STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS JANUARY, 2015

Lumbard & Kellner INSIGHT

S&P 500 2,059 * Dow Jones Industrials 17,823 * 30 year U.S. Treasury Bond 2.75%!

VORACIOUS

Gasoline consumption in the United States declined every single year from 2007 to 2012. Some of that was caused by the 2007-2009 recession, but mostly it was the result of high gasoline prices. The same thing happened after a price spike in the '80s; one of our clients fondly recalls owning a Geo Metro that got more than 50 miles to the gallon!

Consumption really does respond to price. Today's low gas prices are spurring the purchase of gas guzzlers—already more than half of new-vehicle sales are SUVs and trucks—and vacations to Italy that are powered by vast quantities of jet fuel. Soon we'll all go back to grocery shopping twice a week instead of once .... If we do we'll actually spend *more*; because gasoline is only one of the costs of running a car.

Production also responds to price. But there is still shale drilling, and while it's true that the production from a well declines steeply in the first two years, it continues for decades. It can take years for production or consumption to fully react to a change in price.

The US burned *135 billion* gallons of gasoline last year. All of that (some 1,080 gallons per household) went into the air around us! We consume **amazing** amounts of energy. When protesters drive to a rally to call for an end to shale drilling, they burn lots of oil from shale; and then they return to homes warmed by gas, propane, or oil, and turn up the fracking heat.

All the solar power in the United States—all the rooftop solar, plus all those big solar plants in the Mojave desert—totals to 0.7% of the electricity we consume. Not even 1% of our *electric* power, and it's less than 0.3% of our total energy consumption (including gasoline, etc). In our summer issue we pointed out that it would take 31 square miles of solar panels, or at least 1,100 giant wind towers (plus a fleet of shale-gas generating plants, for days like today when the wind isn't blowing), to match the output of the Seabrook nuclear plant.

> "Sadly, electricity markets don't value zero-carbon electricity sources, so nuclear receives no economic credit for producing carbon-free electricity."
>
> – Carol Browner, former head of the EPA

Solar has the benefit of producing power when we need it (on hot summer days), but 31 square miles is a heck of a lot of steep and slippery rooftop. Dr. James Conca of the Institute for Energy and the Environment at NMSU has attempted to offer an apples-to-apples comparison of the dangers of our various energy sources.

Coal is the killer. Every time we produce a trillion kilowatt-hours of electricity from coal—in the United States we do this about 1 ½ times a year—somewhere between 3,000 and 15,000 people die (estimates from ABT Associates and Dr. Conca), mostly from diseases of the lung. Conca further believes that the same amount of coal burned in China kills *280,000*, and adds that "The Clean Air

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Voracious

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Act is one of the most life-saving pieces of legislation ever adopted by any country in history."

Hydropower looks really safe until you consider that the failure of the Banqiao dam in China killed 171,000. Hydro power thus causes about 1,400 deaths per trillion kWh. Dr. Conca projects that the death toll from a trillion kWh of nuclear power would kill just 90, and even that number is inflated by his guess that there will be 4,000 Chernobyl-related deaths in the future. U.N. scientists say that there have only been 60 deaths since that incident 29 years ago …. Other analysts peg nuclear at 40.

At this giganormous scale rooftop solar—which requires sending workmen up *millions* of ladders—would kill 440 people. That's pretty good, but it's 11 times as many as global nuclear power, and there have never been any deaths caused by the 100 plants that have been sitting quietly in the U.S. for 50 years. Wind, backed up by natural gas, is worse than either (see the Energy Insert to our Summer 2014 issue).

Irrational fears of radiation have killed *hundreds of thousands* of people and harmed the environment! The truth is that there's danger in every form of power production, and even more danger in our consumption of fuel. 33,000 people die each year on our highways …. Next time you're watching the TV news, remember that context is everything. ■

FAVORITES

Our favorite stocks are easy to pick out, as they're the biggest holdings. MetLife and Prudential are giant insurance companies that have been designated Systemically Important, which means that they have to get permission to raise their dividends or buy their own stock. This bothers Wall Street so much that the stocks have been at bargain levels for years, even though they've handily outperformed the market since we've owned them.

