LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,851 * Dow Jones Industrials 12,461 * 30 year U.S. Treasury Bond 2.76%

MASSIVELY DISRUPTIVE TECHNOLOGICAL CHANGE

May, **NOT**. T.S. "April is the cruelest month" Eliot had it wrong . . . . The festivities kicked off in Greece, where voters didn't just repudiate austerity and personal responsibility—they elected *Nazis and Communists* to help run the country ("Communists and Neo-Nazis!" exclaimed comedian Jon Stewart, "Two failed-yet-opposing ideologies . . . the ones that battled each other in World War II!"). French voters elected a president who promised to *lower* the retirement age from 62 to 60. Argentina—reminding us why this well-endowed and blonde nation has slid from #10 on the GDP charts to #27—seized a large oil company that had been purchased rather recently by Spain's Repsol, thus making Spain poorer in the midst of her financial distress. Why? Because Spain seems too weak to do anything about it.

Bolivia quickly followed suit, seizing a Spanish-owned electric utility—because Spain seems . . . too weak even to bail out her own banks. Germany is willing to bail out Spain's banks, but then they're going to hand over Greece to the Turks.

Yes, it's true; if Europe enters a *depression* the U.S. economy will slide into recession. And we now know that the leaders of Europe will seize any opportunity to kick the can down the road—and that each of them has the leg strength of a four-year-old. But crisis breeds action, and they are certainly feeling a sense of urgency. The rest of the world's leaders are in a tizzy too; President Obama calls Angela Merkel three times a day. "Angie, baby, you gotta help me out here."

On the following pages you'll find further discussion of Europe and the U.S. economy. The latter is being supported by long-delayed cyclical rebounds in autos and housing, but you have to look outside the box if you want to see a true ray of sunshine. In recent years we've seen disruptive technological change in wireless telephones, but what's happening in the energy markets is **massively** disruptive technological change.

We're not talking about wind towers, solar panels, or nuclear plants that burn nuclear waste. The really big news started with new technologies that allowed the production of natural gas from shale (See "The Natural Truth" in our Autumn, 2009 issue), and we're now seeing rapid growth—galloping growth—in the production of oil from shale.

Count that as *two* big new technologies. The third is deepwater production, which was interrupted by the Macondo spill (an unstoppable geyser of crude!) but is now racing around the world.

The Energy Information Agency says that imports of oil and refined products have already dropped from nearly 15 million barrels a day to little more than 10 million barrels. U.S. oil production has been RISING for 3 years (Hubbert's Pique?), even as gasoline demand has fallen sharply in response to high prices. In a few years we won't have to import any oil at all. Goodbye trade deficit . . .

continued on page 2

... TECHNOLOGICAL CHANGE

continued from page 1

The pace of change is so fast that USGS shale maps don't even cover the information that the companies reveal in their annual reports!

Lower gasoline prices will mean more money in the pockets of consumers; according to the Wall Street Journal the price decline of just the last two months has been worth $40 billion a year in consumer spending. We also won't have to worry about inflation for a long while, so the Fed will have a free hand in conducting monetary policy.

There's more. Everybody's heard that North Dakota's unemployment rate is now just 3%, and that the state can't get enough workers to drill for oil in the Bakken shale—the elephant that oil experts studiously ignored for so many years. Now the employment bonanza is spreading to the shales of Texas, Oklahoma, Kansas, Colorado ,Wyoming, Ohio, and Tennessee . . . These are manly-man jobs that employ the workers who took the biggest hit when the real-estate and construction bubble burst in 2007 and 2008.

There's shale in Louisiana too, but the Pelican State will see a bigger boom in deepwater oil production, slowly ramping up again after the troubling discovery that there's too much oil, under too much pressure, under the Gulf of Mexico. Obama and Putin have just awarded contracts for drilling in the Arctic Ocean; and West African production is soaring. New deepwater discoveries will be more-extensive than anyone expects (bet you haven't even *heard* about *East* Africa), because of the simple truth that the world is really, really big.

Extracting *gas* from shale isn't going to generate a lot of new jobs from drilling, because they've already found too much gas. This job growth will result from innovative (and obvious) uses for gas; there's already a boom in the fertilizer, chemical, and plastics industries—which now have a big cost advantage over their foreign competitors—and these are happy days for anybody who produces or uses electric power. Waste Management says it saves $27,000 a year in fuel every time it converts a truck to compressed natural gas, and there are now 355 liquefied-natural-gas buses in Phoenix alone. [Say what? Phoenix swelters at 100 degrees in the shade, while LNG is *minus* 260 degrees].

