

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,218 * Dow Jones Industrials 10,785 * 30 year U.S. Treasury Bond 4.53%

A SEA OF OIL

China's thirst for oil is putting a huge strain on the world's production capacity. Yet many of the planet's great oil fields have played out, and there are no new elephantine oil fields on the horizon. Terrorism is a constant threat, and Saudi Arabia might not have as much oil as it claims.

That's the story, anyway. A month ago a million energy bulls added to the frenzy by proclaiming that the oil markets would be caught flat-footed by the arrival of winter—in *December*, of all times—in a small corner of the globe. But the truth is that there's plenty of heating oil in storage to meet the winter's needs, and we're very close to the day when the markets will be looking ahead to Spring. There's an ocean of oil underground, all over the world, available to anyone willing to spend the big bucks necessary to get at it. And China's effect on the global market for crude is a long-term phenomenon that has little to do with the price of oil in 2006.

Yes, Chinese oil imports grew 31% in 2003, and yes, China will be a big factor in global oil demand over the next 10 or 20 years. But the

dragon's oil imports will only grow about 5% this year to 4 million barrels a day. That hardly counts as a belt-buster, when you're looking at total world consumption of 81 million barrels.

That 81 million-barrel-per-day figure has been growing by a million or 1 ½ million barrels each year. OPEC and the oil giants have been comfortably accommodating that growth rate for decades, and they were shocked when the price of oil moved above \$40 a barrel. They didn't believe that it could stay above \$30, so they didn't make any effort to increase production; and that's the only reason for today's high prices.

How much difference does a higher price make? Oil companies are accustomed to spending \$5 or \$6 to get at a barrel of crude, and the Arabs have been spending far less than \$2 a barrel. At those prices they're mostly using old-fashioned, low-cost technology that leaves most of the oil "stranded" in the pores of bedrock and other difficult formations.

In fact, the Department of Energy says that you can only get about

10% of the oil in a well via unassisted pumping. Flooding the well with water—already a common practice—will get you 20% to 40%, but you have to spend some serious money on "tertiary recovery techniques"—steam or carbon dioxide injection—if you want to get the majority of what is available.

What is available, according to the DOE, is 377 billion barrels, or *50 years* of US consumption at current rates. That's in the US, home of just 2.2% of the world's "proved" reserves, and the figure doesn't even count our huge, untapped oil shale reserves—which they peg at 800 billion recoverable barrels. But it costs big bucks to get at this oil, and nobody wants to make the investment unless they're sure that oil is going to stay above \$40 a barrel.

They're becoming sure. The price of oil will probably dip below \$30 in our next recession, but the ten-year average will surely be above \$40; and that's bullish enough to justify all sorts of long term projects. Old wells are being

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A Sea of Oil

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reopened, new ones are being drilled, and recovery rates are going up around the world. The Saudis just raised their estimate of proved reserves from 264 billion to 464 billion barrels, and they'll raise the number again if prices don't collapse. At \$60, Saudi Arabia's reserves could be in the trillions of barrels.

\$40 oil will encourage rapid development of Canada's oil sands, and it's more than enough to launch the wind-power industry to serious and significant heights. \$40 is enough to spur investment in a new (and also old) technology that converts coal to diesel fuel. Ethanol and biodiesel are booming; nuclear power is going to make a big comeback; solar is inevitable; and there are huge, important advances coming in power transmission and storage.

Few of these alternatives were attractive when oil was at \$25 a barrel, but that's the whole point. When you raise the price of a commodity, powerful forces come into play. The trouble with the oil

markets is that these forces move very slowly, and they can't even begin to work until OPEC, the oil companies, and consumers begin to believe that prices will stay high.

Consumers showed their muscle in September and October, when gasoline prices hit \$3 a gallon. Consumption declined, and it would have declined much further—to the clear benefit of energy security, national defense, and the environment—if the price had stayed at those levels. The last time gasoline prices soared, 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 *Winning the Oil Endgame*.

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That's the way the markets are supposed to work. High prices cause an increase in supply *and* a reduction in demand. But this time a flood of surplus gas was shipped in from Europe, driving the price down 33%. It's not likely that the feds will reinstate the loony patchwork of MTBE and ethanol blends that was keeping gasoline tankers away from our shores, so you should expect to see the price stay low.

It's probably true that there will never be another refinery built in the United States, but refining margins are taking a beating—and they won't be coming back any time soon. Gasoline consumption will stay high, but the price of oil will decline anyway.

The conclusion? Sell your oil stocks. Sell the producers with big reserves in the ground, sell the refiners, and sell the integrated oil companies. You'll be able to buy them back, at lower prices, two or three years from now.

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Goods are so inexpensive today that it boggles the mind. Can you imagine building a manufacturing plant for the purpose of making calculators that will sell for a dollar? With a retail markup included! And some still say that there's no reason to ask the Chinese to stop manipulating the yuan

The dividends paid by the stocks in the S&P 500 have doubled in the last ten years.

**A BUBBLING
ERA OF FROTH**
It's usually a good idea to avoid the herd; but it's *always* a good idea to avoid a big herd that's been moving in one direction for a long time.



