STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS AUTUMN 2017

Lumbard & Kellner INSIGHT

S&P 500 2,461 * Dow Jones Industrials 21,798 * 30 year U.S. Treasury Bond 2.68%!

FAIRNESS

The rising cost of health care is driving more and more citizens into Medicaid, the program for the poor. Medicaid, in turn, drives up the cost of health care by under-paying doctors. HealthAffairs.org says that it *doesn't even pay half of the discount price* that your insurance company would pay. A survey of thousands of physicians, by CNN, reveals that Medicaid only covers 50% – 70% of their *costs* of providing care.

Forcing doctors to work for free is unethical; forcing them to pay from their own pockets to work is STEALING. The California Health Foundation says that barely more than half (55%) of primary care physicians in California now accept new patients from that state's Medicaid program, Medi-Cal. The shortage of available doctors has caused emergency room visits by Medi-Cal patients to surge by 75% in the past five years, and that pushes up the cost of hospital care for the general population—and causes a shortage of beds in the ER.

Medicaid now covers more people than the British National Health Service. Different states have different rules; the FAQs for the NH Health Protection Program, our expanded Medicaid program, says that assets—such as "money in the bank"—are "not considered when determining eligibility" (https://www.dhhs.nh.gov/ombp/nhhpp/documents/faq-nhhpp.pdf , FAQ #9).

The Affordable Care Act exchanges cover 3.7% of Americans, and the VA covers 2.8%. Medicare covers 17%, and Medicaid has grown to 74.5 million, or 23% of Americans. So 46.5%, or nearly half of our population, is covered by some form of socialized medicine. Gallup says that 11.7% of Americans, 36 million people, *still* don't have health insurance.

It's not as if a policy of swindling doctors is going to balance the budgets of Medicare and Medicaid. Together the two programs now consume more than a trillion of the $3.3 trillion that the federal government raises each year in taxes, and they've nearly doubled since 2006.

Health care is now unaffordable, for most Americans, without subsidies from business or government. If we don't find a way to get costs down, we won't be able to stop the galloping growth of the federal debt. Our children will pull the plug on Medicare and Medicaid, because they won't have any other reasonable choice.

This is why we highlighted the startlingly-low cost of "cash based" medicine in our last issue. MDsave.com offers the names of hospitals willing to perform surgery at very low prices, as long as they don't have to deal with insurance companies or the government. The hospitals are bidding against each other, so over time these prices will *decline* as the cost of medicine elsewhere rises.

How can you make these lower costs available to everyone? Persuade insurance companies to offer insurance based on the low prices that are *listed online*. When their patients need surgery, they receive a check for the clearly-posted price. They might be able to keep part of the check if they shop carefully; and if they decide they'd rather go to Mass General, they simply re-mortgage the house and go. ■

UNCONDITIONAL LOVE

We recently purchased shares of Zoetis, a spinoff from Pfizer that is the world's largest producer of medicine and vaccinations for pets and livestock. They're working hard to grow their "companion animal" business, because Americans will spend more than $69 billion this year on their pets—up from $53 billion five years ago. By comparison, the GDP of North Korea and its 25 million people is less than $13 billion. Pets offer unconditional love, as long as you feed them, and they need drugs for their aches and pains. Zoetis has also introduced new drugs for your dog's fear of loud noises, his hay fever, and his powerful itching. ■

> "You can always count on Americans to do the right thing—after they've tried everything else."
>
> – Winston Churchill

JOBS!

"Americans are less likely to be laid off now than at any point in the last 50 years" says the Wall Street Journal. The Department of Labor says that there are 6 million unfilled jobs available.

Toyota and Mazda will jointly spend $1.6 billion to build a new factory in the United States. Volvo (now Chinese-owned) is building a plant in South Carolina that will employ 2,000. Stanley Black & Decker will spend $35 million to open a plant to build the Craftsman tools that it just bought from Sears. Foxconn, the manufacturer of Apple's iPhone, will spend $10 billion to build a display-panel plant in Wisconsin. Apple itself will invest $1 billion in its partners, such as Corning, who are expanding in the United States. ■

THE NEW ROCKET MEN

Elon Musk: "SpaceX"
Jeff Bezos: "Blue Horizon"
Richard Branson: "Virgin Galactic"
Paul Allen: "Stratolaunch"
Kim Jong Un:
"Incinerate Manhattan"

NORTH KOREA

Vladimir Putin suggests that North Korea won't abandon its nuclear program "unless they feel secure". We're not sure how that could happen, but it does bring to mind John Kerry's musings, after Kim Jong Un ordered his third nuclear test (and the murder of his uncle) that he is "insecure". It probably doesn't help that in 2014 we humiliated Kim with a Hollywood comedy which dwelled on his insecurities—and ended in his CIA-assisted assassination.