We continue to believe that Europe will not drag our economy down, and that even the worst case would be a short-lived downturn. Betting on the worst possible outcome is a low-percentage, aggressive, and risky gamble at a time when cash yields nothing, and the other alternatives look even worse. Why would you want to gamble with your nest egg? ■

"People said, 6 or 7 years ago in the Matthew Simmons era, that Saudi oil production would decline "precipitously" from 9 million a day to maybe 4 or 5 million barrels a day now . . . Today they're producing 10, their capacity is 12 million, and I have no doubt that they have the ability to raise it further. The same comments were made about Russia; that Russia was so inefficient and dysfunctional that it could never sustain its production, yet look at Russia today. There is tremendous supply coming, and it's being matched by new efficiency on the consumption side."

– Nansen Saleri, CEO of Quantum and former head of reservoir management at Saudi Aramco. Hardly anybody was willing to listen to him during the hysteria of the "Peak Oil" years.

DON'T BUY BONDS

Bonds are a fool's bet. They're at the lowest yields and the highest prices since the Mayflower landed in 1620.

There's always one factor that's more important than any other, and right now the most-important truth is that stocks are incorrectly valued. The yield—that is, the earnings yield—on Microsoft is 10%, *more than six times* the 1.5% yield on a ten-year U.S. Treasury bond (the bond was at 5% in 2007 and *fifteen percent* in 1981). Stocks are the only game in town—better than cash, commodities, or money-losing bonds. At this point we'll need some luck to reach our target of a 25% gain in the S&P 500 in 2012; but at a time when investor expectations are lower than Death Valley they could rise quite a bit on no news at all. ■

PENT-UP DEMAND

Economists expected to see 160,000 new jobs created in May, so the news that we'd gained just 69,000 caused fear and loathing and a steep decline in the stock market. *Time for a reality check*, because 100,000 jobs are little more than a rounding error— .0007, or seven one-hundredths of 1%—in a nation where 142 million workers are employed. Is your opinion of government bureaucracies so high that you think these numbers are meaningfully accurate?

It's more likely that our economy is still growing at the sluggish pace of the first three months of the year, when the statistics mills reported huge job gains but GDP growth of just 1.9%. GDP *growth* is the normal and natural state, because every year the population grows, and every year each worker (outside the government sector, anyway) becomes more efficient and productive.

And it happens that right now we're benefitting from long-delayed rebounds in housing and autos. May auto sales, year over year, were up 11% at GM, 13% at Ford, and 30% at Chrysler. The reason is simple; the average car on the road is 11 years old, and has 120,000 miles on the odometer.

Home construction is rising—it's quite noticeable in Hollis—because we've finally soaked up most of the unsold homes. The nation needs 1.5 million new homes and apartments each year, but in 2009 we only built half a million. We're now building more than 700,000 a year, and that means increased sales of sheet rock, roofing, cement, carpet, refrigerators, stoves, flagstones, trees and shrubs . . . most of which are made in the USA.

Manufacturing has generally been a bright spot in this recovery. We're even pulling manufacturing jobs back from China, where rising wages (up *15.2% a year* from 2005 to 2010) are taking away the cost advantages that persuaded manufacturers to go to the extra trouble of doing business halfway across the world.

GDP growth is still being held back by fiscal drag from the end of the "stimulus" programs, so we didn't jump on the bandwagon celebrating the illusion of rapid growth in February. We're not joining the June stampede to despair. The United States and the world are de-leveraging (reducing debt), and the normal and natural tendency is a long, long period of slow growth. We won't easily accelerate to faster growth or slide into a recession, so we'll stick with the obvious assumption—a middle path—until there is a very compelling reason to change course. ■

> "The tax code is the foundation for corruption in American politics."
>
> — John McCain

Paul K. Wright, CFA

Under current law today's 15% capital-gains tax rate will jump to 25%, including the new Medicare tax and the phase-out of itemized deductions. That's a lot, considering that a huge part of capital gains is simply the result of inflation. If you were to inflation-adjust those gains—computers now make this possible— a rich old guy's long-term gains of $6 million (from selling things bought half a lifetime ago) might become gains of just $2 million. Now you can apply a *much* higher tax rate, the press can stop screaming about fairness, and we'll actually have . . . fairness.

In the last 50 years corporations have been paying out a smaller and smaller percentage of their earnings as dividend. Even so, in those 50 years the average dividend has grown ***5.2%per year***. Instead of worrying about what's happening in Greece, investors would do well to pay attention to the big picture.

Drew D. Kellner, CFA

At the close of business on June 8 our "benchmark" account stood at $691,162, up from $655,285 at the beginning of the year—and up 49.7% from $461,826 in January of 2008. It's a real account that has always paid a 1% fee; it was opened in October of 1990 at a value of $100,000.

FACEBOOK: GET 'EM WHILE THEY'RE HOT!

