STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS FEBRUARY, 2011

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,670 * Dow Jones Industrials 11,671 * 30 year U.S. Treasury Bond 4.4%

HAIR OF THE DOG

Unemployment claims are down. The trade deficit is rising. The Fed is printing money. A new cut in payroll taxes and an extension of unemployment benefits will mean growing federal budget deficits—and a big new stimulus for the economy. We're borrowing and spending our way to another boom!

Well, the word "boom" might be a bit over the top, but this is another dose of the same medicine we've been guzzling since the 1980s; party all night, and cure the hangover with a Mimosa in the morning.

Ever since the Great Panic of 2008 we've been saying that the trouble with Stimulus programs is the deflation (the *shrinkage* in the economy) that follows when the programs end. Now even slow-learner Paul Krugman is questioning whether "a year of modestly better performance is worth .. additional debt." Paul Krugman! Too bad the package didn't include some trains, because Paul has loved trains since he was a little boy.

The leading nations of Europe have responded to a similar set of problems—debt and bloated government—with austerity. The Brits have slashed social benefits and half a million government jobs, fending off a bleating chorus of American critics who fret that the result will be further economic weakness. Well, duh; but Canada actually slashed deeper in the mid 1990s, when it courageously battled a combination of debt, deficits, and bloated government that ranked among the worst in the world.

In fact, Canada's debt—as a % of GDP—was actually worse than the one that has caused the Greeks to cry for help. A shocking one-third of all government tax revenues were being devoured by the cost of interest that the nation had to pay on its debt. You never heard about this from our "news" media, but our neighbors to the north laid off *fourteen percent* of the government's work force. The 490,000 layoffs under way in Britain sound like a lot, but it's just 8% of total government employment.

At the same time Canada reformed its welfare system, reduced benefits, cut corporate taxes, cut income taxes, and launched a Value-Added Tax that shifted part of the "penalty" of taxation from income to consumption.

If that sounds harsh, take a look at the results. Over the course of the next ten years the percentage of Canadians classified as low-income declined by more than 30%, according a new book titled <u>The Canadian Century</u>. Welfare recipients declined from 10.7% of the population to 6.8%. The federal budget was balanced within 3 years, and the nation went on to produce 11 straight budget surpluses.

Austerity works. In recent months these policies have been copied by Britain, Ireland, and the entire continent of Europe (none of whom gave any credit to Canada whatsoever). This might not be the best time to follow suit—somebody somewhere has to buy things, if the world economy is to keep chugging along—but let's not fool ourselves into thinking that we can spend our way back to financial health. ■

FURTHER GAINS IN 2011

Inflation is crawling along at barely more than 1%. The bond market has nevertheless been in a panic; investors have pushed the yield on the 30-year Treasury bond almost to 4.5%, at a time when money-market funds give you a yield of *zero*.

Investors are afraid because they've all watched the YouTube video that says Quantitative Easing Too is really just printing money, and that printing money is "*the last refuge of failed economic empires and banana republics*".

Commodity prices have been pushed up by a million investor bets. The gold fund known as GLD now owns 1,300 *tons* of gold (for comparison, China and Switzerland each have 1,050 tons) and copper is being hoarded in Chile, in China, and in the overstuffed accounts of JP Morgan at the London Metals Exchange.

In fact, investors have pushed up the prices of raw materials all over the world, but our inflation rate hasn't budged. And it's not going to budge as long as we have lots of people looking for work—and lots of idle machinery, factory buildings, and offices. Commercial real estate, housing, and home builders are going to have another bad year.

GDP growth will actually slow down in 2012 and 2013. The payroll tax cut will only last 12 months, and the 2009 earmark programs are still winding down. Every time a stimulus program ends, GDP shrinks a little.

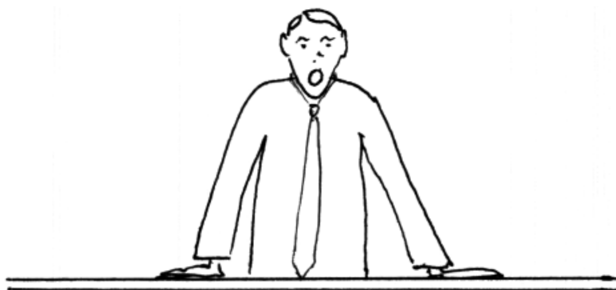
The new members of Congress were elected on a promise that they'd slash federal spending and deficits. What we know for sure is that we'll see big cutbacks in state governments, which employ 60% more people than Uncle Sam does. And we'll see massive cutbacks in cities and towns, which employ *four times* as many workers.