Some experts believe that North Korea has EMP technology, which would allow the impoverished nation to destroy huge swathes of American electrical infrastructure with a single nuclear-tipped missile. Another concern is that Kim Jong Un can get a lot of badly-needed hard currency by selling nuclear and missile technology to Iran, which has repeatedly threatened to destroy Israel. We sent Iran $1.7 billion last year, so they do have cash on hand.

Is this a reason to sell stocks? If your electric power goes out for 2 months you won't be comforted by the knowledge that half your portfolio is in cash. And we probably wouldn't be able to buy stocks at bargain prices during the blackout. It could be just as hard to buy during the short-lived selloff that would result from a successful bombing of North Korea. The Chinese stock market actually ***went up*** after the September nuclear test, which was conducted just ***50 miles from the Chinese border***.

Our position is that you shouldn't sell stocks unless you are *very* sure that you will be able to buy back in at lower prices, *and sure that you will, in fact, buy back in at lower prices*. That's much harder than most people think. ■

RISE OF THE ROBOTS

In July the unemployment rate hit a 16-year low. Jobs have been created in each of the last 83 months, a record. Technological advances continue to destroy jobs, but at a pace that's *slower*, not faster, than before. We're spending more and more of our incomes in sectors, such as health care and education, that are resistant to automation.

These sectors are not becoming more efficient, so costs are rising. "Instead of worrying about robots destroying jobs" says Greg Ip of the Wall Street Journal, "business leaders need to use them more, especially in low-productivity sectors. Someday robots may replace truck drivers, but it's more urgent to make existing drivers, who are in short supply, more efficient."

Artificial intelligence ("AI") will take jobs from white-collar workers, not just the semi-skilled. And the capabilities of robots and AI are increasing, even as the cost declines. But it's not that different from the offshoring of manufacturing jobs to China, and the offshoring of software and call-center jobs to India. Amazon is destroying retail jobs by the hundreds of thousands (and some experts guess that the total could eventually reach 2 million), but we have somehow muddled through.

It's worth remembering that the vast majority of our citizens were engaged in agriculture, in some form, in the early 1800s. The mechanization of wheat fields and forests caused vast waves of layoffs, and drove millions to emigrate from farms to cities to take jobs in the mills.

So we've seen this movie before. And, even though many of these new tools are already available, we haven't seen a wave of job losses because wages haven't been rising very fast. We're still expecting that wages will rise, pushing up inflation and causing the Federal Reserve to become more aggressive about raising interest rates. That's a process that could lead to our next recession. But what if wages *don't* rise?

Inflation would continue to bumble along, at 2% or even less. Interest rates would stay low, and this long economic cycle would become longer and longer. The stock market bubble that's ahead of us would grow bigger over a longer time period. And new industries would slowly rise to employ all the inexpensive workers, just as new industries were created in the wake of the massive job losses in farming in the 1800s. Shovels were replaced by backhoes, telephones became commonplace, and wintertime fruits and vegetables became affordable to everyone. Living standards rose at every level of society. ■

From the Urban Dictionary:

"Top Definition: LUMBARD"
"Someone who is on the chubby/fat side and is really lazy"

Paul K. Wright, CFA

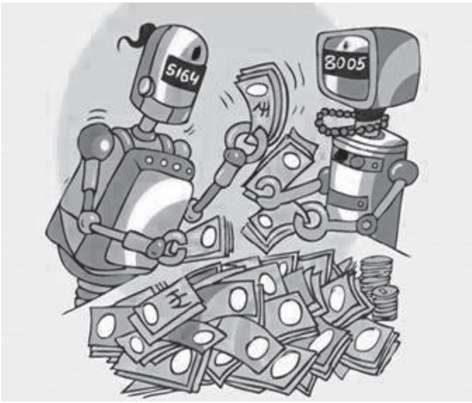
"Remember when Millennials didn't buy cars and houses? Well now that they are 18-34, they are doing both. In fact, according to *Zillow*, Millennials are now the largest group of home buyers. They are also dominant in the SUV market. As their families get bigger (so much for the myth Millennials don't want families) they are upsizing, resulting in an 11% increase in large SUV sales in the first half …. Car sales are falling."

– Chris Low, FTN Financial

FedEx has been a very good stock for us, and the company's earnings have grown so fast that it still looks inexpensive. No, Amazon is not going into the shipping business …

FedEx, AT&T, and Walmart all have something in common. If you have 100 customers per square mile, you can deliver packages or cell-phone services at lower cost than a competitor who has just 50 customers per square mile. When it comes to distribution, bigger is better.

INVASION OF THE ROBOTIC HEDGE FUND MANAGER



Robots are coming to the investment business, and they're definitely going to take some jobs. Are we scared? Nah. We've done well for our clients. Our benchmark account—a real account that's managed to match the "balanced" objective of most of our clients—now stands at **$1,122,366**; up from $1,027,111 in January and $241,129 on the first day of 1999. We'd like to tell you the 1990 value, but the SEC won't let us because we failed to save four statements from the late '90s.

