STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS AUTUMN 2021

Lumbard & Kellner

INSIGHT

S&P 500 4,529 * Dow Jones Industrials 35,338 * 30 year U.S. Treasury Bond 1.92%

THE RISING TIDE

In 1981 you could buy a U.S. Treasury bond that promised to pay you 15.25% for thirty years. And it really did! 40 years ago bond yields were very high, and – this is the same thing—the prices of bonds were very, very low. Fed Chairman Paul Volcker pushed them down because he was determined to kill inflation.

Bonds were cheap, stocks were cheap, and real estate was cheap. CDs were popular because they paid *even more* than 15.25%, but that was fool's gold. Those high rates only lasted until the CDs matured.

Real estate was cheap because mortgage rates hit ***18.45%***. If 18.45% mortgage rates were still around today the mortgage on a $350,000 home, with 20% down (borrowing $280,000), would cost $4,323 a month. Annual payments would be $51,874, and total interest payments over the 30 years of the loan would be **$1,276,205**.

Today, at 3.1%, the monthly payments on that same home would be just $1,196. Total interest payments over the life of the loan? **$150,433**. So today you can easily afford to spend three times as much on a house. That's why there's been panic buying in real estate.

Interest rates affect stock prices in the same way, so we've been in a roaring bull market. ***Stocks still don't fully reflect the unusually-low interest rates of today.***

Of course, "unusually-low" is not normal. Rates might rise for decades, causing massive losses in bonds. The unprecedented spending binge that's under way in Washington will push rates higher, as soon as the Fed allows this to happen. A few years from now the federal government will find that the interest payments on its debt have soared to a trillion dollars a year, crowding out even the social programs that have gobbled up the budget in recent decades. Ever-rising interest rates suggest lower returns on stocks, real estate … *everything*. This constant headwind lies ahead, somewhere, and the markets quiver every time they're reminded of that fact.

The happier news is that, even if the yield on the 10-year treasury ***doubles*** from 1.3% to 2.6%, today's 4% earnings yield on stocks will still make them look like bargains. And those earnings are growing. They've been growing so fast that analysts keep raising their estimates, for individual companies and for the market as a whole.

As the years go by that "4% earnings yield" will become "5%", then "6%", then "7%" … Warren Buffett used to shock audiences by telling them that the Dow would eventually go to 36,000. It's almost there! So it's time to set a new goal, and say that the Dow is going to go to 100,000.

Of course it will! It's just a matter of time. ■

OCTODECUPLED

Our Benchmark account, an actual fee-paying client account that holds cash and bonds as well as common stocks, stands at **$1,871,241**. It's worth more than 8 times its $217,974 valuation on December 31, 1999, just before the great millennial tech-stock bubble burst. For further information please see our website, www.Lumbard.com.

EVS ARE COMING!

Did you know that you can plug into the Ford F-150 Lightning, and use it as a generator for your house or your job site? It accelerates from 0 to 60 in 5.3 seconds. Electric vehicles really are coming, and that means that we're going to need a whole lot more electric power. They're already struggling to generate enough power in California and Texas.

That surely means more natural gas generation, benefitting pipeline operators such as Kinder Morgan (KMI - $16), and vast numbers of drilling companies. We'll also see a next-generation nuclear plant. TerraPower, founded and championed by Bill Gates, will build its first modest-sized and super-safe molten-salt nuclear plant in Wyoming, replacing an existing coal plant.

Old nuclear plants also produce no carbon dioxide or other pollution, so it would be a bad idea to retire any more of them. The Department of Energy says that many of these plants can produce power for 80 years. Adding a decade of life sharply reduces the cost of power and the environmental impact.

80 years is a long time. PacifiCorp is replacing wind towers after just 10 years of operation, sending 1,000 giant fiberglass blades to a giant landfill. Solar seems safe and the panels last for 25 years, but you'd have to operate more than 10 million acres of rooftop solar arrays for 40 years, with fewer than 100 deaths, to equal the global safety record of commercial nuclear power. *Including* Chernobyl and Fukushima.

For more on this topic search YouTube for a TED talk by Michael Shellenberger; "Why Renewables Can't Save The Planet". ■

BUT … SELL EV STOCKS

Every global auto manufacturer is spending billions on electric vehicles. There are *four hundred* EV manufacturers in China. One of those, WM Motor, has 1,000 engineers and 1,200 patents. The Economist says that WM's land, labs, and factories were given to it, free of charge, by the provincial governments of Zhejiang and Hubei.

WM aims to export the bottom half of electric cars, the "skateboard", which includes the chassis, batteries, and power management, to auto manufacturers around the world at irresistible prices. Big Auto will be reduced to making auto bodies, and competing for a tiny slice of profit. ■

Why do growth stocks lag when interest rates are rising?

