

Lumbar
& Kellner

INSIGHT

S&P 500 2,730 * Dow Jones Industrials 24,899 * 30 year U.S. Treasury Bond 3.13%

HIGHLY PRODUCTIVE



After years and years of worry that the economy was **Too Cold** (so sluggish that it would simply slide into a recession), Wall Street is now worried that it's **Too Hot**. Unemployment is low, and wages are beginning to rise. If higher wages push inflation up to 3%, the Fed will hit the panic button. Interest rates will shoot up and push us into a recession!

This is just a new way to express the recurring fear that 2008 is lurking around the next corner.

2018 is not at all like 2008. And we'll offer you a much-happier Goldilocks ("**Juuust Right**") scenario in which the next recession is pushed far into the future. If each worker produces a little bit more next year, wages can rise significantly without pushing prices higher. Automation, the very thing we were afraid of last year, can save the day.

For centuries, American workers have been doing exactly that. Every year they become more productive, and these advances in "productivity" have been the source of wage increases and nearly all of our prosperity.

The invention of carrot harvesters (check 'em out on Youtube!) put people out of work, but the operator of a machine earns a lot more than a guy who digs carrots by hand. And the cost of carrots declined, so the cost of food went down a little bit for everybody.

The same was true of plows, tractors, trains, cranes, and assembly lines. It's been a hard road, with job losses in the millions. But what really happened is that these job losses *freed* millions of workers to go forth and create indoor plumbing and refrigerated trucks. We don't have to eat moldy cabbage all winter, or trudge to the outhouse in the dead of night.

Since 2010 we've barely had any productivity gains at all. Employers didn't buy labor-saving equipment, because they were trying to create jobs and get people employed. *13 million* Americans were hired. Investment in labor-saving machines? Not so much.

Now that it's hard to find workers, they're going to buy

those machines.

Automation will allow them to produce more without replacing the workers who quit, for higher-paying jobs, last week. Inflation will be held in check.

There have been other reasons for the lousy productivity growth and low wages of the last 8 years. Deloitte says that American workers now check their phones 47 times a day. That's *almost an hour a day*, according to OfficeTeam, and it got worse and worse until about 3 years ago.

In the last few years efficiency was also destroyed by job hopping—millennials change jobs every 13 months!—and by the relentless creep of regulation that was mandated by states, cities, and the federal government. The mountain of rules soared higher in the wake of the financial crisis, with the federal government alone contributing *more than half a million new additional* pages since 2009.

799 new banks opened in the United States from 2001 to 2006. From 2011 to 2016 there

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were only **TWO**. This regulatory suffocation caused job losses in all sorts of industries, and caused wages to stagnate. Inequality rose.

Productivity can rise from here. Amazon has destroyed hundreds of thousands of retail jobs, and spread a lot of misery; but it's increasing productivity in the inefficient retail sector and pulling inflation down.

Tired of being asked whether you want cheese? McDonald's is installing touch-screen menus at its restaurants. The full leap to the future was on display at a bar and restaurant in Houston, where three employees were doing the work of six. They made salads and pizzas, served drinks, and provided excellent service. The touch-screen menus suggested an 18% tip, so those employees were probably making three times the pay of the workers in the restaurants nearby.

This business cycle is going to be the longest ever, surpassing the ten-year expansion of the 1990s. Wages will rise, and the economy will grow. If inflation stays under control we'll have a long run ahead of us. ■

If you get an e-mail from U.S. Bank, or any bank, it's almost certainly fraudulent. Don't click on any link in any e-mail unless you're absolutely sure of the sender.

CASH IS BURNING HOLES IN THE POCKETS OF INVESTORS

JP Morgan believes that stock buybacks could exceed \$840 billion this year. Apple alone will spend \$100 billion.

