. Nothing in our Newsletters should be construed as a guarantee, warrantee or prediction of future economic or market events, political events, any portfolio results, advisory account returns, or other outcomes.