Stocks often rise immediately after an Initial Public Offering, but buying shares on that basis can hardly be described as investing. A friend of a client discovered that his investment adviser had put *50% of his portfolio* into Facebook shares on the first day of trading. Any student of diversification knows that half that money should have gone into Venezuelan lima bean contracts . . .

PETULANCE ACROSS THE POND

John Convery has always said that you can't have a growing economy if your banking system is broken. By the time this issue dries on the printing presses it's likely that Europe will have agreed on a plan to support all her banks . . . and funds will also be made available to help Spain through the temporary distress caused by the bursting of a gigantic real estate bubble. Note that Spain's debt, even now, is a good bit less than that of the United States (adjusted for the size of the two economies)—a fact that should offer comfort to the Germans and caution to us.

America's debt, deficits, regulatory burden, and unfunded-liability problems (the future cost of overgrown entitlements) are worse than those of the continent as a whole. If not for the problems created by the euro, Europe would be on a slow but steady path of recovery.

The Greeks should take a close look at Iceland (remember Iceland?), which is doing quite well after devaluing its currency and exporting a trillion tons of cod. Exchanging the euro for a falling Greek drachma would be a quick way to sharply lower the bloated salaries of the entire Greek nation . . .

And if a falling krona has been such a good thing for Iceland, all Europe should be cheered by the continuing decline of the euro. Usually a declining euro would mean an increase in the cost of oil and other commodities, but they've been declining too!

We won't even *try* to guess what Europe's leaders will do to tie together or break apart the dissimilar, disparate, and disappointed nations of Europe, but we do know that the hysteria can't go on forever. "Buy at the point of maximum pessimism" said Sir John Templeton. Can we really be that far away? ■

OMNIBUS PRIVACY NOTICE

You have no privacy. Google knows everything there is to know about you. Your bank has been hacked by software experts in Nigeria, and your medical records (annotated with exclamation marks and smiley faces) have been circulating in Russia and the Ukraine for months.

You have now been notified. There is no further need for the billions of privacy notices that have created an environmental and financial catastrophe; the blame for which should be affixed firmly to some moron in Washington.

Iraqi oil production will surpass that of Iran before the end of the year, and it is growing rapidly. Iraq's government hopes to *quadruple* production to 12 million barrels a day by 2017.

HOW WE PICK STOCKS

Picking stocks seems like a huge challenge, involving vast amounts of research on hundreds or even thousands of names. But a few simple principles can make the process easier.

1) **They're All Good.** We've just been through a rough decade, but it's still true that stocks—all of 'em, as represented by the S&P 500 and other indices—offer your best path to a comfortable retirement. They're all good! The best mindset is one that asks "Do I have a good reason why this stock should *not* be in my portfolio?"

2) Summer Better Than Others. Over time, the most-popular stocks (those with the highest PE ratios) will underperform the market, while the least-expensive and least-loved companies outperform. Inexpensive stocks have bigger dividends and bigger earnings—yes, they have bigger earnings!—and they often shrug off bad news because investors were already expecting the worst.

Buy good companies. John Convery's definition of a "good" company is one that's run by competent people who know their business and stick to it—and who are working not for themselves but for the benefit of the shareholders.

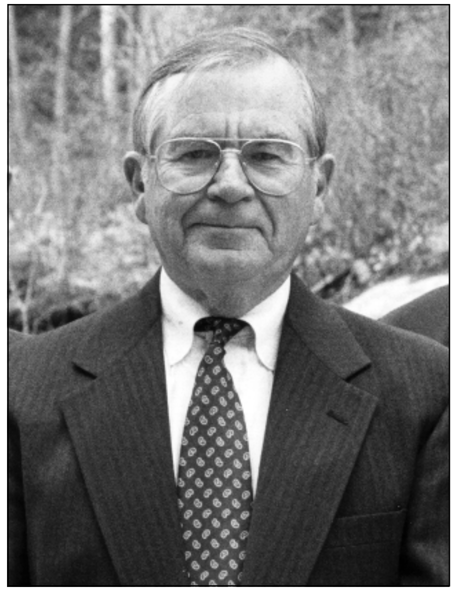
"Mine the borders!"

–A Greek candidate's platform in the May elections.

3) Get On Your Cycles and Go. Some industries grow faster than others, and there's a huge and predictable difference in their performance at certain points of the business cycle. If we're entering a recession you want to own various kinds of utility stocks, but you should be selling them now unless you expect another downturn soon. We don't. We happen to have a very good economist (Paul Wright), but even if we didn't we'd hang our hats on the simple truth that recessions and expansions eventually come to an end—although right now we need to add that a very-slowly-growing economy can grow for a very long time.

4) Diversify. Humility is an essential trait for a stock picker—you don't have to work to acquire it, because it will be imposed on you soon enough—so we spread our bets around. You'll want to keep some of those steady-Eddie stocks even when you expect the economy to boom.

