Lumbard & Kellner INSIGHT

S&P 500 2,171 * Dow Jones Industrials 18,401 * 30 year U.S. Treasury Bond 2.31%!

OH HAPPY DAY

The stock market is at record highs, after ***painful*** winter lows that resulted from fears that we were about to enter another recession. Sometimes the market seems to have malicious intent, and this time it declined until huge numbers of people had sold all or part of their holdings.

Then, as always, it surged upward without warning. Our "benchmark" account—the one you've seen in these pages for decades—now stands at $973,021, up from $900,652 at the beginning of this year (and $241,129 on the first day of 1999. For more information, see our website). We'd like to thank our clients for hanging tough during the most-bewildering (for us) winter since the Internet bubble of the late Nineties.

Successful investing is mostly the result of emotional strength, rather than brilliance. If you pull your money out of the market every time Wall Street panics, you won't get much benefit from the magic of doubling. The major stock market averages have doubled every 7 or 8 years, including the reinvestment of dividends. Even if future doublings will take 10 or 11 years, you're still going to see remarkable growth.

It never looks like much until you get to the fourth doubling. Try it! The key is that *half* of all the money in your investment account was generated by the most-recent doubling. All the growth of all the prior years produced the other half. The graph looks like a hockey stick.

That's an important lesson for generations X, Y, and Z. Your Roth IRAs will seem to grow slowly for decades, but then will skyrocket in hockey-stick fashion. Patience pays, as does persistence. ■

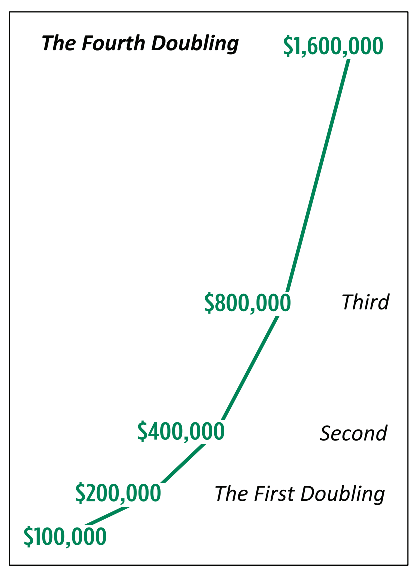
CHINA IS OK!

"How healthy is the Chinese consumer? New home sales—for which buyers must put down at least 20% cash in a market without subprime mortgages—rose about 29% year-over-year in the first half of 2016 …. Sales of SUVs rose 44%."

– Andy Rothman, Investment Strategist, Matthews Asia

"Emerging and developing economies now account for almost 60 percent of global GDP—up from just under half only a decade ago. They have contributed more than 80 percent of global growth since the 2008 crisis, and have been the main driver behind the significant reduction in global poverty."

– Christine Lagarde, Managing Director of the IMF. We invest in emerging markets because that's where the growth is; and because emerging market stocks are really cheap. They've gone exactly nowhere since September of 2009. In 2007 they were 50% higher than they are today. ■



Deepwater Wind has anchored five 600-foot wind towers, twice the height of the Statue of Liberty, to the sea floor south of Block Island, RI, incentivized by a sweetheart deal that will force Rhode Islanders to pay a massive surcharge for the power the towers produce; even when there is no demand and power has to be bled off as heat.

"The contract has a built-in price escalator of 3.5% per year. That means by the end of the 20 years National Grid will be paying Deepwater **50 cents** for each windy kilowatt hour."

– Forbes Magazine, The wholesale cost of power in New England is about 4.3 cents.

MOST ENTITLEMENT SPENDING GOES TO PEOPLE WHO ARE NOT POOR

"The U.S. program that pays elderly Americans' hospital bills will exhaust reserves in 2028, two years sooner than last year's estimate, trustees of the program said on Wednesday"

– Reuters, June 22, 2016

In 2015, the federal government collected an all-time record of $3.25 trillion in taxes. According to the White House Budget Office, 83% of that sum—almost all of it—was spent on "Human Resources." $1.03 trillion was spent on Health Care (Medicare, Medicaid, ACA, etc); $508 billion went to "Income Security" (disability payments, the cash payments known as the Earned Income Tax Credit); Social Security cost $888 billion ….

Yes, we all pay into the Social Security system as if we're paying into a retirement plan. But all the funds that have ever been collected—even the ones in the "trust funds"—were spent immediately. The same is true of Medicare. In June the Medicare trustees said that Medicare will run out of money in 12 years; and the latest Social Security statements say, in black and white on page 2, that in 18 years you will only receive 79% of the benefits that are shown on page one.

