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INVESTMENT  
COUNSELING

INSIGHT

Nasdaq Composite 2,605 \* Dow Jones Industrials 12,218 \* 30 year U.S. Treasury Bond 2.90%

## THE MOST PROSPEROUS ERA IN THE HISTORY OF THE WORLD

Our unemployment rate is high, the stock market is struggling, and sluggish growth seems to stretch far into our future. It might not be easy to take a step back and feel appreciative for the progress we've made, and the progress we've helped bring to the rest of the world. Yet it's very clear that we're living in a time of peace and extraordinary plenty.

**Two hundred years ago** the average life expectancy, worldwide, was just 26 years. The life of man was nasty, brutish, and short—and poor. Incomes, wealth, and life expectancies had remained frozen for a thousand years—in fact, they had advanced little since Roman times.

Yet change and progress were stirring. In the next 100 years the life span of the average American male *nearly doubled*, amidst all the improvement in nutrition, working conditions, and living standards that such a great leap implies. Property rights, free markets, free societies, and the rule of law were driving prosperity across Europe and North America.

The lives of Americans in 1912—a century ago—were nevertheless quite poor by the standards of today. Fewer than 10% of the homes had telephones, and only 14% had bathtubs. Automobiles were rarer than hens' teeth, and most workers—men, women, and children—labored from dawn to dusk.

Today even our poorest citizens are healthier and wealthier. Many have automobiles, and most have mobile phones—in fact, those who don't have cell phones can get them free, via a Universal Service Fund program that's funded by a tax on your phone service. The only people who go hungry in America are those who have not connected with the federal food programs (SNAP, Child & Adult (CACFP), Women Infants & Children, Elderly Nutrition, etc.), or with state welfare programs. Or with soup kitchens and shelters, or the massive (and studiously ignored) outreach of churches nationwide.

This bounty may be of little comfort to those whose savings are in CDs at 1%, or those who

were laid off in a downsizing or merge—and have been eating away at their savings for years as they find another job or launch a new business, without any help from public assistance. We've been there, done that, and it's no fun. And yes, *most* Americans felt wealthier five years ago, and they look back on the technology bubble of 1999 as the best of times. But if you were lucky enough to enjoy the best times in the history of the world, do you really have cause for gloom?

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**In 2012 the U.S. stock market will rise more than 25%**

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We should all feel rueful about the way we partied in the last couple of decades, but as dwarfs sitting on the shoulders of giants we have greater capabilities than we've ever had. Not just the greatest in history, but we—right here—have the greatest technological, agricultural, and humanitarian capabilities on today's planet. We enjoy unparalleled freedoms, as well as protection from dictators, despots, and invading armies.

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## THE MOST PROSPEROUS ERA ...

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Nowadays the successes of China, India, Southeast Asia, and Brazil often cause anxiety about job losses, but let's not forget that we used to wonder how we could possibly help the huddled masses of Asia, Africa, and Latin America. According to the World Bank the average life expectancy for the entire globe—including places like Somalia and Darfur—now stands at 69.4 years! And the truth is that the United States played an important role, by helping other nations understand the prosperity that flows from free markets and the rule of law.

This isn't just a time of prosperity. It's also a time of world peace. Sure, there's trouble in Afghanistan, and there's reason to worry about Iran and North Korea. But have you seen the history of the 20th Century? Some of the centuries that

preceded it were even worse; during the Thirty Years' War (1618–1648) the male population of the German states was nearly *cut in half*.

In 2012 you'll see a grudging acceptance that these are not, after all, the worst of times. The pervasive gloom of Wall Street will lift, as will the ridiculously-depressed prices of equities. We're going on record with a prediction that in 2012 the U.S. stock market will rise more than 25%, and that parts of the world will do even better.

In the words of the philosopher Bobby McFerrin, *Don't Worry Be Happy*. And spread that cheer to your friends and neighbors; we'll all have a good year in 2012. ■



*John Convery Jr., CFA*

## MORE GOOD NEWS

In December the 45-cents-per-gallon tax subsidy for blending corn ethanol into gasoline, and the 60-cent-per-gallon tariff on imports of Brazilian ethanol expired with a whimper—not a bang. They slid into the sunset without a vote in Congress. As the Wall Street Journal said, it wasn't the "Viking funeral" the ethanol lobby deserved, but it was good news all the same.

"The American legal system is the most lawyer-friendly on earth. It is head-thumpingly complex. The regulations that accompany the Dodd-Frank law governing Wall Street, for example, are already more than 3 million words long—and not yet half written. Companies must hire costly lawyers to guide them through a maze created by other lawyers. They must also hire lawyers to defend them against attacks by other lawyers on a playing field built by lawyers."