5) Diversify More. Up until now we've been talking about the S&P 500, but small-company stocks offer better returns over time. We think they're expensive now, but we own some and always will. Emerging economies, such as those in Southeast Asia, are growing faster than our own . . . . Spread some money into the rest of the world as well.



John Convery Jr., CFA

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

6) Take Some Chips Off The Table. If one of your stocks has tripled, it's now a larger percentage of your holdings—and a much bigger bet than it was when you bought it. Chances are it's also become a popular stock, and you know how we feel about popular stocks. So sell some. You might want to sell it all, but at least trim it back so that it's not an oversized holding.

And if a stock goes down, swallow hard and consider buying more. The same rules apply to your bonds, cash, and other holdings. Diversify in ways that will protect you from inflation (and rising interest rates), recession (and falling interest rates), famine, flood, and everything else you can think of. Buy what's unpopular, and sell when it becomes popular. And keep your emotions in check.

THE FISCAL CLIFF

On December 31 the "Bush Tax cuts" expire, returning us to higher Clinton-era tax rates for the *working class* and the *middle class* as well as the wealthy. If this happens, consumers from all walks of life will spend less—and the result will be an instant recession.

At the same time, unemployment benefits will end for millions of Americans receiving extended benefits, and the employees' share of FICA payroll tax will rise from 5.65% to 7.65%. Large government spending cuts (including $600 billion of defense cuts) will automatically go into effect. A new Medicare tax, plus recent changes in itemized deductions, will push the top tax rate to 44.6%. Top earners would also see dividends taxed at 44.6%, and we're just talking about federal rates. Property taxes, sales taxes, and state income taxes will continue to be charged as well; if you live in California your total tax bill could approach 60%.

There are plenty of Baby Boomers in this country who would rather retire than pay half of their income in tax, and that means less tax revenue rather than more. The top federal tax rate was 70% in the 1960s and 1970s, and we didn't collect as much tax as we did in the Clinton years, with a top rate of 39.6%.

"Suppose you were an idiot. And suppose you were a member of Congress. But then, I repeat myself."
– Mark Twain

The early betting (from Goldman Sachs, the people who actually run Washington) says that Congress will just kick the can down the road, extending today's tax rates for a couple more years. That makes sense—it's not as if our legislators have shown much courage in the last 50 years—but the pressure for bold action is building.

At some point in the next two years there will be a Grand Bargain that reforms our ridiculous tax system and keeps Medicare, Medicaid, and Social Security from going into bankruptcy. It *has* to happen, because we're not far from the day when foreign investors flee; and rapidly-rising interest rates then threaten to push the interest cost on the debt to $1 trillion a year. A little bit of courage could avoid this Greek death spiral—ain't nobody going to bail *us* out—and set the nation on a sensible path much sooner.

It's not all gloom and doom. It really is possible to push up GDP growth enough to generate more tax revenue and more jobs, by removing some of the dead weight of government . . . The Pollyannas among us hope that it could even happen in the Lame Duck session at the end of this year. Call them Eagles, atop the fiscal cliff . . .

– John A. Lumbard, CFA

John Lumbard, CFA

"We ate cupcakes, white bread, real butter and bacon . . .We drank Kool-Aid made with white sugar. And we weren't overweight. Why? Because we were always outside playing! No one was able to reach us all day. And we were O.K.

We fell out of trees, got cut, broke bones and teeth . . . no lawsuits . . . We ate worms and real mud pies, and the worms did not live in us Forever.

We had freedom, and failure; success and responsibility. And the result was 50 years of innovation and new ideas."

–edited and excerpted from an anonymous e-mail.

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.

General Disclosures:

Statements in this communication are the opinions of Lumbard & Kellner, LLC and are not to be construed as guarantees, warranties or predictions of future events, portfolio allocations, portfolio results, investment returns, or other outcomes. None of this material is intended as a solicitation or offer to purchase or sell a specific investment. Readers should not assume that all recommendations will be profitable or that future investment and/or portfolio performance will be profitable or favorable.

General Disclosure: The contents of these Insight Newsletters are for General Educational Information and Market Commentary only. Our goal is to provide Educational Communications that are limited to providing general information about investing, such as information about types of investment vehicles, asset classes, strategies, certain geographic regions, or commercial sectors. None of the material contained in our Newsletters should be construed as constituting an offer of our investment advisory services with regard to securities or a recommendation as to any specific security. These Newsletters are only opinion commentary. Similarly, materials that provide our general market commentary are not intended to offer advisory services with regard to securities. Our Market Commentary and Opinions rendered are aimed at informing current and prospective investors of market and regulatory developments in the broader financial ecosystem. Nothing in our Newsletters should be construed as a guarantee, warrantee or prediction of future economic or market events, political events, any portfolio results, advisory account returns, or other outcomes.