China and India will continue raising interest rates to slow their overheated economies. Austere Europe will barely grow at all. The Chinese will tire of building empty apartments for investment, and the growth of raw material imports will slow. A client recently returned from Chile, and reports that there's a stupendously-large pile of copper near downtown Santiago, waiting for the right day to sell.

If the dollar falls 5% against all the world's currencies, the decline should cause the price of gold and copper to go up 5%. That's it; just 5%. And the dollar could easily rise against the euro and the Japanese yen.

Low inflation and stable currencies will eventually calm the nerves of bond investors, at least when they're not being hammered with bad news from municipal and state governments. Stocks look even better; the S&P 500 is up, but it's still possible to find blue-chip stocks with dividends that are twice the inflation rate, and earnings per share that are large enough to offer the kind of share-buyback magic that we wrote about on page 4 of our last issue. You can find that issue at www.Lumbard.com. ■

"Unnamed sources have revealed that Kimberly-Clark, maker of Huggies, Depends, and other brands, is in talks to acquire WikiLeaks, the incontinence product for warlocks and witches."



"Consider the gentleman—his name is Cheng Yue Shi—who told me that he owned 43 flats in and around Shanghai. He doesn't rent out any of them . . ."

-- Fortune Magazine, describing one of the owners of tens of millions of empty homes in the Ghost Towns of China.

THE OTHER SHOE

The next (and hopefully last) shoe to drop will be the debt problems of state and local governments. They responded to the flush times of the last decade with new hires (even the small towns of New Hampshire bulked up with firemen and policemen), and now they're struggling to balance their budgets.

The worst states and cities added workers *and* increased pay dramatically—most notably with rich retirement and health care packages negotiated between unions and the politicians they had in their pockets. Retire at age 50 on 80% of your pay!

Voters have suddenly awakened to the fact that these unions weren't organizing against rapacious robber barons, but against *them*—The People. The state to watch is California, which *needs* to go bankrupt to re-negotiate staggering pension and health-care benefits, but which just elected a governor who received huge campaign donations from public unions—$1.4 million from the prison-guard union alone.

> "The state of California's real unfunded pension debt clocks in at more than $500 billion, nearly eight times greater than officially reported."
>
> -- The Los Angeles Times

Legal scholars believe that states can't declare bankruptcy unless Congress creates a mechanism to allow it; but what will happen when the cash runs out and there's no money to pay this week's salaries?

The new Congress is in no mood to bail anybody out, but it might be willing to give Jerry Brown and other governors the option of a fresh start and re-negotiated contracts

> "A true financial valuation of unfunded pension liabilities [in Illinois] reveals a debt of more than $200 billion for the state and local governments. That is around $42,000 per Illinois household . . . ."
>
> -- The Chicago Tribune

Bankruptcy might also be an opportunity to undo other Californications, such as the MegaBucks Bullet Train that rich people and railroad buffs will ride from the tiny farming town of Borden to the tiny farming town of Corcoran, 60 miles south in the Central Valley.

Investors are already worried. When they become *scared* they'll sell the bonds of good states and bad states alike. In many cases it's best to ride out the storm, but you need to prepare yourself for the likelihood that the prices of your tax-exempt bonds and bond funds will be quite a bit lower in the months ahead. ■

> It's often said that the effects of banking crises last for seven years.
>
> This one started in 2007—so we're almost halfway through!

VALUE in ASIA

Singapore Telecom pays a 4.6% dividend, and the company's holdings extend far beyond the small island that is its home base. Growth comes from the ownership of big stakes in wireless companies across Asia; yet the stock sells at a bargain price.

We purchased the Thai Fund at a time of violent street protests that depressed the shares and the entire Thai market to attractive levels. Attractive, that is, if you noticed the enormous investments in automobile factories (Toyota, Ford, and Mitsubishi) that were underway at the time—confirming that the protests had little effect on the economy.