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“Our world is always in perfect balance. Right now the oceans are getting warmer, but the housing market is cooling off.”

CARS OF THE FUTURE

62% of the energy consumed by the average car or truck is lost to engine friction. According to the Department of Energy and the EPA, only 15% of the gasoline you buy is actually used to “move your car down the road or run useful accessories, such as air conditioning.” Obviously, there is enormous potential for improving the fuel economy of cars, and we’ll see great strides in the next decade.

The key is to find ways to shrink the size of the engine. Smaller engines generate less engine friction and use far less fuel, even when they’re placed in heavy vehicles. Hybrid drive allows you to regain the acceleration of a large

engine, and the entire assembly—engine, batteries, and electric motors—can be shrunk further if we use exotic composites to take all the dead weight out of the body and frame.

The notion that heavy vehicles are safer is an old wives’ tale. Researchers from Honda Motor have proven that cars are safe because the front end crushes in a controlled manner; the safest cars are the ones with the biggest and best-designed crush zones. Better car design will easily save 10,000 lives a year (out of a total of 42,000), but that future can’t arrive until the stiff, high truck frames of today’s SUVs and pickup trucks have rusted into oblivion.

Meanwhile, you’ll see dramatic changes in the kinds of fuel consumed. Ethanol enjoys tremendous political support, and biodiesel is coming. But the biggest news of 2006 will be the dramatic expansion of plain old diesel. Cleaner diesel fuel will soon reach the market, and you will see a tremendous surge in a number of diesel engines offered by car dealers. Our own Drew Kellner has a diesel Volkswagen Jetta that gets 45 miles per gallon in real-world, all-around driving.

The sum total of these advances—lightweight, rust-proof carbon-fiber cars, gasoline-hybrid and diesel-hybrid engines, and improved battery technology—will push fuel economy above 100 mpg. That’s a far greater gain than we now need to end our dependence on oil imports from the Middle East.

The parade will be led by Japanese and European car companies; partly because of the incentives created by the high fuel prices of their home countries, and partly because their auto companies have the financial strength and long-term strategic vision needed to make the necessary investments.



“We’ve been ahead 33 years in a row, and I think the betting odds are we’ll be ahead for the next 33 years.”

— General Motors CEO Rick Wagoner, commenting in January, 2005 on the likelihood that Toyota would overtake GM as the world’s #1 auto maker.



John Lumbard, CFA
Photo by Rick Balboni

Our client accounts have grown to almost \$50 million, fueled by dividends, interest, and capital gains on common stocks, foreign bonds, domestic bonds, and other securities. The “benchmark” account that we’ve been tracking since 1990 now stands at \$378,468, up from \$100,000 at inception. You probably see numbers like that all the time, but this is not a stock fund. Over time the account held nearly half its assets in bonds and cash. It rose steadily in the years following the bursting of the millennium bubble.

LOSE WEIGHT AND QUIT SMOKING!

Sanofi-Aventis is probably just a couple of months away from approval for its anti-obesity drug Accomplia. The drug blocks cannabinoid receptors in the brain, which are also involved in the body’s response to tobacco dependence. The company’s web site explains:

“Sanofi-Aventis’ approach developed from the knowledge that cannabis smokers often experience extreme hunger pangs, which cannabis smokers refer to as “the munchies”. Sanofi-Aventis worked on the premise that if cannabinoids stimulate appetite, blocking cannabinoid receptors in the brain might reduce appetite.”



SEC rules, thankfully, are long on substance and short on red tape. One exception is the requirement that each year we offer part II of our form ADV to clients and prospective clients. The form is remarkable in that it contains little information that anyone would find useful—but the SEC requires that we offer it in writing, and that you respond in writing to request a copy.

We’ll send you one even if you just call on the telephone. Call us at (800) Lumbard, which works out to (800) 586-2273. That’s Lumbard, not Lombard. (800) 586-2273.

INVEST OVERSEAS

The United States *still* has a trade deficit with Europe, despite a huge, three-year decline in the dollar versus the euro. In October our trade deficit with Europe was twelve billion dollars. Worldwide we exported \$106 billion of goods and services in October, and imported \$176 billion.

The dollar was strong for most of 2005, because rising short term interest rates drew investment from foreigners looking for a good place to park short-term cash. It’s likely that the long campaign of rate increases is about to end, so it will become harder to coax new cash from overseas.

Right now we need \$70 billion a month. The dollar will move lower in 2006.

Intel has announced a \$25 billion buyback of its shares, in an effort to boost the price of the stock. The company says that it has purchased 2.5 billion shares (for \$49 billion) since 1990, but apparently the purchases did little more than soak up the shares issued in the stock-options program. Since 1990 the share count has declined from 6.4 billion to 6 billion



Most investment errors are emotional, not intellectual.

Give us a call at 1(800) Lumbard. **Not (800) Lombard!**
(800) **Lumbard**. That’s (800) 586-2273.



Drew D. Kellner

REFI MADNESS

During the last three years the United States has enjoyed historically low interest rates, and staggering levels of home price appreciation. This combination allowed American homeowners to borrow ever-larger sums of money at lower and lower rates, by refinancing their homes. Millions leaped at the chance to lower their monthly mortgage payments while remodeling the kitchen, buying a car, or adding \$50,000 into their bank accounts.