That's nearly a trillion dollars that will be stuffed into the pockets of stock-market investors. D'ya think that some of this will be used to buy equities? And what about the cash paid out as a result of mergers and acquisitions? What about the trillions of dollars that will come out of bond funds as bond prices decline? ■

“Our competitors all buy staples that are completely manufactured overseas, mostly in China. They're put in a box and shipped over, so they're not subject to tariffs. But the steel wire that we bring in, because we want to make staples here in the U.S., is subject to tariffs. We're extremely frustrated that we could go overseas and buy finished staples. But because we want to keep jobs in New Jersey, the Section 232 tariffs are a problem for us.”

– Gary DuBoff, CEO of Arrow Fastener, explaining why it makes little sense to put tariffs on steel instead of finished goods such as staples.

Remember the protests against the Dakota Access Pipeline? A lot of the organizing was done by Russian agents. The idea was to keep U.S. oil production from rising (and thus depressing the price of Russian oil), while sowing discord and thus undermining the idea that democracy is superior to dictatorship.

“There were [Facebook] posts, for example, expressing concern about climate change and others mocking it. This tracks previous reports about how the Russian disinformation campaign worked to inflame other sensitive political issues — and worked both sides — on racial and religious matters, immigration policy and same-sex marriage.”

– The Washington Post



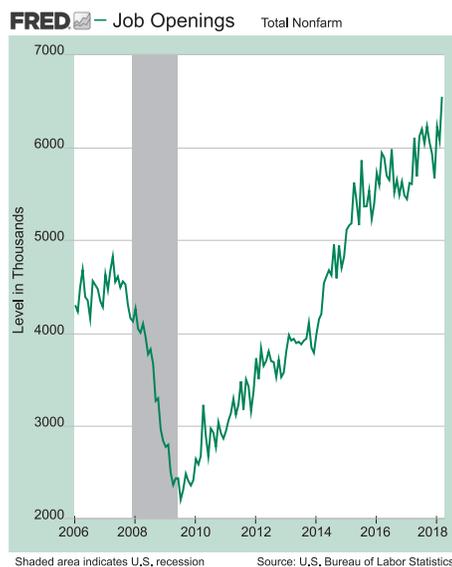
K9 VITTLES

If you really loved your dog—if you *really* loved your dog—you'd feed him Lumbard & Kellner locally-sourced organic grass-fed hand-made nutraceutical dog food, hydrated with artisan water from a deep mineral spring in a conflict-free trade zone. Now with Kale!

KEEPING COOL

Wall Street's latest fascination is the inflation rate. The core PCE deflator, the Fed's favorite measure, has been rising since September, but it's only up to 1.9%. Ever since the financial crisis our central bankers have been trying to push inflation *higher*, not lower, and they haven't even quite reached their 2% target.

It's true that the Consumer Price Index is at 2.5%, and wages seem to be rising a bit faster than before. They certainly *should* rise, because job openings have reached a record 6.5 million, at a time when fewer than 6.6 million are looking for jobs.



We should all be happy to see wages rise, after years of stagnation! The last two recessions were caused by the bursting of bubbles in tech stocks and housing, but investors worry that most of the downturns before the 1990s resulted from higher inflation rates that caused the Fed to “slam on the brakes” and push interest rates sharply higher.

There have been small bubbles, such as Bitcoin, in the last few years, but there aren't any big bubbles in sight. The historic large contributors to recession, such as housing, capital goods, and consumer durable goods, are far from a heated state. In the absence of a large bubble, perhaps it will be inflation that ultimately produces a more classic recession. When might this occur? Not this year, and probably not even in 2020.

Meanwhile, corporations are reporting their best earnings ever. S&P 500 earnings for 2018 should exceed \$160, up from \$133 last year, and 2019 earnings should be in the neighborhood of \$172. Earnings growth can push this stock market higher. ■

Why do economists find it so hard to understand what the economy is going to do? Simple. 322 million Americans are doing whatever the hell they want, 24 hours a day.

Isn't it wonderful?