Over the long term, investing in inexpensive "value" stocks has provided much better returns than investing in the popular "growth" stocks. But growth has been beating value for ten years.

So what's going on? You can point to the emergence of a handful of giant, fast-growing companies, but you should also note that interest rates were falling steadily in those years. Lower interest rates encouraged investors to pay more attention to big earnings and dividends that are far in the future. As rates declined the "present value" of those future earnings rose, and rose higher.

Rising interest rates, then, should be harder on growth stocks than on the "value" stocks that have big Earnings Per Share today.

What stocks do well when interest rates are rising? Life insurance (Brighthouse – BHF $49, MetLife — MET $61, Prudential—PRU $105) and other financials such as Goldman Sachs (GS - $413) and Keycorp (KEY - $20). These companies will be glad to see rates rise, because low rates made it hard to squeeze in a profit margin between their borrowing and lending rates.

If rates are rising because of economic strength there's a whole slew of stocks that outperform when the economy is roaring. We've been highlighting copper stocks Freeport McMoran - FCX $36 and Lundin Mining - LUNMF $8. We recently added Hudbay Minerals - HBM $6, because a strengthening world economy nearly always causes copper demand to rise strongly. EVs and the electrification of the economy will push demand even higher. ■

WHY DOES IT GROW?

John Convery of our investment advisory board says that "the economy wants to grow". Lately investors seem to feel that it can't grow without help from the Fed or borrowed "stimulus" dollars, but that's not how the world actually works.

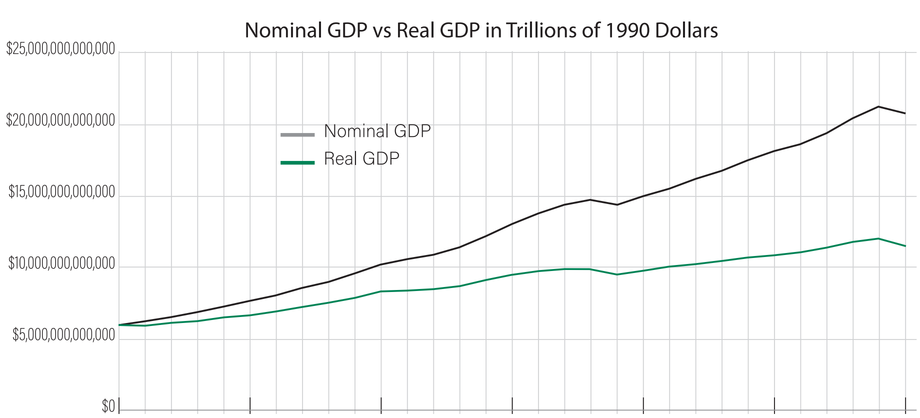
GDP grows because the population grows, and because each worker produces a little more each year. Innovators innovate, entrepreneurs make risky investments that create jobs, and employers provide better equipment to their employees, who find better ways to get the job done. Lately GDP has been roaring and corporate earnings have been surprising to the upside, because workers are getting more done each hour.

This productivity growth has accelerated because "Working From Home" was a spectacular success. Broadband, smartphones, and a host of other innovations are finally showing up in the economic statistics. Smartphones and social media were a huge drag on productivity in the early going, but workers have already maxed out the amount of time they can spend texting, house hunting, and online dating while at work. Now the positives of these tools are coming to the fore. We've all figured out how to be productive anywhere, anytime.

To be sure, WFH was a luxury available to little more than 20% of American workers, but even small gains in productivity are a big deal, for GDP growth and standards of living.

Corporations produce a big part of GDP, and they grow at the same rapid rate. We're not talking about the tiny inflation-adjusted GDP growth rates you hear in the news. The revenues of corporations grow at the rate of GDP including inflation. "Nominal" GDP has grown at a robust 6% rate over the last 70 years. It shrank in 2009 and 2020, and only grew at 4% or so in between, but it's been roaring in the last 17 months. Up 23% since the pandemic low in April of last year.

Corporate earnings grow a little



Graph: Jay Conway, CFA

Drew D. Kellner, CFA

bit faster than GDP, because of stock buybacks and other factors. If a corporation slowly buys back half its shares, this will cause its earnings per share to almost double. And part of those earnings are paid to the shareholders, the owners, as dividends, which have averaged 2% in the last 30 years. It's no different from the part owner of a bicycle shop, who expects to receive some of the profits each year.

Almost every American has the opportunity to participate in this American Dream. Start small. Giving up a bad habit (cigarettes, booze, Starbucks) will allow almost anybody to save enough to become a part owner of several famous companies. There's nothing easy about self denial, decades of patience, or the fear of losing money in a stock-market decline; but millions of people with low incomes have achieved this success.