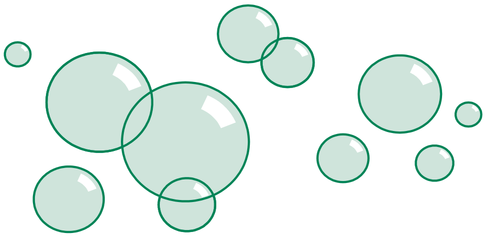
Both systems were designed for a world with lots of Baby Boomers working and paying taxes, and a small population of retired people. In the future we won't have as many high-earning workers paying into the system, and we'll have more retirees to support. The numbers don't work.

Most of those "Human Resources" programs are described in Washington as Entitlements. In a previous letter we printed a Center on Budget and Policy Priorities chart which showed that only 32% of Entitlement spending goes to households whose income falls in the bottom 20%. The New York Times tweaked the numbers, bumping the 32% figure up to 33%, but still asserted that **most entitlement spending goes to people who are not poor**.

And **most of the budget now goes to entitlements**. It's hard to escape the truth that our federal government is mostly a machine that transfers money from one group of people to another. The even harder truth is that these transfers are not from rich to poor.

The question that we should ask about each of our redistribution programs is "did politicians, in the past or present, win re-election or election by promising to increase the size of this benefit?" Promising to protect a large existing benefit also counts … Many of the programs that they created are now "untouchable" programs that grow rapidly every year, and are not affected by any budget process or other control.

The last recession was seven years ago, but the Congressional Budget Office now forecasts a deficit of $590 billion for 2016. Several years from now, when interest rates are higher, the interest cost on the ever-swelling debt will put a huge hole in the federal budget; and cause us to slash all these programs. ■



This has been an era of bubbles. In the 1980s, gold rose to $873 an ounce, and silver reached $107. In the 1990s, Internet stocks soared to the sky. The bubble kept growing because the herd of believers kept growing. They convinced each other, and all of their friends, that it was safe to buy the stocks of companies without earnings.

As the tech bubble burst we were already inflating huge bubbles in real estate and in mortgages. Investors convinced each other that it was safe to buy Liar Loans, and that you could get rich by living in a bigger house.

A growing bubble in commodities was barely interrupted by the financial crisis that followed. There were "shortages" of copper and rare earth minerals, and the world was running out of oil. The Saudis were lying about their reserves!

Today's bubble is in bonds. The yield on the 30-year US Treasury bond has declined from 15.3%, in the early 80s, to just 2.2%. *Bonds have appreciated more than 400%, over the course of 35 years.*

Investors used to buy bonds for income, and buy stocks for appreciation. But today they buy bonds, with their tiny yields, for appreciation, and buy stocks (overpriced electric utilities and REITs) for their income. It's a gigantic bond bubble, and American investors believe that it will get bigger because our 1% and 2% bonds look much more attractive than the bonds in Europe. Nearly half of all the world's government bonds are now trading at a negative yield!

To ordinary people negative interest rates seem like an extraordinarily dumb idea, and they are right. Bond buyers in Europe are now willing to *pay interest* to own bonds, betting that they will appreciate because next year their yields will be *even more negative than they are today.*

The central bankers of Europe and Japan convinced each other that negative interest rates would cause consumers to spend more (and also save their governments from having to pay interest on their growing debt). What really happened is that terrified retirees slashed their spending. Workers are spending less and saving more for retirement, and corporations, worried by slowing sales, are holding on to their cash.

This is a very big deal. Central bankers around the world have loosened monetary policy, again and again, to try to offset the recessionary tendencies that have accompanied the growth of the welfare states in Europe, the U.S., and sad-sack Japan.

Former Fed Chairman Alan Greenspan has been saying that we have paid a huge price for having a big social safety net. In the U.S., he says, entitlement

Paul K. Wright, CFA

programs have been growing "dollar for dollar" at the expense of savings since 1965. Savings are the key factor in investment, productivity, growth, higher wages, and increases in our standard of living. "That's what's killing us" Greenspan emphasized in a CNBC interview.

Yes, there is a bubble in bonds. But common stocks are not overpriced, because interest rates are so very low. Today the 5.8% "earnings yield" for the average S&P 500 stock looks huge when compared with the 1.6% yield offered by a ten year U.S. Treasury bond. For most of the last 35 years the yield on 10-year treasury bonds was a good bit *higher* than the earnings yield on stocks. **Bond yields would have to triple or quadruple before you could say that stocks are overpriced**.

