

Lumbar
& Kellner

INSIGHT

S&P 500 2,126 * Dow Jones Industrials 18,235 * 30 year U.S. Treasury Bond 2.99%!

EASY MONEY

If you follow the financial news at all, you're heartily sick of hearing breathless updates about the Fed's next move. Are they going to raise interest rates in September? In July? In ... September?

Who cares? Interest rates are at the lowest level since the Pilgrims landed. Someday they're going to start rising, and they'll rise slowly for a long time. Why do you need to know the month and the week?

When they do rise, they'll still be low. This is a bad time to own bonds, or bond funds of almost any stripe. Especially funds invested in long-term bonds. But it's a great time to get a mortgage!

We can well remember marveling, in the early 80s, at the amazing and precious 7% rates that friends had on their mortgages. Today's mortgage rates—you can lock in 4% for 30 years!—are an insane bargain, particularly when you consider that the interest is tax deductible.

That's not the only government subsidy at work here, because Fannie Mae and Freddie Mac (now wards of the state) are able to borrow money at very low interest rates that reflect a government guarantee of repayment. In effect the federal government borrows the money for you. And last year the Federal Reserve bought a lot of the nation's mortgages to keep the rates low. They printed money and loaned it to homeowners

We don't know what the rate would be without all this meddling. But seriously, would you lend money at 4%, knowing that the loan could last 30 years if interest rates rise—and that if interest rates *decline* the homeowners will laugh at you and refinance?

At the peak of the housing bubble, private investors and fixed-income mutual funds bought hundreds of billions of dollars' worth of mortgages that were *called* liar loans. The lesson to be learned is that huge numbers of people can be wrong together—there's no safety in numbers!—and it

happens all the time. There's a bear market in bonds ahead, and the losses will be measured in trillions of dollars.

So far short-term interest rates haven't gone up at all, but the Fed is uncomfortable with the fact that their monetary policy has been abnormally easy. And they're well aware of the moral hazard of giving our Congress an excuse to overspend. Why balance a budget when the Fed can just print money to cover the shortfall? The U.S. Senate went four years, from 2009 to 2013, without even passing a budget. In the most recent budget negotiations President O'bush asked for a *bigger* deficit.

Bonds will decline for years, until the eve of the next recession. Stocks will rise until then. You won't have to worry about stocks until inflation starts to pick up, or there are other excesses in the economy—at which point the Fed will *cause* a recession by raising interest rates to painful levels. That day is far in the future. ■

WATER WATER EVERYWHERE

“California failed to reach Governor Jerry Brown’s goal of 25% reductions outlined in a historic April 1 executive order Cumulative water savings since last summer have totaled only 8.6%.”
—ABC News

So much for mandates, voluntary restrictions, and shaming the neighbors. What actually works is to put water meters on every home and business, and then charge enough that homeowners decide to shrink the size of their big green lawns. Why should water be free?

A water meter initiative was launched by Arnold Schwarzenegger in 2004, so they just need to speed it up (the due date is 2025) and raise the prices. The money raised can be used to construct desalination plants. Next year desalination will provide *half* of the water used by residences and businesses in Israel; their wastewater is processed for agriculture.

In fact, next year a plant capable of producing 54 million gallons of drinkable water per day will open in Carlsbad, California. It will cost a billion dollars, a good part of which was spent on regulatory hoohah from the Bureau of Reclamation, the California Coastal Commission, the State Water Resource Control Board, and other federal and state agencies—and six years of battling *fourteen* environmental lawsuits.

California would need about 116 of these plants to serve all of California’s urban water needs (they’ll only need 80 if homeowners start paying real

money for their water). But the resource—the ocean—is limitless. Tom Hernandez of nearby Encinitas,



CA helpfully pointed out, in a letter to the editor, that \$100 billion might be the final cost of California’s high speed train to nowhere. So let’s flip a coin. Heads, they build a \$300-a-ticket train for the 1%. Tails, life-giving water for the 99%. We’ll toss in a few gallons for the 1% too. ■

“Utah Has the lowest level of income inequality and one of the lowest poverty rates [of the 50 states]. That is partly thanks to a highly successful economic policy; it has a flat income tax of 5% and invests heavily in infrastructure.”

– The Economist. We’ll add that Utah is also the most-charitable state, giving 10.6% of all its income to charity (compared with less than 3% for most New England states). Its compassionate policies have caused it to become a magnet for the homeless. The skiing ain’t so bad, either

We receive e-mails from a technical analyst who says that one market index has been doing too well (it’s “overbought”) while another has performed too poorly (it “broke support”). You might think that you can balance the happy news of one against the sad news about the other, but you can’t.