That's rare. Stocks are usually at bargain levels for a reason, and investors have been selling in disgust. It's our job to figure out whether that's justified. Corning and IBM are facing stiffer competition in markets that aren't growing as fast as before, but we think they'll continue to grow. Walmart declined because of tight budgets among the shoppers who depend on it; but a stronger economy and Internet sales have lifted the shares to new highs.

Foreign stocks have been lagging for a long time, but we're still waiting patiently for an upturn in the Matthews Asia Dividend Fund, the Thai Fund, and Singapore Telecom—which owns large minority stakes in several crown-jewel Asian wireless companies. ■

Tall men earn more than shorter men; it's worth 1.8% *per inch*, according to economists Persico, Postlewaite and Silverman.

POPULISM AND THE ENVIRONMENT

Venezuela has the *largest oil reserves in the world*. Larger than Saudi Arabia by 27 billion barrels. And this is a country where grocery stores literally have bare shelves, and shoppers stand in line to get their—rationed—share of new shipments. The oil industry is a mess, not just in terms of production and profits, but also in terms of environmental damage. Journalists describe oil slicks in Lake Maracaibo, and pipeline ruptures in which a fire hose of oil poured into rivers because the national oil company, PDVSA, refused to stop the pumps.

PDVSA makes big US oil companies look like paragons of environmental stewardship. Like Lily Tomlin's Ernestine (*"We don't care. We don't have to. We're the Phone Company"*), PDVSA employees don't have to answer to regulators or anybody else.

Populist President Hugo Chavez maintained power through redistribution, which bought the votes of the poor and the working class. The cash that bought these votes came from the confiscation of property owned by farmers, wealthy individuals, and oil, mining, telecom, and electric companies. Price controls bankrupted many of the producers who remained. ■

CREATIVE DESTRUCTION

In 1806 Frederic Tudor began buying ice in New England in the wintertime, and selling it in the Southern states and the West Indies—even as far as Calcutta—using plentiful sawdust as an insulator. His customers were thrilled and delighted, in the way that people today are thrilled and delighted by their cell phones. Nobody complained that Tudor was getting rich …. And few tears were shed when refrigeration killed the trade before the 20th century began.

This is Creative Destruction. Innovation improves lives, but it also displaces and destroys businesses whose technology becomes outdated. Jobs are lost—huge numbers of jobs, every single year—but consumers gain so much that the benefits far exceed the pain. A month of unskilled labor buys so much more today than it did after WW II that you'd have to say that creative destruction has done more for the poor than our social safety net.

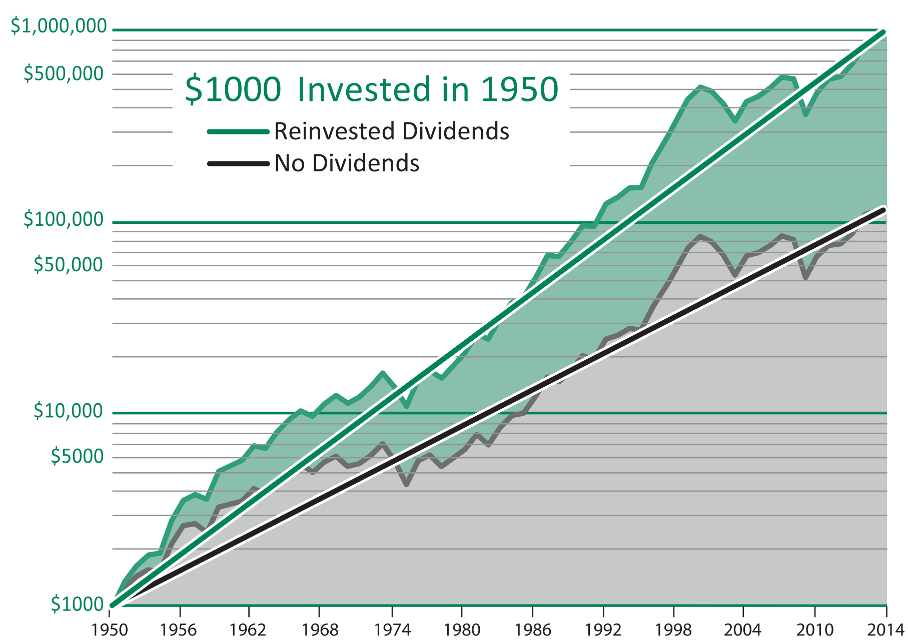
Every month about 60,000 new businesses open in the US, while 60,000 or so go out of business. And every month we gain about 5 million jobs and lose about 4.8 million (2.7 million of whom quit in favor of better opportunities). The "jobs gained" number you hear each month in the news is a tiny residual number. It's steadily rising.