We also purchased shares of the Matthews Asia Dividend Fund—which focuses on our kind of value stocks—and shares of an exchange-traded Vietnam fund. The GDP of this nation of 86 million is only 1.5 times the GDP of New Hampshire—but it's growing at a 7% rate. ■

> " . . . the Governor also plans his own space program for California, complete with a communications satellite, a space-faring academy with courses in space law and trade and a space research institute within the University of California."
>
> -- Time Magazine, describing Gov. Jerry Brown, January 30, 1978

Drew D. Kellner, CFA

S*XTUPLED!

On December 31 our benchmark account was valued at **$623,903**; up from $231,542 ten years before, and $100,000 in October of 1990. For more information please visit our web site, www.Lumbard.com, or give us a call at (800) Lumbard; (800) 586-2273.

DEATH AND TAXES—AND SOME UPBEAT NEWS!

You've probably read that the new "Obama-GOP" tax deal offers a temporary extension of existing tax rates, and a temporary reduction in the payroll tax that's supposed to be (LOL) setting aside funds for our future retirement. But that's only part of the story.

During 2011 and 2012 there will be *no federal estate tax* on estates smaller than $5 million. The tax rate on estates larger than $5 million will be 35%. And these rules will also apply to gifts; during the next two years you can give $5 million to a family member without paying any gift tax at all.

Furthermore, the biggest concern of estate planners has been eliminated. If your spouse dies with less than $5 million in his or her name (thus not taking full advantage of the tax exclusion) you'll be able to apply the unused part of the exclusion to your own estate.

The "Bush tax cuts" are now the permanent (that's the word used in the bill) law of the land for 98% of our citizens. This applies to marriage penalty relief, the 15% top tax rate on dividends and interest, and many other items. For the other 2% of the population (married couples earning $250,000) the current rates will be extended for two years.

A larger Alternative Minimum Tax exemption will prevent the AMT from claiming another 21 million households. And yes, in calendar year 2011 employees (not employers) will be allowed to pay just 2/3 of the Social-Security portion of their payroll tax. ■

From the Letters Section of the Wall Street Journal

Sirs;

We're not eager to defend the Fed's inflationary tendencies, but those who want to put us back on the gold standard have some 'splainin' to do. When our economy doubles in size, as it most surely will, do they plan to have us double our gold holdings? If other growing nations have also turned to the gold standard, will we all be bidding for shrinking stocks of the ever-less-useful yellow metal?

What we really need is a new charter for the Fed that focuses all its energies on monetary stability. And we need a new charter for the Congress which insists that it do its job of managing the nation's budget. We're not going to achieve lasting fiscal and monetary discipline any other way.

John Lumbard, CFA

Let's say that the pundits are right, and we only have a few decades' worth of oil left on the planet. You're still left with the question of how fast we pump the stuff out of the ground. If we pump at 80 million barrels per day, oil prices will go up. If we pump at 110 million b/d, oil prices will plummet.

"You can always make news with doomsday predictions, but you can usually make money betting against them."

-- John Tierney, who in 2005 bet Matthew "Peak Oil" Simmons $5,000 that in 2010 the average price of oil would not be above $200.

INCENTIVES RULE!

In December the Boston Globe ran a front-page story on the "dangerous incentives" created by a program that offers cash to the parents of children taking psychotropic drugs for ADHD. The number of children on these drugs has predictably swelled, and a program that once focused on children with severe physical disabilities such as cerebral palsy "now largely serves children with relatively common mental, learning and behavioral disorders." You can't get the cash unless your child takes the drugs.

In happier news, we've been exporting gasoline to Saudi Arabia! American companies receive a 45-cent-a-gallon subsidy for blending American ethanol with gasoline, and the Saudis (coals to Newcastle!) are pleased to buy it at bargain prices.

"The feds just made available a $300,000 grant to the city of Hartselle, Ala. That money is earmarked to help build a Cracker Barrel restaurant. The money is supposed to create up to 200 jobs. Not counted in this job creation number: the jobs lost at other restaurants when Cracker Barrel takes away their customers."

-- Economics professor Art Cardin, in Forbes

Federal subsidies for colleges and universities were meant to hold down tuition costs, but instead have enabled a massive increase in spending—*fresh sushi in every dining hall!*—that has driven tuitions above $50,000 a year. And then there's the nutty web of disincentives and incentives that are driving up costs in health care . . . .

Of all the faults of our congress-people, the greatest is their inability to recognize the unintended consequences of new legislation, and understand that these incentives are often the most powerful aspect of any bill. Brilliant minds and sophisticated arguments are most unhelpful in this regard, because they contribute to the illusion that it's possible to piss into the wind without getting wet.