Fortunately, they’re running a special on a year’s worth of freeze-dried food at preparewise.com. If you spend more than \$1,000, they toss in a free two-person, 72 hour, 2,000-calorie-per-day kit. We did the math, and that’s 12,000 calories.** They don’t say what flavor.

**If they mean 2,000 calories for both people, don’t buy it.

FLYING HIGH

Boeing has orders for 5,500 jets. Airbus, which has produced 9,081 aircraft in its entire corporate history, has orders for 6,400 more. It expects to take *ten years* to build them all.

5,100 of the Airbus orders are for single-aisle aircraft. If you go to Airbus to buy one, you’ll probably be offered a delivery date of 2025 Early next year Bombardier will make its first deliveries of the C Series, a carbon-fiber and aluminum-lithium jet that can carry as many passengers as a Boeing 737 while burning a lot less fuel. In 2016 Bombardier will stop *spending* money on the C-Series and start *making* money on it. We believe that the overall impact on the company will be huge. ■

EUROSCLEROSIS

Oh, those undisciplined Greeks! They can't get through a single year without another loan from the Germans, and they just don't seem to have the political will to balance their budgets. Greek politicians get elected by promising to continue spending, and the economy is snarled by heavy regulation, unions, and an inefficient tax system. Unemployment is high, and growth is low.

It's tempting to view Greece as an aberration, but the unhappy truth is that—over the course of the last 20 years—unemployment in the Euro area has averaged 9.7%. Right now it's at **11.3%**, and it would be a lot higher if not for Germany, where unemployment is running at just 4.7%. This problem of sluggish growth is shared by most of the European countries, as well as Japan and former European colonies such as Argentina and Brazil. And our own country isn't exactly tearing up the track, despite low energy prices and a huge boom in energy-related jobs.

Economists call it Eurosclerosis: the sluggish growth that results from an accumulation of fatty deposits in the arteries of advanced economies. The hard-working and disciplined Germans have done well with the European Welfare State, but in most countries it has brought debt, dependency, and stagnation. Businesses are slowed by social and regulatory burdens that grow every year—that's what regulations do—and the nation's work ethic is slowly eroded by growth in social safety nets.

Germany is an exception because it embraces growth and change. The Germans work harder, but the main reason their unemployment rate is so low is that German companies ruthlessly cut costs, invest in new equipment, and *eliminate jobs*.

Greek workers can't compete with the efficient workers of Germany, even though the average wage in Greece, about 15 euros an hour (\$17), is half the average German wage. After a year-long slide the euro is now too low for the Germans, and still much too high for the Greeks. If Greece drops out of the euro its currency will plummet, perhaps causing the average Greek wage to drop to \$10 an hour. Foreigners will buy more Greek goods, and employment will rise.

Politicians all over the world think this is a great idea. While Brussels was slapping down the euro, Japan was forcing down the yen. Russia ripped the ruble, and Vietnam devalued the dong.

But hold on a second—those politicians could get the same result by calling for massive wage cuts for millions of employees! What's so great about that? And let's not forget that competing for the title of "cheapest labor", whether by currency devaluation or massive wage cuts, is a hard road. The average wage in Greece's next-door neighbor, Bulgaria, is just 3.8 euros, or \$4.25 an hour. Perhaps the EU will address that glaring inequality by calling for a redistribution of income from the wealthy Greeks to the poor Bulgarians



Paul K. Wright, CFA

In our last letter we pointed out that every month the U.S. gains about 5 million jobs and loses 4.8 million, while 60,000 businesses go bankrupt and are replaced by 60,000 new ones. Despite the best efforts of government we still have a dynamic economy in which painful change is the norm. Our per capita GDP is 23% higher than that for Germany, and 43% above the EU average.

The jobs lost in painful change won't return in the same companies, or even in the same industries; but new industries will emerge. If it's hard to keep the faith, just remember that stagnation always brings poverty and despair. Nations that embrace growth and the terrifying future are the ones that succeed. We can improve living standards for all our citizens if we reward investment, entrepreneurialism, and hard work. So, how about a little tough love? ■

THE TOILET PAPER CONSPIRACY

“[Venezuelan] Government officials say they are increasingly on an offensive to combat what they call greedy capitalists teaming up with President Obama’s administration and with the political opposition to hurt the leftist government by generating shortages of staples such as cooking oil, diapers, sugar, and toilet paper.”