– The Economist

"Our movie culture has descended into immaturity, deep and inhuman violence, a pervasive and flattened sexuality. It is an embarrassment.

In Iraq this year I asked an Iraqi military officer doing joint training at an American base what was the big thing he'd come to believe about Americans in the years they'd been there. He thought.

"You are a better people than your movies say."

– Peggy Noonan,  
in the Wall Street Journal

Housing starts have been rising steadily. In November they were up 9.3% versus the month before, and **24.3%** higher than the figure for November 2010. The news was delivered with the qualifier that "we need to get back to a million starts before we can declare that it's a healthy market", but why, exactly, do we need to put a Debbie Downer spin on everything?

## THE CASE FOR A BULL MARKET IN 2012

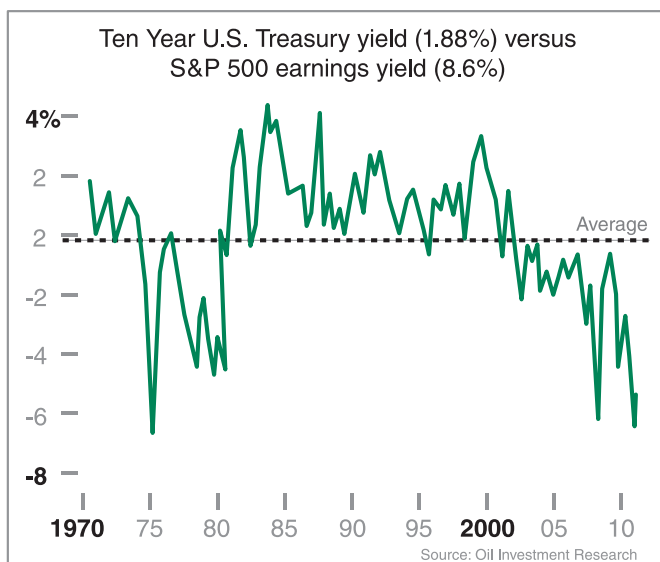
We expect a powerful rally in world stock markets in 2012. The most important reason is that stocks are cheap, but they reached these low levels because investors feared that the troubles of Europe would cause a recession in the United States. This now appears very unlikely. A recession is already underway in the southern half of Europe, and yet the U.S. economy has strengthened.

New unemployment claims have been dropping steadily since May. Lending by commercial banks—especially to less-creditworthy borrowers—is growing rapidly. New home construction (particularly multi-family homes) has increased sharply in the past year. Some of this strength will disappear when Congress takes further steps to reduce its huge budget deficit, because there's a clear tradeoff between growth and deficit reduction. We *need* to stay on a path of slow growth to bring our debt under control.

Slow growth doesn't mean lousy corporate earnings. Our economy has been growing slowly since 2009, but corporations have performed very well. They've refinanced debt, cut costs, pushed up revenues, raised dividends, and purchased their own stock in huge amounts.

In response their shares went exactly nowhere in 2011, at a time when they should have been lifted by falling interest rates. When interest rates and bond yields are declining, bond prices are rising—and stock prices are supposed to rise along with them. Dividend yields are supposed to decline, because shares are moving higher.

Below you'll see a graph (Citi Research, published in Barron's) showing the relationship between the prices of stocks and bonds since 1970. Above the line the yield on bonds is unusually high relative to the yield on stocks, so stocks are expensive. Below the line the yield on bonds is low, while the yield on stocks is high . . . . In this case the yield is not the actual dividend yield but the "earnings yield" which is the dividend that the average company *could* pay out if it paid all its earnings as dividend.



*Paul K. Wright, CFA*

Right now interest rates are at historic lows—the yield on long term (ten year) U.S. Treasury bonds is below 2%—so the yield offered by stocks should be at historic lows as well. It's not. Their earnings yield is well above 8%; roughly double the level that is suggested by historic relationships.

We don't believe that U.S. Treasury bond yields will remain at unusually low levels—we believe that bond prices will slowly decline from here—so instead of a 4% earnings yield we'll pencil in a more-modest move to a 6.67% earnings yield. That might seem like an oddly-precise figure, but it equates to a nice round price-to-earnings multiple of 15 times earnings.

Those earnings, of course, are rising all the time. Higher earnings, coupled with a PE multiple of 15, should push the stock market **up 25% in 2012.** ■

*Paul Wright, CFA, is our Chief Economist and Strategist.*



Drew D. Kellner, CFA

## NO DRAMA

After all the wailing and gnashing of teeth we heard in midsummer the **S&P 500** ended the year almost perfectly flat (down .04, but **up 2.11%** including dividends), while the Nasdaq dropped 1.8%. **Our benchmark** account rose to \$655,285, **up 5.03%** over the course of the year. It opened in 1990 with \$100,000 in cash, has never been bolstered by additions, and has always paid a 1% fee.