“For 25 years, the fundamental question regarding NATO was not raised in polite company ... Given the fact that the EU has almost as large a GDP, and almost 200 million more people than the U.S., why isn't Europe's collective contribution to NATO's military capability larger than the U.S.?”

– George Friedman,
Geopolitical Futures



Paul K. Wright, CFA

COSTLY

“Our results show that economic growth has been dampened by approximately 0.8 percent per annum since 1980. Had regulation been held constant at levels observed in 1980, our model predicts that the economy would have been nearly 25 percent larger by 2012. Regulatory growth since 1980 cost GDP \$4 trillion in 2012, or about \$13,000 per capita.”

– Duke and George Mason Univ. professors Coffey, Peretto, and McLaughlin, in a paper that estimates the wage stagnation and unemployment—and thus inequality—that have resulted from over-regulation. **\$13,000 per American! Per year!** ■

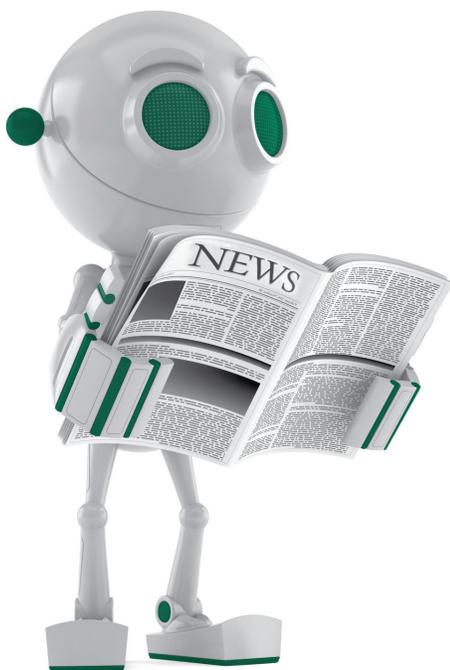
“It's tough to make predictions, especially about the future.”

–A Danish proverb erroneously attributed to Yogi Berra. It can even be tough to get the past right.

ARTIFICIAL INTELLIGENCE

More than 30 years ago the Black Monday crash of 1987 owed a lot to the use of automated systems that promised to sell shares to protect the value of a portfolio if the stock market declined. Of course, falling prices caused the machines to sell; and this caused prices to fall more.

It was a herd phenomenon! Sell orders from machines “scared” other machines, causing them to sell; and this scared dozens more. Similar forces were at work during flash crashes, in stocks and currency markets, in 2010, 2013, 2015, and 2016. Machines aren’t stupid, *but they do stupid things*. As for humans, well, just because all your friends are jumping off a cliff, that doesn’t mean that you should jump off a cliff too. ■



RECYCLING IS IN TROUBLE!

If you toss greasy pizza boxes into the “cardboard” bin at your local recycling center, you’re a polluter. The entire load of cardboard might wind up in a landfill, because grease is incredibly destructive to the paper-making process. Similarly, plastic bags jam recycling equipment, and coated-cardboard milk and juice containers are *not* recyclable.

Soon you might not have to worry about these things, because recycling firms are going out of business all over the country. China, which had been the end market for many of our West-Coast recyclables, recently announced that it would only accept uncontaminated materials.

Now there’s a massive surplus of recyclables in the United States, and prices have fallen to bankruptcy levels. You can help by tossing the questionable materials into the trash, which around here are used to create electricity.

Washing bottles (and then trucking them across the country) can use a lot of water and a lot of energy. Yes, “wishful recycling” is a thing ... And if you really want to do something good for the environment, drive less. Cutting your driving by just a few miles a year will have more beneficial impact than recycling all your trash. ■

INTEREST

The average New Hampshire student now carries more than \$33,000 in student debt, and the national total is now \$1.5 trillion. But it’s those same young college graduates who will bear the burden of our national debt, now *\$21 trillion*, up from just \$2.5 trillion in 1988. The debt doubled to \$5 trillion in 1996, doubled again to \$10 trillion in 2009, and doubled yet again to \$20 trillion in 2017. \$40 trillion is just a few years down the road, because the Baby Boomers are beginning to retire. They’ll pay less tax, and begin to collect Social Security and Medicare.