When the next recession gets under way the machines will be forced to sell, because their clients will pull money out. Our greatest value in recent years has been in keeping our clients invested despite their deep misgivings, and it hasn't been easy. Our greatest value in 1999 and in 2007 was in reducing equity holdings at a time when everybody ***knew*** that investors should stay fully invested in stocks all the time.

Machines don't have friends. In 2007 they wouldn't have known home buyers who felt impelled to buy "before it's too late", mortgage brokers who helped buyers get "no-document" mortgages, or rocket scientists who figured out how to wrap these "toxic waste" mortgages into CDOs that could be sold to pension funds in Norway. When people are fearful, they tell us; and when they're confident and fully invested they tell us that we should be fully invested as well. ■

Billions of dollars are flowing out of famous-name hedge funds in the wake of double-digit losses over the past two years. Who could have expected that a fund charging ***2% of assets plus 20% of capital gains*** could have a bad year?

Hedge fund managers still get a special ultra-low tax rate on part of those earnings, but they'll lose another giant tax break next year. Early in 2018 they'll have to declare, as income, billions of dollars that they were able to stash ***tax free*** overseas. They never paid taxes on the income, and never paid taxes on the growth of those accounts.

Anybody in favor of tax reform?

Tens of billions of dollars are still flowing each month into bond funds and bond ETFs. It's still a bad idea. The losses will be in the hundreds of billions, or **trillions**, of dollars. Yet bonds are still described as a safe alternative to stocks, and investment advisers still tell their clients that they should allocate more to bonds as they get older.

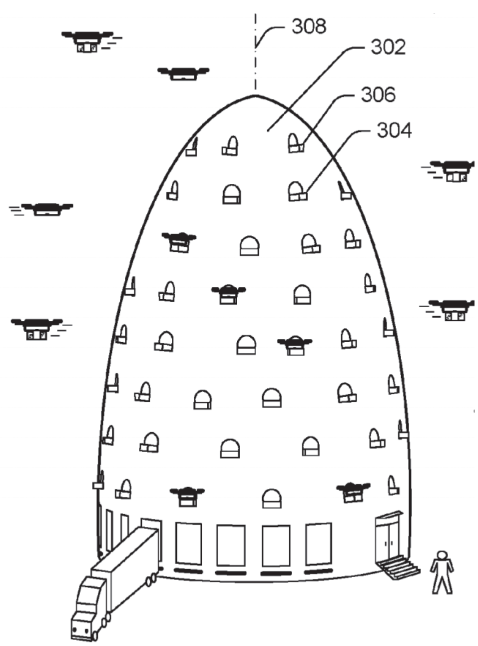
THE AGE OF RETIREMENT

"Pensions will consume about a quarter of Illinois's general fund this year. Nearly 40% of state education dollars go toward teacher pensions."

–The Wall Street Journal

The chickens are coming home to roost, in states and cities where politicians bought union votes by promising rich retirement plans. The problem will grow in the future, because Baby Boomers are retiring in droves all over the world. Don't buy the bonds of these entities, because defaults are likely. Detroit and Puerto Rico have shown the way, as have Greece and Argentina. Venezuela, soon.

SERIOUSLY?



Source: CNN Money

A drawing from a patent awarded to Amazon for a "drone fulfillment center".

THE FUTURE OF TRANSPORTATION

Investors continue to believe that all of us will soon be riding in shared, autonomous electric vehicles. Hah! You'd have to squint *really* hard to see that in recent sales figures for cars and trucks. Want to tow your boat? Need all-wheel drive for that ski trip to Vermont? What about car seats for the kids? When you think about it, this is really just "Zipcars" that are dropped off at your door. After nearly 20 years, Zipcar has a million members but just 10,000 cars.

In 1897 the Electric Carriage and Wagon company had a fleet of 12 electric taxicabs, with quick-change batteries, in Manhattan. That will come again, but the idea that electrics will sweep quickly across the country is a fantasy brought to you by the same people who push for trains, and then never ride them. Electrics would arrive much sooner if these same folks would push for higher gas taxes, but they never do. Apart from Mexico, the United States has the lowest gas tax, by far, in the 34 countries of the OECD.

This U.S. tax policy has fostered a massive increase in the size of the average commuter vehicle. More than 63% of new-vehicle purchases are now pickup trucks or SUVs, up from 49% in 2007; and they're much larger than the light trucks of yesteryear.