For information on fees, minimums, and performance (as well as every newsletter we've published since 2002), visit [www.Lumbard.com](http://www.Lumbard.com). ■

It makes no sense that you can get a whopping 6% dividend on shares of AT&T at a time when long term bonds (10 year US Treasury bonds) yield less than 2%. AT&T pays that dividend, and still has cash left over to buy back shares and make investments in growth. Seriously, do you think that the bonds will give you a better return over the course of the next 5 years? Really?

In the February 2007 issue of *Insight* we looked forward to the day when electric and plug-in hybrid vehicles would be able to communicate with electric utilities, buying power at steeply-discounted rates during minutes of low power demand.

That day is almost here. In September Ford will begin selling plug-in hybrids that allow the driver to indicate that he needs his battery fully charged, but doesn't care when the charging happens as long as it's completed by 7 AM. The utility will sell him that power at half price, pleased to be able to smooth out some of the peaks and valleys of power demand that cause it to keep huge amounts of power-smoothing equipment (including giant natural-gas-fired plants that sit idle most of the time) on standby.

The result will be lower electric prices for *everybody*, because we'll be able to produce most of the nation's power in big "base load" plants—coal, gas, and especially nuclear—that produce power for pennies an hour but need to run 24/7 to be truly efficient. Charging cars at night solves a Big Problem in the world of power, and it's going to lead to lower consumption, higher efficiency, less pollution, and lower prices. This is a revolution, and you heard it here first. ■

We like the stock of Ford (F - \$11), which doesn't pay a dividend but which is priced with the assumption that economic disaster lies just ahead. That disaster already happened, in 2008. It's time for investors to stop fighting the last war, pick up their heads, and look into the future rather than the past.

IBM (\$184), Oracle (\$25), and Microsoft (\$26) are big, strong, growing companies; and again, they're priced as if disaster lies just around the bend. It isn't.

We also like Fedex (\$83), another oddly-underpriced company that is riding the wave of online shopping. When you shop online Fedex revenues go up, and there's also magic happening on the cost side. Higher shipments mean fuller delivery trucks, shorter trucking routes, lower costs, and rising earnings.

Seadrill (\$33) pays 9% (!) The company has a very modern fleet of deepwater rigs—at a time when deepwater is a new frontier of unlimited promise—and a management team that is focused on dividends and shareholders.

Overseas we like Singapore Telecom (\$24), which owns large chunks of the biggest telecom companies in Asia; The Thai Fund; and the Matthews Asia Dividend Fund. Toss in a few shares of the Korea Fund, in the hope that South Korea will offer Kim Jong Un a billion dollars and a private island in exchange for unification . . . ■

## THE STATE OF EUROPEAN WELFARE

Wall Street and the media have been obsessed with the fear that investors will refuse to buy the debt of several European nations—causing a spiral of higher interest rates, compounding debt, and severe austerity that plunges the entire world into recession.

That's not going to happen, and in the near term the continent's leaders will continue to grasp for short term solutions and kick the can down the road. But this has been a heavy blow to the European Welfare State Model, and it's obvious that the nations which spent beyond the limits of affordability are headed for significant pain. So it's more than a little surprising that our media have made so little effort to draw parallels with our own debts and deficits.

As a bloc the euro zone is *less* indebted than the U.S., and its government deficit is lower. And we run up our debts in the same

ways. According to Census data published by the Wall Street Journal, 48.5% of Americans live in households that receive some form of government benefit, up from 30% in 1983. And we share Europe's great future problem, which is that we've promised larger benefits than we will possibly be able to afford once the Baby Boomers have retired in numbers (and stopped paying significant taxes).

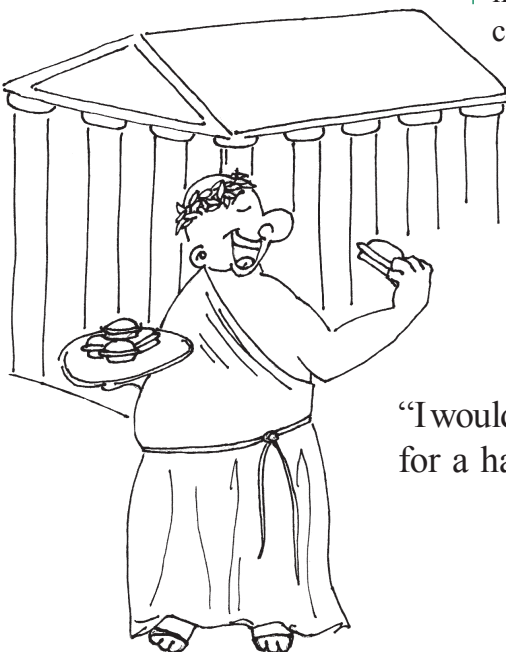
We also have patronage jobs, special tax breaks, tax fraud, subsidies, Medicare fraud, red tape, bureaucracy . . . . As with the troubled countries of Europe, these issues cause deficits and debt, and they also create inefficiencies and disincentives that are—right now—putting millions of people out of work.