GDP wants to grow. Stocks want to go up. ■

Jay Conway, CFA

WAGES

"Average weekly earnings since January are up $15.59, but with inflation surging to levels not seen since the early 1980s, real weekly wages are down $8.99, the largest real-dollar drop in wages since Bureau of Labor Statistics data were first collected in 2000."

— Mike Solon and Phil Gramm in The Wall Street Journal.

Wages are losing ground to inflation. This inflation surge should moderate, but it's important to watch because inflation is hard to kill. Inflation fears cause consumers to bid prices higher, and cause workers to demand bigger raises that drive up the cost of goods for other workers.

Except, that is, for government employees; and the growing number of beneficiaries of programs such as Social Security, Medicare, SNAP, and the scores of other social-safety-net programs. Everything touched by government is indexed, using an inflation rate that is consistently higher than the index used by the Federal Reserve. President Obama tried to substitute an index that wouldn't push inflation higher, but he was quickly pushed away. ■

SUBSIDIES

When the Fed pushes interest rates down to unusually-low levels, it helps borrowers. It also hurts retirees (and teenagers) who keep a big part of their savings in CDs and savings accounts.

It's called "financial repression". The term applies to any actions, from the Fed or the Congress, that favor some parties while intentionally hurting others.

Subsidies and government guarantees pull investors away from other projects. And when Congress runs deficits it sucks up money from everywhere, diverting investment from productivity-boosting and job-creating projects to, ummm, congressional priorities:

"Financial repression happens in the first place because the project the politician wants to spend money on is a productivity clunker, at the cost of fruitful investment in innovations that would permanently increase living standards."

–Joseph C. Sternberg, in The Wall Street Journal. He's the author of "How the Baby Boomers Stole the Millennials' Economic Future". Yes, it's your children who will ultimately be left holding the bag when the mountain of debt comes due. ■

The lumber shortage ended quickly, and mysteriously. There were no announcements of sawmill expansions, but there were plenty of trees to harvest. Back in the Nineties institutional investors flocked to timberland investing, assured that it was impossible to lose money. When lumber prices were low they'd be able to wait a year or two for better markets—and in the meantime the trees would grow 10% a year!

Never underestimate the magic of free markets. Right now there's a computer-chip shortage that has crushed the production of cars, appliances, and all sorts of things. But it's already a near certainty that there will be a glut in a couple of years, because Taiwan Semiconductor, Intel, Samsung, and others have announced the construction of huge new fabs, and expansion of existing facilities. You can also expect a glut of electric vehicles, because there are way too many manufacturers spending way too much money. ■

"Nearly 19,000 unaccompanied children crossed the border in July—almost equal to the record set this past March."

—The Wall Street Journal, quoting U.S Customs and Border Patrol data.

GROWTH

Delta virus cases are ripping through the country at a pace likely in the range of a million per day. As a result, immunization is increasing rapidly and a peak in cases may be close at hand, starting with the Southern states and moving North. We already have two examples of peaks in Delta having occurred in recent weeks, in the UK and India.

Economic growth should continue strong for the next 2 to 3 quarters as the economy fully opens. Infrastructure bills might add an incremental $600 billion in spending over the next 8 to 10 years, starting in late 2021. Much of it will not be paid for.

This should allow 2022 inflation-adjusted GDP growth of roughly 3% or so. The toughest question is inflation, which has leaped higher. How much is transitory and how much will be sustainable? A sustained inflation rate of 3% or above would prove problematic, rattling the Federal Reserve and causing interest rates to rise quite a bit.

As of now, no recession is in sight. Stock valuations are reasonable. The biggest threat would be rising interest rates that push the 10 year U.S. Treasury bond above 3%, or perhaps 3.5%. That isn't likely to fully play out until the 2023/2024 period.

Corporate earnings have been one of the biggest economic stories of the year. At the start of 2021, Wall Street analyst earnings forecasts for the 500 companies in the S&P totaled up to $167. They raised their estimates again and again, and now expect 2021 earnings to be $198. The final number could exceed $205 or more, 23% above their estimates at the beginning of the year—and **26% higher than the reported earnings of 2019**.

Massive government spending, coupled with solid productivity advances and good cost controls have combined to give us these numbers. Currently we expect 2022 earnings to be 7% higher than those of 2021, despite a 3% hit to earnings from spending and tax legislation to be passed.

Rising earnings mean higher stock prices, as long as interest rates don't shoot higher. For the very long term, we might guess that investors will get a 5% to 6% annual common-stock return over the next 10 years. Inflation might take half the benefit away, but still leave equities with far better returns than bonds or cash. ■

"Of the ***total income earned by the middle class***, the percent of income from government transfers has grown from 19% in 2000 to 28% in 2017."

– USA Facts

Tyson's corporate strategy is focused on the fact that, around the world, people eat more meat as their incomes rise. TSN - $78.