Bond yields will rise, bond prices will fall, and surprised investors will respond by selling ***trillions*** of dollars' worth of bonds and bond funds. A good part of that cash will find its way into the stock market. ■

THE WAR ON POVERTY

"The official poverty rate in the United States, defined as lacking resources for life's basic needs, was 19% in 1964. It had fallen to 12.1% by 1969, the year Johnson left office. Last year, it stood at 15%." – USA Today

What would a victory in the War on Poverty look like? Our inner cities would not be places of despair and hopelessness, and they would not be zones of violence where most Americans fear to tread. Hunger in America has been overstated by fundraising ads (food stamps feed 45 million Americans, and the USDA runs 14 other food programs), but by any other measure—murders, drug overdoses, despair, alcohol abuse, fatherless parenting that dooms the next generation to more of the same—our inner cities are in a constant state of crisis.

NBC and Pew say that 38% of all African-American children live in poverty. Front Page magazine says that we as a nation have spent "$20.7 trillion in 2011 dollars over the past 50 years on welfare programs, far exceeding what the U.S. has spent on every war it has fought."

Speaker of the House Paul Ryan puts the figure much lower, at $15 trillion, but a report to members of Congress by The Congressional Research Service said that the War in Afghanistan, in 2011 dollars, cost just $321 billion. Iraq cost $784 billion, the first Gulf War cost $102 billion, and Vietnam, in 2011 dollars, cost $738 billion. President Johnson's War on Poverty clearly cost far more than his War in Vietnam, and far more than all the wars that followed.

There have already been 500 murders in Chicago in the first 8 months of this year. Last year there were 344 murders in Baltimore, and even little Milwaukee counted 145 homicides in a list offered by FactCheck.org, which was trying to make the point that homicides have declined. They have—because we have imprisoned huge numbers of violent young men—but the murder totals they offered for *just nine cities* added up to 2,248 in 2015.

There wasn't any year in which American troop deaths in Iraq and Afghanistan reached even half that figure.

The War on Poverty has been underway for 50 years, and we're still losing. We are lost. ■

"Lately, we find ourselves engaged with investors who believe fully robotic taxis will be the dominant model of vehicular transport by 2030/2035."

– Adam Parker, auto analyst at Morgan Stanley. Apparently these are hedge-fund managers who don't know anyone outside of New York City.

"The new Toyota taxi aims to serve people who might need a bit of assistance, like the elderly, disabled, and foreigners, Toyota said."

– The Wall Street Journal. It's about time somebody started looking out for foreigners!

MEDICAID FOR THE 1%

FAQ #9. "Do you consider assets when applying?"

"Assets/resources are not considered when determining eligibility for NHHPP [New Hampshire's expanded Medicaid program]. "Resources" are money in the bank or assets like a home or car."

– From the website of NHHPP. According to Medicaid.gov, 58.5 million Americans were enrolled in Medicaid in 2015.

"About 49% of the population lives in a household where at least one member receives a direct benefit from the federal government."

–The Washington Post

OVERHEARD AT A CAFÉ IN OREGON

"I literally don't know a single person who is not voting for Bernie, nor a single person who ever eats fast food. Yet the polls show Bernie losing and I see fast food restaurants still in business. Am I out of touch?"

From the USDA website for SNAP (food stamps): "Soft drinks, candy, cookies, snack crackers, and ice cream are food items and are therefore eligible items. Seafood, steak, and bakery cakes are also food items and are therefore eligible items."

Our safety nets were designed by politicians, for politicians.

61% of all light vehicle purchases are now SUVs and pickup trucks. Gas is so cheap that you can afford to lug around a couple thousand more pounds of steel! We won't go back to the much-smaller cars and trucks of the 1990s unless gasoline becomes so expensive that drivers begin to care about fuel consumption. The way they do in Europe.

Gas taxes can be raised, if the Congress and the President can reach a deal on tax reform. Yes, it's *absolutely* possible, because Republicans would vote for any plan that simplifies our bizarre tax system, as long as it doesn't involve a tax increase. The President would have to propose the gas tax increase, but he has always been a proponent of fossil-fuel reduction. It's the biggest environmental issue in America today. Everybody in Europe is talking about us. ■

"The challenge that was posed in the U.K. referendum is present in many countries around the world, albeit in different forms. What has become universal is the dismissive attitudes of the elite to their challengers ...The French Bourbons and the Russian Romanovs had similar contempt for the crowds in the streets [before the French and Russian revolutions].