Social Security says that in 2035 it will only be able to pay 75% of your promised benefits. It

says this right on your benefit statement! The Medicare trustees say that they’ll run out of money in 2029, which is just *11 years from now*. Federal Medicaid spending is growing like kudzu, strangling state governments even as it smothers doctors’ offices, hospitals, and Washington D.C.

If the government pays 2.5% interest on \$40 trillion, or 5% on \$20 trillion, the cost to taxpayers will be **a trillion dollars a year**. Congress only collected \$3.27 billion in taxes in 2016, and should collect about \$3.34 trillion in 2018.

A government that never balances its budget doesn’t have a budget process at all. ■

STOCK ROUNDUP

Merger and Acquisition activity is running at a record pace, and lots of our companies have been in the news; AT&T, Time Warner, Shire, Disney, Brighthouse (spun out of MetLife), and Walmart. We also have shares of M&A kingmaker Goldman Sachs.

We bought Time Warner at bargain prices, liking its movie studios and other “content” in a media-obsessed world. Then we saw that the shares of Disney had been falling for three years, and jumped at the chance to buy another “content” producer. Disney knows how to use its film assets in theme parks and merchandising. We’re “contented”.

Takeda is playing the role of the “White Knight” in its tender offer for Shire, but it’s not rescuing Shire from another buyer. It’s rescuing Shire from itself, after bitter infighting relating to the company’s goals and acquisition strategy.

We sold some of our shares of Tyson when they were at higher prices, and then bought some back when they declined after a soft earnings report. Trimming at the highs and buying at the lows has done well for us over the years. ■

We often see wistful musings about the state of battery technology. If only it were better ... The truth is that current battery technology is phenomenal. It’s just that we use SO MUCH energy.

SPENDING

There’s plenty of money available to invest in laborsaving devices that will prevent inflation from accelerating. Apple is going to repatriate \$252 billion from overseas accounts to the United States, as a result of the new tax law, and spend some of that money on U.S. manufacturing. Other corporations have trillions overseas, and trillions already in the United States.

And they’re spending. First Solar will build a solar-panel plant that will employ 500 workers in Ohio. Big River Steel will spend \$1.6 billion on a new steel mill in Texas or Arkansas. Samsung just built a washing-machine factory in South Carolina, and LG is building one in Tennessee.

Adidas just built a *shoe* factory, of all things, in Georgia. Toyota, Mazda, and Tesla are building assembly plants. And iPhone manufacturer Foxconn is building a \$10 billion factory in Wisconsin that could employ 13,000. ■

“The average new vehicle on the road is longer, wider, and taller than the vehicle it replaces ... After years of improvement, the average EPA mileage of vehicles sold in the U. S. has stagnated around 25 mpg.”

– The Wall Street Journal. If the United States had raised the gas tax instead of signing the Paris Climate Accord, we’d all be driving 50 mpg cars right now.



Drew D. Kellner, CFA

Ivy-league schools have been praised for their fabulous investment results, which were boosted by investments in hedge funds and private equity. The landscape has changed a lot. Barron’s reveals that, over the 10 years ended last June 30, Harvard’s \$37 billion endowment earned just 4.4% a year. Yale and the U. of Penn did better, at 6.6% and 6%, but the S&P 500 clocked in at 7.2%. A portfolio invested 80% in stocks and 20% in bonds, all the time, would have returned 6.7%.

The value of a fee-paying client account that we track for performance, and frequently mention in this newsletter, is now \$1,228,766. That’s up from \$241,129 at the beginning of 1999, near the peak of the tech-stock bubble. For more-detailed performance information please visit www.Lumbard.com.