The good news has been reflected in stock prices. Below you'll see a chart that shows the S&P 500, with and without dividends, from 1950 to the end of 2014. $1,000 grew to almost $1,000,000! If you've been worried that our stock market is Too High, you'll be relieved to see that it's really just meandering along its long-term trend line. The first of the three peaks on the right side of the graph is the tech-stock bubble of 2000. Now *that* was Too High.

Today equities are at fair value. Earnings growth should take them higher, as we're still predicting the economy will grow at a moderate pace. In 2015 the Federal Reserve will continue to work its way toward a "normal" monetary policy, in which short-term interest rates are higher than inflation. This process has unfolded over the course of nearly six years, and there are still years ahead.

Paul K. Wright, CFA

When investors look back, wistfully, on the stock market of 2009-2016 they'll marvel at how steadily it advanced. The "market panics" of those years—*they seemed so significant at the time*—barely show up in the graph! ■



www.simplestockinvesting.com; updated from 2010 to 2014 by Kevin Ciot, with data from Robert Shiller.

Bill Nye (the Science Guy) has a custom-made license-plate holder that bears a message for the driver behind him:

TRY MONOTASKING

BEIJING – Celebrating the milestone with hugs, jubilant cheers, and singing, over 600,000 Chinese citizens assembled in Tiananmen Square today to watch the U.S. debt clock mounted above the Forbidden City reach the landmark sum of $18 trillion dollars.

"You could stay home and watch it on TV, but it's much more exciting to be here with people from all over the country to celebrate this momentous day," said Beijing resident Xiao Bu, noting that he always arrives in the early morning to stake out a good location in the square every time America's debt rises by another trillion. "I remember my father taking me to see the $5 trillion mark so long ago, and now I'm bringing my own children here to take part in the festivities."

– The Onion ☺

*Our debt really **has** crossed $18 trillion ....*

"I have to confess, it is hard not to develop a lot of self-doubt about your previously held views when you watch [nothing but] Russian TV for a week."

– Vitaliy Katsenelson, CFA, on the power of video images—after watching footage of the Ukrainian army bombing schools.

It's not just Russian TV; the media are helping to polarize our own country, as conservative viewers gravitate towards Fox and progressives gravitate toward CBS. If you're looking for the middle, try ***This Week with George Stephanopoulos*** (Sundays, noon EST on ABC). It offers a range of viewpoints and illuminating debate. ■

QUADRILLION!

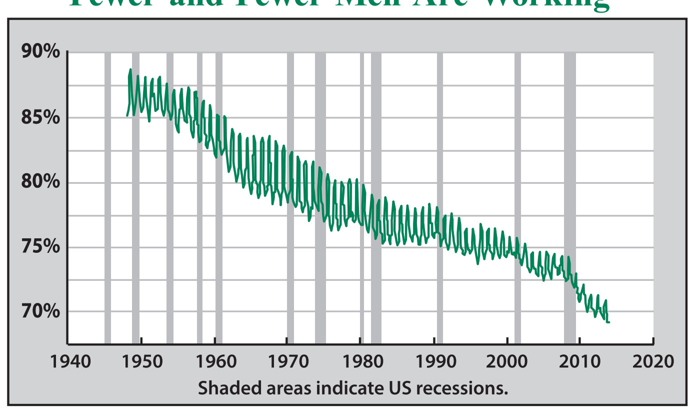
Japan's spending is twice as large as the tax revenue it collects each year! That's so hard to believe that we just looked it up again; in the year ended March, 2014, tax revenue was 47 trillion yen, and government expenditures were 97 trillion yen. Some economists would insist that this kind of stimulus would cause an economic boom, but Japan hasn't seen decent growth in 25 years. Total debt is 1.2 quadrillion yen and rising ■