– The Wall Street Journal

“Marissa Mayer is America’s best-paid female chief executive. The Yahoo boss ranks seventh in terms of overall CEO pay, with her total compensation amounting to \$42.1 million. Safra Ada Catz of Oracle [earned] \$37.7 million while Lockheed Martin’s Marillyn Hewson has an annual pay packet of \$33.7 million During the latest fiscal year, female CEOs in the S&P 500 earned an average of \$18.8 million, exceeding the \$12.7 million average paid to the 455 male CEOs listed.”

– Niall McCarthy, Statista.com.
[http://www.statista.com/chart/3452/highest-paid-female-chief-executives//](http://www.statista.com/chart/3452/highest-paid-female-chief-executives/)

Those double-digit million-dollar salaries are only paid to a handful (roughly 300) of the nation’s CEOs. The Bureau of Labor Statistics says that the average salary for CEOs is just \$180,700 a year. ■

25 YEARS

This spring marks the 25th year since we opened our offices in Hollis, overlooking the orchards of Brookdale. At the time our assets under management were *Zero*, and it was slow going from there. We now have more than \$150 million under management.

The Memorial Day market value of an account we often reference in our newsletter was \$975,263. If you’d like further information or context please go to www.Lumbard.com, and click on the “Performance” tab.

DON’T BE EVIL

“We don’t need you to type at all, because we know where you are—with your permission—we know where you’ve been—with your permission—and we can more or less guess what you’re thinking about. Now is that over the line?”

– Google Chairman Eric Schmidt, in an interview with [The Atlantic](http://www.theatlantic.com).

Google, which only reads your e-mails with your permission and never saves more than the last 8 digits of your Social Security number, spends more on Washington lobbyists than any corporation except GE. ■

“If you keep your nose to the grindstone, you don’t have any nose.”

– Leslie Wexner, founder of The Limited, on the importance of staying in touch with consumer trends.

KIDS’ CORNER

“In March, House Budget Chairman Tom Price released a proposed draft for the federal budget that would reduce federal spending by \$5.5 trillion over the coming decade and trim the federal budget to 18.2% of the U.S. economy by 2024.

Why is this number important? Because over the past 75 years, tax revenue to the federal government has averaged 18.2% of GDP. Only twice in those 75 years has tax revenue exceeded 20% of GDP: once briefly towards the end of World War II, and again briefly at the end of the dot-com boom.

Federal spending is currently at 20.3% of GDP, and on the present trend it will reach 22.3% of GDP within a decade. The shortfall, of course, has to be borrowed. All of it. The burden of repayment will fall on our children.”

– James Schaefer, WeElectedYou.org

“While today’s 65-year-olds will receive on average net lifetime benefits of \$327,400, children born now will suffer net lifetime losses of \$420,600 as they struggle to pay the bills of aging Americans.”

– The Wall Street Journal, quoting research by famed B.U. economist Laurence Kotlikoff that estimates Social Security, Medicare, and other benefits.

BUYING ‘EM UP

Corning, the Gorilla Glass company (GLW – 21 ½), has repurchased about 20% of its shares since 2011. In that time span Pfizer bought back 18%, and CBS bought about 21% of itself. For every ten shareholders that these companies had four years ago, they now have eight.

Fewer shares remain, so earnings *per share* are bigger than before. And the cash from the buybacks tends to return to the stock market. More demand for shares, fewer shares available to buy

The effect is particularly powerful for companies selling at bargain prices. A company that sells at ten times earnings can buy 10% of itself every year, if it spends all its earnings on its shares. Earnings per share would rise at a rapid pace even if revenues aren't growing. ■

Last year the CFA Institute did a poll among members, asking them to vote on the best retirement programs. The winner was Australia, which mandates that employers and employees make contributions similar to our FICA. But Bruce and Sheila get to put the funds into accounts that belong to them, so they don't feel that they're being victimized by a shell game. Why don't we ever look for good ideas in other nations, and adopt the ones that seem to work?

ON THE GRID

Georgia Power offers a 1.3 cents-per-kilowatt-hour electric rate, to drivers of plug-in hybrid and electric cars who charge between 11 PM and 7 AM—when its nuclear plants produce more power than is needed. It's a special rate to encourage more people to buy cars with big batteries, and thereby help smooth the huge swings of power demand that utilities have to deal with every day.

Here in NH the night-time rate is the same as that in the daytime, so there's no reason for you to consume less power in the day and more at night. This Depression-era pricing model results in more pollution, higher costs, more fossil fuel consumption, and more carbon-dioxide production. At night we have *too much power*, while in the daytime—especially in the summertime—we have to fire up inefficient “peaking” plants that burn fossil fuels.

Actually, our electric rates are 50% higher than those of Georgia. They're also 50% higher than electric rates in South Carolina and Tennessee. All three are states that have carbon free, pollution-free nuclear plants just as we do, but they still have fully-regulated markets. Apparently our “deregulated” market isn't working very well.