CLEAN AIR

In 2015 China and India each suffered more than **1,800,000 deaths from air pollution** caused by cars, coal-fired power plants, gas-fired plants, firewood, etc. That year “only” 155,000 died of air pollution in the U.S., according to a study by 40 researchers that was published in The Lancet.

Coal always tops the danger lists, but in terms of **deaths per trillion kilowatt-hours** some of the things you consider deadly are safe, and most of the things you consider safe (rooftop solar, car emissions, wind power) are deadly. Wind and rooftop solar only seem safe because they are so very tiny. If you replace a big power plant with 1,100 wind towers (or 31 square miles of rooftop solar) *and* a big natural-gas backup plant, alternative energy won’t seem so very safe—or environmentally benign.

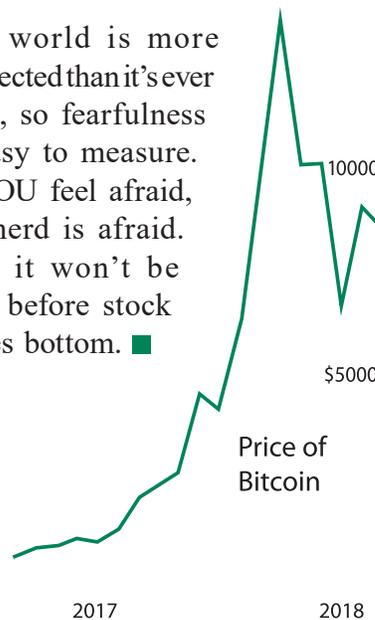
Nuclear power has been safer than anything. The numbers, from NextBigFuture and Forbes, include Chernobyl (60 radiation deaths) and Fukushima (one). The Environmental Defense Fund has been working to stop the closure of nuclear plants in Illinois and elsewhere. If New Hampshire’s Seabrook plant closes pollution will increase. People will die. And there will be more carbon dioxide in the atmosphere. ■

DISPASSION IS BEST

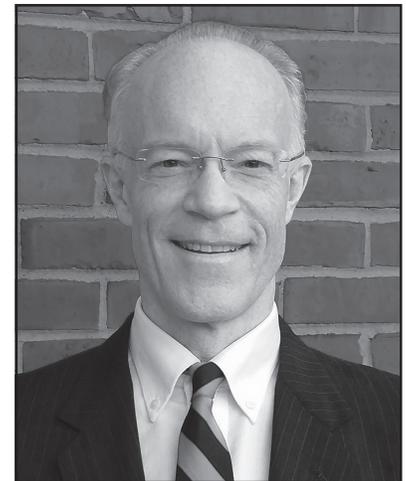
People believe what they want to believe, and they’ll help each other create a giant bubble of illusion. Americans still believe that red wine prevents heart disease because they *want* to believe it, despite clinical trials showing no benefit in humans. And, yeah, alcohol is a neurotoxin that causes cancer.

Owning tech stocks seemed like a sure thing in 1999, and real estate was a sure thing in 2007. That year the world almost ran out of oil! But nobody wanted stocks, or oil, in 2009; and recurring waves of fear caused huge numbers of people to bail out early during the first seven years of this long bull market.

The world is more connected than it’s ever been, so fearfulness is easy to measure. If YOU feel afraid, the herd is afraid. And it won’t be long before stock prices bottom. ■



– John Lumbard, CFA



John Lumbard, CFA

“Geologists and paleontologists think that during much of the Paleocene and early Eocene [34-66 million years ago], the poles were free of ice caps, and palm trees and crocodiles lived above the Arctic Circle.”

“Earth’s hottest periods—the Hadean, the late Neoproterozoic, the PETM—occurred before humans existed. Those ancient climates would have been like nothing our species has ever seen.

Modern human civilization, with its permanent agriculture and settlements, has developed over just the past 10,000 years or so. The period has generally been one of low temperatures and relative global climate stability.”

– The NOAA’s Climate.gov. The coldest centuries of the Ice Age were just 15,000 to 20,000 years ago.

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