We have laws that reward borrowing, consumption, participation in housing bubbles, and exploitation of tax loopholes. Federal and state governments penalize workers, savers, and investors, while rewarding early retirement, gasoline consumption, large families, single-income households, and unemployment.

Yet we (The People) can also be faulted, for incentivizing our legislators to buy our votes with earmarks and entitlements. It would be bad enough if they bought votes with money from their own pockets, but this cash is taken from the pockets of our children . . . . Not so many years ago we saw a billboard in Boston proclaiming that the local congressman's constituents "**get their fair share . . . and then some**".

Irresponsible spending has to be funded, so Congress found ways to lie about the true size of the annual budget deficit. According to the Social Security Administration it was Lyndon Johnson who first proposed the "unified budget", a scheme in which the size of the deficit is reduced by deducting that year's contributions to the Social Security trust fund. Congress happily went along, and 40 years later they're still offering up that big ugly lie.

Over time morality shifts to accommodate anything that's put into law. If the government were to offer $1,000 tax credits for killing domestic pets, they would soon begin to disappear from the streets—and killing pets would become socially acceptable. "Your retriever? Oh, sorry—I thought you knew. Muffy Wilson shot it last week. But you know, she was getting *killed* on her taxes. She really needed that deduction."

The Brits are leading the way back. They just abolished 192 government agencies, and are "substantially reforming a further 171". Rule Britania. ■

- Unemployment is below 10%, so employment is *above 90%.*
- 91% of the homeowners who owe money on a mortgage are making their payments every month without fail.
- 30% of homeowners have no mortgage at all!

Now, doesn't that feel better?

A NEW YEAR'S RESOLUTION OF THANKSGIVING

"A growing body of research suggests that maintaining an attitude of gratitude can improve psychological, emotional and physical well-being. Adults who frequently feel grateful have more energy, more optimism, more social connections and more happiness than those who do not, according to studies conducted over the past decade. They're also less likely to be depressed, envious, greedy or alcoholic. They earn more money, sleep more soundly, exercise more regularly and have greater resistance to viral infections . . . . Kids who feel and act grateful tend to be less materialistic, get better grades, set higher goals, complain of fewer headaches and stomach aches and feel more satisfied with their friends, families and schools than those who don't."

— Melinda Beck,
The Wall Street Journal

Gratitude is good, and it's not just a one-way street. The act of giving brings similar benefits, particularly when there's more involved than just writing a check. Each year tens of millions of Americans devote great chunks of their free time to charitable activities, and find that their lives are deeply enriched by the experience.

You would think that these truths would be well known, at least on an intuitive level, but millions of our best-educated and most-sophisticated citizens haven't a clue. It's a problem for families and child-rearing, and it's a problem for national policy. For many years now the prevailing attitude has been that government can do a better job of taking care of our less-fortunate citizens, because it can insist that all Americans of means pay their fair share.

Government *does* need to provide a safety net, and it *is* true that charity is an afterthought to many Americans. Syracuse University's Arthur Brooks says that politics are not a factor here; religious people are twice as likely as secular liberals or conservatives to give blood, volunteer for non-religious charitable work, or engage in non-religious financial giving.

The important point is that we all lose when government crowds out private charity, either by taking over services that were already well-funded or by taxing at levels that cause charity to shrink. Taxpayer-funded charities are monstrously inefficient when compared to private charities, and they engender no sense of gratitude among the recipients; in fact, gratitude is often replaced by a disgruntled sense of entitlement. And the donors lose nearly as much; has anybody ever derived satisfaction from writing a check to the IRS?

Our nation needs to balance its budgets, so taxes will rise in the years ahead. And much of the revenue collected will be spent on things that only government can do or will do. The key is to recognize that government is not a cornucopia, but the deep pocket of last resort. When government steps away, we all need to step up---to enrich our lives further with the joys of giving.

– John Lumbard, CFA
January, 2011

*When the National Commission on Fiscal Responsibility issued its proposals, with a suggestion that we should stop piling debt on the backs of little children, the wing nuts at the Spending Lobby claimed that the poor and elderly would have to eat cat food. Catcalls for the "**Catfood Commission**". . . . Proof once again that we'll have to amend the Constitution to force Congress to **do its job**. Google "We Elected You" to visit http://WeElectedYou.org/.*

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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