Paul K. Wright, CFA

Buy Life Insurance Stocks. Sell Health Insurance Stocks.

IbisWorld says that there are 690,060 people employed in the Health & Medical Insurance industry. That's a huge dead-weight cost in our healthcare system, and it doesn't even include the federal employees who handle healthcare billing at Medicare, Medicaid, Obamacare, SCHIP, the Indian Health Service, the VHA, Tricare, FEHB, Healthy Start, or Title X.

Add in the countless hours spent by doctors, nurses, and hospital administrators on health-insurance paperwork, and you see that this can't continue. Congress is not talking about fixing this, but why take the risk of buying the stocks of health insurers? ■

"China relies on coal for about 70% of its power."

–The Wall Street Journal

CAUGHT IN THE NET

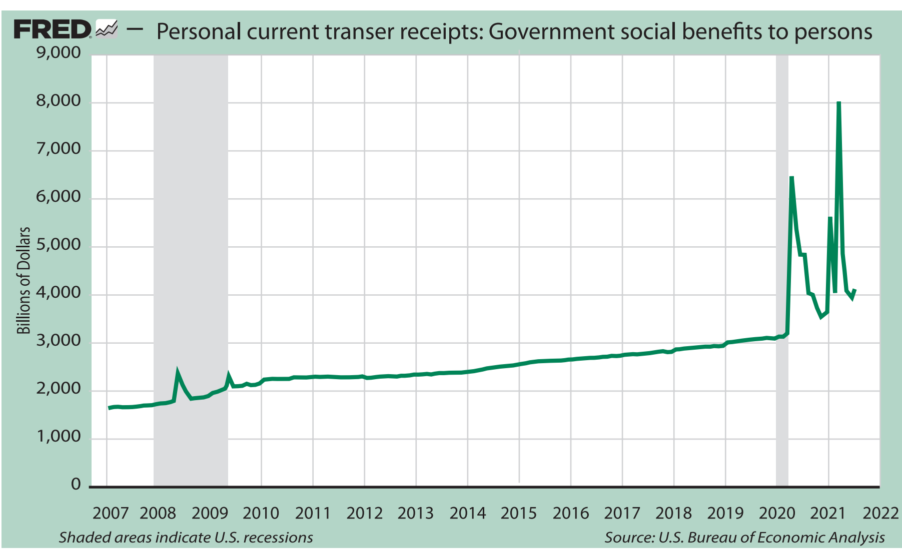
"Ask not what your country can do for you. Ask what you can do for your country" said John F. Kennedy in 1961. In 1962 America's social safety net cost just $29 billion, and ***49%*** of JFK's budget was spent on defense.

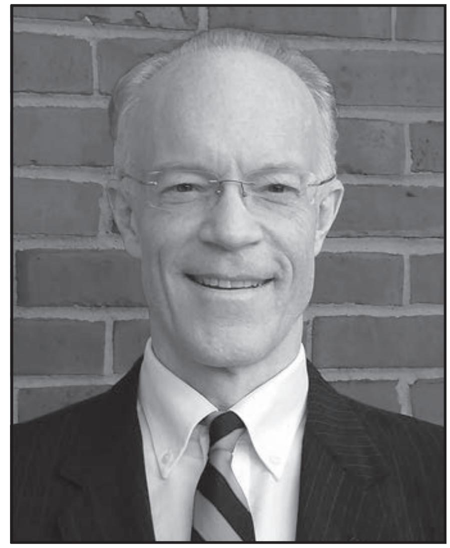
The social safety net has grown very steadily since, to $1.7 trillion in 2007 and $3 trillion in 2019. The graph below shows annual rates, each month, so the $2.7 trillion of the first stimulus legislation, which brought a quick end to the recession in April of 2020, *looks* like $6.5 trillion. The economy was roaring when the next two rounds of checks were mailed, to the vast majority of Americans. We're still wondering why any of these funds were mailed to people with steady incomes, instead of to those who needed help.

In 2021 Federal tax revenue will be just $3.8 trillion.

Today all the things you think of as "government"—the departments of the Interior, Defense, Justice, Labor, Housing, Agriculture, *everything* except the transfer programs—have shriveled to 33% of the budget. They're shrinking fast. Social programs, many of which benefit the middle class instead of the working poor, are considered *mandatory* spending.

Also mandatory is the payment of interest on the federal debt. It's been a small number, but it will shoot higher as we add debt and interest rates rise to normal levels. Nearly 75% of federal spending over the next decade will happen on autopilot, without any intervention from elected lawmakers. ■





Friend Miguel, after listening to a discussion about the billions that are now lavished on American pets, commented

"When I was growing up in Venezuela we had pets. But we ate them."

As people become wealthier they acquire pets that they don't eat. Covetrus, CVET - $22, is a beneficiary of this trend.

– John Lumbard, CFA