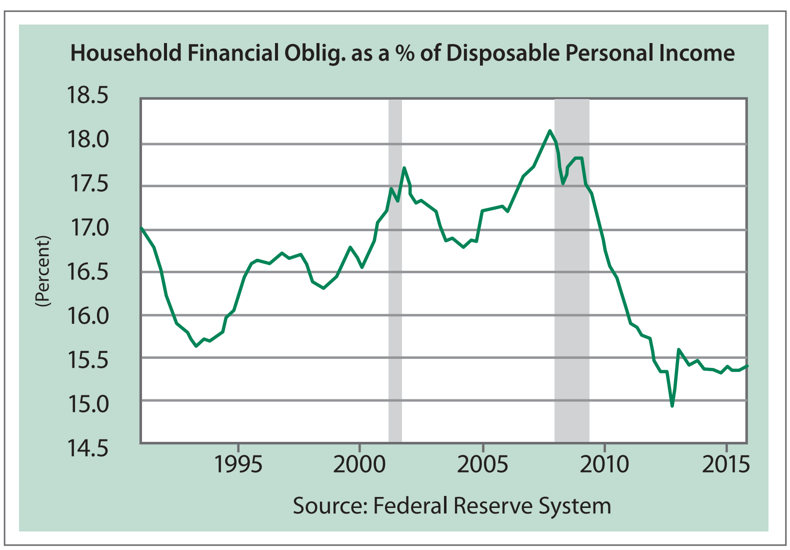
"The fact that the elite had no idea of what was happening beyond their circle of acquaintances, is a far greater crisis in the West than whether Britain is in the EU or even if the EU survives."

– George Friedman, Geopolitical Futures (and Stratfor). Friedman believes that Europe is slowly sinking—economically, politically, and militarily—under the accumulated weight of misguided elitist decisions. ■

Drew D. Kellner, CFA

"Over the past 15 years the Fidelity Dividend Growth Fund has generated total returns of about 5% annually. But by jumping in and out of the portfolio, the fund's investors have earned about two percentage points less a year, according to Morningstar."

– Money Magazine



The chart above shows that household debt payments (compared to household income) are as low as they were in the early 1980s! Low interest rates help, but consumers are in much better shape than you might have realized.

UPWARD MOBILITY

"Switzerland will decide on June 5 whether to pay its citizens a basic income to replace welfare benefits … Economists like it because unlike welfare benefits, basic income does not phase out if people work. As a result, there is no abrupt disincentive at various income levels the way there is with so many government assistance programs."

– Chris Low, Chief Economist, FTN Financial.

The Swiss vote failed, but it's still a good idea. Surveys suggest that there are millions of American welfare recipients who would like to take a job but simply can't, because their benefits would be cut off. There's no way that an entry-level job can pay enough to cover the loss of benefits. It's like having a tax rate that exceeds 100%.

Milton Friedman first proposed the "negative income tax" in 1962. It exists today as the Earned Income Tax Credit, although it was added to our 80 means-tested social programs instead of replacing any of them, as Friedman wished. In recent years the Universal Basic Income has been championed by Charles Murray at the American Enterprise Institute, who would give every adult American a stipend for health care and $10,000 a year, and then dump our entire welfare state.

Business Insider says "In 2012, there were 179 million Americans between the ages of 21 and 65 (when Social Security would kick in). The poverty line was $11,945. Thus, giving each working-age American a basic income equal to the poverty line would cost $2.14 trillion."

That sounds like a lot, when our all-time record tax collections for 2015 were $3.25 trillion. But we could reduce our welfare outlays by the amount of the checks we write to welfare recipients. It would also be "a wash" for middle and upper-income taxpayers, who would pay higher taxes to offset the checks they receive. We'd give more to lower-middle-income taxpayers, but more people would work—at a time when the labor participation rate is plumbing 35-year lows.

The Bureau of Labor Statistics says that 62.8% of "adults" (aged 16 and over) are now working; down from 65.7% in June of 2009, when the last recession ended.

Workers would leave the disability and welfare rolls, and as they climbed from entry-level jobs to mainstream employment they would become taxpayers.

John Lumbard, CFA

Politifact asserts that a mother with two young children in RI can receive $26,000 in benefits even if she isn't able to get subsidized housing. If she takes a job she'll have to pay for babysitting and transportation, FICA, and other taxes and expenses. She'll have less time with her children, and less time to sleep. It won't make sense to walk away from $26,000 in benefits unless a new job is going to bring her a *lot* more than $30,000 a year.

If, on the other hand, $10,000 of her benefits is a guaranteed income that she won't ever have to give up, it's going to be much easier for her to take a $26,000 job—that eventually leads to a $36,000 job. ■

– John Lumbard, CFA