This can't last forever. Short-term interest rates are rising (the Federal Funds rate is now 4.25%, up from 1% not even two years ago), and the trend is beginning to impact long-term rates and the mortgage market. Rising rates could spell the end of the refinancing boom, and the end of a related boom in consumer spending that has been fueled by funny money.

The second concern regarding the "Refinancing & Mortgage" bubble has to do with the plethora of creative mortgage products that are now available. Interest-only, negative amortization, limited income verification, and other buy now – pay later mortgages have helped to drive home ownership to record levels, but they pose a danger to uninformed borrowers, to the banking system, and to our economy.

A recent Federal Reserve survey of Senior Loan Officers revealed that a quarter of the nation's banks have invested heavily (at least 26% of their mortgage portfolios) in "Exotic" mortgages. 67% of banks surveyed have increased their investments in exotic mortgages in the past year.

Also popular are Adjustable Rate Mortgages (ARMs) which have a short fixed-rate period and then reset yearly to current rates. The risk here is that rising interest rates would force borrowers to make higher mortgage payments, and could cause a significant increase in defaulted loans.

Alan Greenspan and others believe that the total impact of the increased home-related borrowing of the last few years might be equal to all the growth of the economy. If that is true, this is no time for the banks to take risks with their loan portfolios. This is a time for caution, particularly with investments in the housing and banking sectors.



MORE JUNK, LESS TIME

Ben Bernanke, incoming Chairman of the Federal Reserve System, says that it's not an excess of American consumption that has caused the world economy to become so unbalanced. The problem is an excess of foreign savings, and *under*-consumption by nations such as China, Japan, and Taiwan.

That perspective helps to explain why the dollar hasn't declined further, and why our interest rates remain at low levels even as we borrow like crazy. But there's no reason why the next move has to be an increase in Asian consumption. Perhaps Americans will instead decide to consume less.

In this country consumption has a madness to it. An irrational exuberance. Many American homes have been overwhelmed by consumer goods to the point where there is a negative impact on the quality of life. The time required to buy goods can be described as "leisure", but you can't say that about returns, repairs, disposal, or all the organizational chores that are demanded by excessive abundance.

It's frankly hard to imagine that we'd all embrace the simple life, but don't think it can't happen. Consumption can't hold a candle to happiness. And the consequences of such a shift—to our lifestyles, our economic growth, and to the world economy—would be profound.



A SEA OF RED INK

In 2005 federal taxes per household were \$19,147. Federal spending per household was \$21,956. The difference is what the federal government *says* it borrowed, in the name of each household, in 2005.

But the government's accounting scheme is a lie, and it has been for decades.

In 2005 the "real" deficit was more than \$4,300 per household, or \$500 billion in total. Social Security loaned the Congress more than \$170 billion to help shrink the size of the (\$330 billion) reported deficit.

That loan was made via a purchase of US Treasury bonds, which are the only form of investment that the Social Security trust fund is permitted to hold.

The bonds offer the safety of an investment which will always be repaid (the government does, after all, have the power to print money), but this is not an arm's length transaction.

In fact, it's a very ugly transaction. The Congress runs deficits, and then papers over the yawning gap by taking money out of the Social Security trust fund.

They'll only be able to do that for a few more years, because in 2018 the trust fund will begin to cash in the bonds that it holds. That's a huge reversal, and it will be difficult to attract enough new lenders—new buyers of Treasury bonds—to make up the enormous shortfall. Taxes will rise sharply even as interest rates shoot higher. Higher interest rates, of course, mean bigger budget deficits, because

the already-huge interest expense on all existing Treasury bonds will rise.

The way out of this mess is to balance the budget, and make Social Security a truly independent retirement program with separate, untouchable funding. That isn't going to happen until we find a way to invest the trust fund in something other than Treasury bonds.

Most observers believe that this means private accounts. Australia has a system that's worth emulating, and we shouldn't allow our "not invented here" mindset to keep us frozen to the tracks. Private accounts would allow us to invest part of the funds overseas, and there can be no doubt that we need to invest more in areas of the world that are growing rapidly.

Up until the turn of the millennium Americans received a lot of dividends and interest from overseas, but we now pay more to foreigners than we receive from them. That's not a good thing, for a large, mature economy with an aging population.

A nation of retirees cannot easily repay debts to foreign nations. There's a train wreck coming, and we need to take action today.

John Lumbard, CFA

GONE PHISHIN'

In early November a California man was indicted for using viruses to seize control of the personal computers of tens of thousands of people, and for renting out the use of those computers—as many as 10,000 at a time—to people who wanted to send spam or launch Internet attacks.

In our last two issues we proposed that this sort of fraud is not just possible but likely, and now we're

seeing it begin to blossom. Once you've taken the time to think about what ought to be possible—and you recognize that there are literally millions of potential high-tech criminals, worldwide, attached to the same Internet that we all use on a daily basis—you quickly become very concerned about the future of online banking, online transactions, and corporate networks that have any connection, whatsoever, to the Internet.

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.

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