Many of us donate each year to soup kitchens and food banks, because mental illness and sudden hardship prevent many Americans from connecting with government programs. But next time you see an ad asking for donations to "end hunger in the United States", know that food stamps are now issued to *47 million people,* up from 33 million in 2009.

47 million would encompass the populations of New York, New Jersey, *all* of New England, Idaho, Montana, and both of the Dakotas.

It's $76 billion a year, and that's just the SNAP program. There are *10 million* Americans in other food programs for children, the elderly, women and infants, families with dependent children …. ■

Fewer and Fewer Men Are Working



Labor Force Participation Rate For Men
St. Louis Federal Reserve, using BLS data

THE SUN STILL RISES IN THE EAST

"When you measure national economic output in "real" terms of goods and services, China will this year produce \$17.6 trillion — compared with \$17.4 trillion for the U.S.A. As recently as 2000, we produced nearly three times as much as the Chinese."

– Brett Arends, MarketWatch, quoting IMF figures

China's economy is now larger than that of the U.S. It's hard to imagine that Pax Americana, the American Peace, can continue as we slide to also-ran status.

In 2017 China will produce *twice* the greenhouse gas emissions of the United States, and during the next 10 years the dragon will *add* as many coal plants as we have in all 50 states. But the Chinese are leaping ahead of us in nuclear plant design, because they have no qualms about building experimental plants. They're building German pebble-bed reactors, and using designs from France, the US, Canada, and Japan; and they're looking into thorium, a nuclear fuel that's barely radioactive.

It's not hard to imagine that Chinese white-collar workers will supervise American blue-collar workers in the construction of future power plants. The "good paying jobs" are awarded to those who innovate …. Each plant costs gobs of money to construct (jobs and stimulus!) but then costs little to run—for the next 6 decades. A big nuclear plant only burns 2 cubic yards of fuel in an entire year. ■

Drew D. Kellner, CFA

"If you have ten thousand regulations, you destroy all respect for the law."

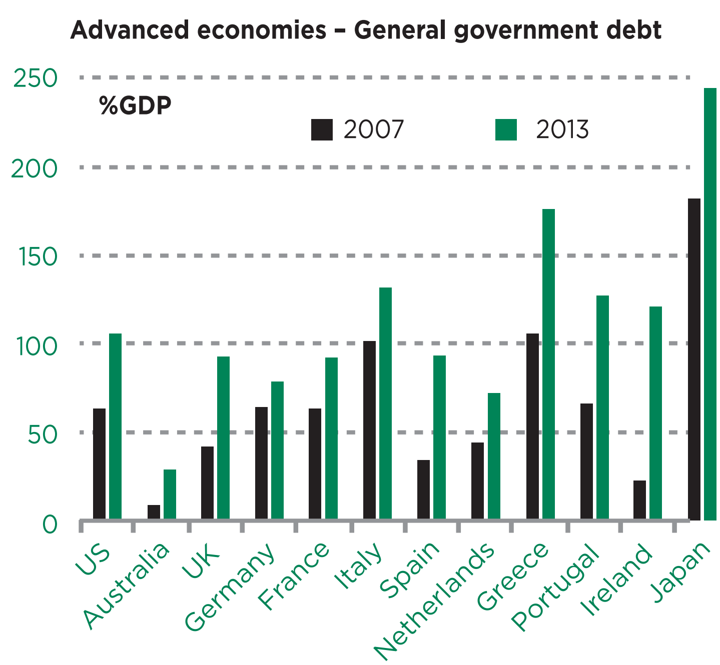
– Winston Churchill

GLOBAL POPULISM, GLOBAL DEBT

In Japan, in Europe, and in most of the world's democracies, the most important trend of the last few decades is that politicians have learned to buy votes with taxpayer dollars. This is far worse than allowing politicians to buy votes by handing out cash from their own pockets.