The whole point of free markets is that they create incentives that make the world a better place. If we're not getting the right incentives from “deregulated” markets, those markets are broken. ■



Drew D. Kellner, CFA

“Repressive regimes from Russia to Venezuela and from Iran to Belarus are tumbling down an economic spiral The shale-gas and hydraulic-fracking revolution is lighting a figurative bonfire under the world's petrocraacies.”

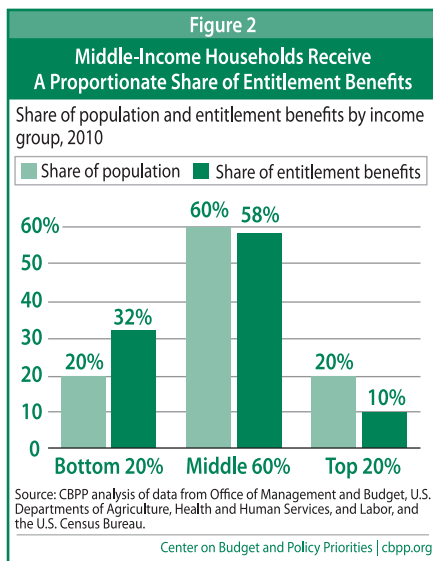
– James Bloodworth of [Left Foot Forward](#), in [The Wall Street Journal](#)

“Overall cancer rates are much lower in India than in western countries. U.S. men get 23 times more prostate cancer than men in India. Americans get between 8 and 14 times the rate of melanoma, 10 to 11 times more colorectal cancer, 9 times more endometrial cancer, 7 to 17 times more lung cancer, 7 to 8 times more bladder cancer, 5 times more breast cancer, and 9 to 12 times more kidney cancer.”

– Michael Greger, M.D. Consumption of fruits, vegetables, and spices such as turmeric (the one that gives curry its color) might play a role.

ENTITLEMENTS

In 1980 entitlements—Medicare, Medicaid, Social Security, Food Stamps, the Earned Income Tax Credit (cash paid to workers who earn less than \$51,000 a year), and other social spending—made up about half of all federal government outlays. Today these programs make up two-thirds of government outlays. The bulk of that entitlement spending goes to the middle class:



As the Baby Boomers retire, entitlement spending on middle-income Americans will increase. ■

Over a long lifetime the difference between “saving a little bit of money each year” and “borrowing a little money each year” is generally counted in the millions of dollars.

O, CANADA

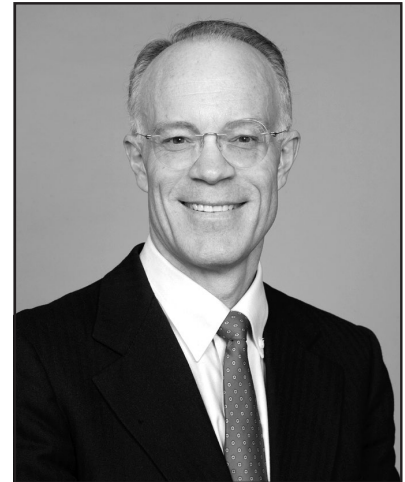
According to World Economic Forum rankings, the burden of government is more harmful to businesses in Greece than in the United States. But Namibia and Turkey are better. China—China—is a lot better, probably because it hasn’t had as many decades to accumulate bad regulations and laws.

The US has slipped from 23rd to 82nd place in the past 7 years. Canada, in 39th place, has passed legislation that places “strict controls on the growth of regulatory red tape on business,” says the Treasury Board of Canada. “Under the One-for-One Rule, for every new regulation added that imposes an administrative burden on business, one must be removed.” ■

LIFE IS GOOD

“Today,” Matt Ridley writes in his book *The Rational Optimist*, “of Americans officially designated as ‘poor,’ 99% have electricity, running water, flush toilets, and a refrigerator; 95% have a television, 88% a telephone, 71% a car, and 70% air conditioning.”

“Cornelius Vanderbilt had none of these.” ■



John Lumbard, CFA

Good accounting matters. So when Broadcom (BRCM - \$47) announced that its accounting would henceforth be transparent and honest, we bought shares. Broadcom, like other computer-chip companies, used to hide the fact that it was giving lots of stock options and shares to employees; but now it’s recording them as an expense. Hopefully the change will spread to other chip companies.

Some foreign stock markets will offer higher returns. In April we bought shares of an ETF that is essentially an index fund of 900 stocks in emerging markets. Remarkably, those 900 stocks had not appreciated since December of 2009. They’re up 7%, but we figure there’s still room for a little appreciation

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