Higher gas taxes (and, while we're at it, jet fuel taxes) would change all this in a hurry, while still allowing consumers to buy the vehicles they want to drive. Politicians say that higher taxes would hurt the poor, but that didn't stop the nations of Europe. Most of them have lower incomes than the U.S., and heavy, regressive value-added taxes. The poor of Egypt are *really* poor, but Egypt just slashed its fuel subsidies, causing gasoline prices to rise 50% in June. ■

TAX CREDITS

The market for electric and hybrid cars is still ruled by subsidies and CAFE regulations. Ford and GM *need* to sell these cars to avoid paying CAFE penalties.

All electrics are still eligible for tax credits, but InsideEVs.com predicts that the $7,500 tax credit for a Tesla or GM vehicle will end in about a year—after a 4-5 month grace period that's triggered when each company hits the 200,000 mark. When Elon Musk talks about "manufacturing hell" he's hoping that he can build and sell a hundred thousand cars during this grace period, and lots more in the winter of 2018-2019, when he can offer a $3,750 credit. He has 400,000 orders secured by *refundable* deposits …

Keep an eye on BMW, which is *already* paying CAFE penalties. BMW will have that $7,500 advantage, in selling the capable i3 and the sexy i8, until the spring of 2020. The timetable for Ford and Toyota is about the same.

Drew D. Kellner, CFA

While we're at it, we'll put in a kind word for the Chevy Volt, a capable and roomy electric car with *no range anxiety.* You can drive into the wilderness, because it has an onboard generator to keep the battery topped up. And when it's running on gasoline you get 45 mpg. That's partly because of regenerative braking, which captures much of the energy—an appalling amount of energy—that is lost when you put your foot on the brake. ■

If you want to do something good for the environment, use less fuel. The impact of saving even a few gallons of gasoline or jet fuel is greater than a whole year of recycling bottles and cans; because the latter need to be trucked, sorted, trucked, melted, trucked, and then finally made into products. It takes a lot of plastic bottles to make a pound of usable carpet fiber, and you can cancel much of the environmental benefit if you do a lot of washing.

$20,000,000,000,000

The federal debt is about to surpass $20 trillion. When interest rates get back up to normal levels, generations X, Y, and Z will have to pay annual interest on the federal debt of **a trillion dollars a year**. Bigger interest payments mean faster growth in the debt, which is already accelerating because of the soaring growth of entitlements. Today **83% of the taxes we collect are spent on entitlements and other "Human Resources"**. Sadly, less than a third of that entitlement spending is used to help the poor.

The Baby Boomers have been paying lots of tax, because they've been in their peak earnings years. Now they're all retiring. They will join Medicare, which is headed for serious trouble, and Social Security, which is in much better shape. Still, if you look carefully at page 2 of ***your*** latest Social Security statement you'll see the words:

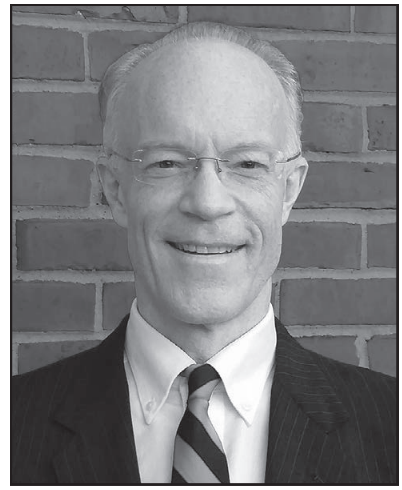
"Your estimated benefits are based on current law … The law governing benefit amounts may change because, **by 2034, the payroll taxes collected will be large enough to pay only about 79% of scheduled benefits.**"

The Medicare trustees say that Medicare will run out of money in 12 years. Sure, we can raise taxes on the top 1%, but they're only 1% of the population. You would need a million Americans, each paying a *million dollars* in tax, to raise a trillion dollars. And that wouldn't have been enough to cover the federal government's health care outlays in 2016. Four years from now, according to the White House Budget Office, you'll need to levy million-dollar taxes on 1,457,000 people to cover those health care costs.

When JFK was president the top rate was 91%, and we collected less in tax than we are collecting now. In fact, between 1936 and 1970 the top tax rate was always above 70%, but in all that span there were only four years in which we collected more tax, as a percentage of GDP, than we collect today.

The real problem is that we don't actually have a budget process, because Congress doesn't have to balance the budget. The constitutions of Switzerland, Germany, and Austria now have "debt brakes" that force politicians to pay down debt during economic expansions. In the United States a balanced-budget amendment to the constitution passed the House in 1995, and came within a single vote of passing the Senate. In 1995 our debt was a quarter of today's level. ■

– John Lumbard, CFA



John Lumbard, CFA

"In Singapore almost everyone has to pay something for their [health] care. When it's your money, you really ask yourself: Do I really need this?"

– Dr. Jason Yap, Director of marketing for a large hospital in Singapore. Singapore spends only 4% of its GDP on health care (the U.S. spends 17% of GDP), but Singaporeans have a greater life expectancy than Americans. Their infant mortality rate is lower.

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