This spending has caused a steady increase in government debt, all 'round the world. Debt slowly builds, a society's work ethic slowly decays, and options slowly narrow. It's not just Venezuela, Argentina, Greece and Portugal!

Below you'll see a chart of the increase in debt in many developed countries from 2007 to 2013. Economists have long said that debt begins to harm a nation's economic growth when it reaches 90% of GDP. America's debt really *has* crossed the \$18 trillion mark, and proper accounting would put it much higher. ■



Source: Mauldin Economics, IMF, EC, SG Cross Asset Research

John Lumbard, CFA

HINDSIGHT

A gallon of gasoline contains as much energy as 80 sticks of dynamite, but in many places it's now cheaper than a gallon of milk! Three years ago, when gasoline was at $4, it would have been easy to pass a tax law saying that if it dropped below $3 we'd capture a good part of the decline in higher taxes. Gas prices would have declined a little instead of a lot, and we wouldn't have to shamefully borrow as much money from the Chinese—in the names of our children.

Foresight

Environmental activists hire fuel-guzzling ships to harass oil-drilling platforms, but rarely push for policies like gas taxes that would make a difference. All other developed nations have a policy of shifting taxation from income taxes (which discourage work and income) to gasoline taxes (which discourage gasoline consumption). There is no European debate, at all, about the regressive nature of their gasoline taxes. ■

On December 31 our "Benchmark Account" stood at $953,948, up from $241,129 on 12/31/1998. That's a return of 8.97% per year.

The account pays fees, based on our fee schedule from the 1990s (top rate of 1%), and otherwise has not experienced any additions or withdrawals (income is reinvested).

Over those years the Barclays Aggregate bond index returned 5.28% per year, and the Citigroup 3 Mo T-Bill index returned 2.08%. The Dow Industrials returned 6.68%, the Nasdaq returned 5.84%, and the S&P 500 returned 5.22% (including dividends). Past performance does not guarantee future results, and investments carry risk of complete loss. The results of this account cannot legally be construed as being representative of all accounts.

TAX TIME

The tax code now totals 70,000 pages! Apparently that's not enough pages to clarify the fine points, because our accountant tells us that you can call the IRS three times with a question about partnership taxation, and get three different answers, "none of which are right".

After the tax season is over you might sit down with *your* accountant and ask about new additions to the tax law. The vast majority of Americans still pay at rates set by the "Bush Tax Cuts", because they were made permanent in 2012. But there are lots of tricks and traps; there's the Alternative Minimum Tax ("*you always pay the higher rate*"), and two new Affordable Care Act taxes that were labeled "Medicare" even though none of the funds they generate are earmarked for Medicare.

There's a 0.9% surtax on wages of couples earning $250,000 or more, and a 3.8% ACA tax that can push the tax rate on long-term gains to 23.8% for larger incomes. But, as before, there are NO capital gains taxes due on securities that you hold in your name at the time of your death. Ask about "stepping up the cost basis". ■

The Economist says that the United States spent only 4.4% of its GDP on health care in 1950. It now consumes 17.2% of GDP. That's far more than any other country in the world, and more than three times what Singapore spends—and the residents of Singapore live longer than we do!

Federal spending on health care has skyrocketed, but the number of Americans who are covered by health insurance has barely budged—it's still 41 million people, despite millions added to the Medicaid rolls. Maybe, instead of focusing on health *insurance* we should be focusing on improving the *health care* system. Our thoughts on that can be found in our January, 2014 issue. ■

– 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.

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