The immediate concern for Europe is the need to reassure investors so that they'll continue to lend money to governments and banks, and interest rates won't rise. Numerous countries have been flouting an EU

mandate to keep budget deficits within 3% of GDP, so many observers are suggesting tighter limits—0.5% of GDP—that are enshrined in the constitutions of each nation.

Most Americans (74%, according to a July poll by CNN) and most congressmen and senators (328 from both parties, in recent votes) want to do the same thing here—but in a way that allows additional spending during recessions and wars. You can be sure that Congress is going to open up those floodgates from time to time, but a balanced-budget amendment to the Constitution would nevertheless slow the growth of the nation's debt. In 1997 a similar bill came within a single vote of passing both houses, because our legislators knew that they had not balanced\*\* a budget since 1960. ■

\*\*The 1969 budget was “balanced” with the help of deceit; that was the year they introduced the “unified budget” gimmick, which claims FICA receipts as if they are taxes.



“I would gladly pay you Tuesday for a hamburger today.”

© Laura Lumbard

The graying of America isn't just an abstract financial problem. Right now we have lots of workers, and a small retired population that receives the best care in history. In future years we'll have a large retired population, and few workers to fix the plumbing, change the bed pans, pay the (huge) taxes, and keep the lights on. Next time you find yourself worrying about future unemployment, think about that. There's going to be a labor shortage!

## COMMODITIES

There are shocking revelations afoot. Rare earths aren't, in fact, rare. U.S. oil production is *rising*, not falling. Scarce cotton is now so plentiful that the price has dropped 57%. We've got way too much natural gas. And no, China isn't going to soak up the glut in the world copper market.

In each case, higher prices caused an increase in production and reduced demand. It's a simple lesson, but one that investors struggle with because there's such a long lag before new copper mines are opened or new oil fields are discovered.

The oil shortages of the 1980s gave way to glut in the 90s after oil was discovered in the North Sea. Today the discoveries are in the deep water of Brazil, the Gulf of Mexico, East and West Africa, and the Arctic—and you can be sure that more elephants will be found. Oil-bearing shales all over the world will begin to give up their bounty, even as Libyan production roars back from nothing. Iraq's

production will double to 4.5 million barrels in four years, on its way to a goal of 12 million barrels a day—more than any nation has produced to date. Hubbert's Peak was a mole hill.

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*“Why, I've believed as many as six impossible things before breakfast”  
– the queen, in Alice in Wonderland*

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The price of natural gas has fallen from \$13 per thousand cubic feet in 2008 to barely more than \$3 today—the sort of level that you'd associate with a Middle Eastern country. We need to start *exporting* natural gas in large volumes, or quickly build up the infrastructure to use it here. It's hugely valuable in the production of nitrogen fertilizer and steel, but so far the primary use of this gas has been to displace coal in the generation of electricity.

That's not such a bad thing, because coal emissions—mercury, sulfur dioxide, nitrogen oxides, and the particulates that cause so much lung disease—have been killing tens of



*John Lumbard, CFA*

thousands of Americans each year. Keep that in mind next time you're reading a story about the possibility that gas fracking could pollute hundreds of water wells; on the one hand we're talking about ensuring clean water for showers, and on the other we're talking about American fatalities that are several times our death toll in the Iraq war. Lots of people died because we substituted coal plants for nuclear in the 1980s and 1990s, and we need to start looking at these big decisions from a scientific and rational perspective.

The one commodity that is never affected by meaningful increases in mining activity is gold. Gold! They said it was a sure thing, but high prices also cause demand to wither. In the last four months the price of gold has fallen more than \$300 an ounce.

– John A. Lumbard, CFA

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*“New gas discoveries—mostly the result of technological change (capitalism at work!) that allows gas to be gathered from the continent's massive shale reserves—will keep gas prices pinned at low levels for many years . . . While our economy is boosted by cheap gas from shale deposits, the world economy will be boosted by cheap LNG.”*

– *Insight*, Autumn, 2009.

*In the same article we recommended Golar LNG at \$9.50 (we sold at \$27); Atmos gas distribution (we bought at \$23 and sold at \$34); and NiSource gas distribution at \$13 (we still have the stock, which is almost at \$24).*

**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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