

LUMBAR D
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 3,019 * Dow Jones Industrials 13,104 * 30 year U.S. Treasury Bond 2.95%

LAND OF THE SETTING SUN

When news came that we had not, like lemmings, jumped off a Cliff, celebrations broke out across the nation. Nearly a million people jammed the streets around Times Square, and the party lasted well after dawn. As the sun rose—coincidentally the first day of a new year—revelers quietly rejoiced over the \$62 billion a year in tax increases and \$1.2 billion in spending cuts that had resulted from weeks of pitched battle in the bowels of the Capitol.

That's billion with a B. Last year the nation raised \$2.4 Trillion in taxes, and spent \$3.5 Trillion. We've never raised \$3.5 trillion in taxes, either in dollars or as a percentage of GDP. Not even in World War II! So, in 2013 Congress will continue to massively stimulate the economy, at a trillion-dollar-a-year rate, even as the Federal Reserve stimulates massively by printing money and holding interest rates near zero.

Consumers have responded by purchasing autos and homes, and factories are humming. But it seems clear that the Cliff Jump should be an annual event,

in which the voters are asked whether they really want to borrow another trillion dollars to juice the economy for a mere 12 months.

Greece, Italy, Spain, Portugal, France (new to the club, recently added by the IMF) and Japan have also been overspending for decades, so it's clear that you can't count on the political class to step up to its responsibilities.

Japan is the country to watch. The island nation's debt—a *quadrillion* yen—is the biggest in the world; worse than Greece, Iceland, Portugal, Eritrea, or Zimbabwe, and actually bigger in dollar terms than our own. It was able to reach that lofty level because Japan's citizens—some of the world's most diligent savers—were willing to lend the government as much as it wanted. Now the hard-saving older generations are retiring, and the government is beginning to borrow from foreigners.

Japan's economy is shrinking, and the former export powerhouse has become an importer. The electronics industry is reeling from a long series of bad decisions, missing

the entire wireless revolution and instead betting on cameras and the hypercompetitive TV market. Sharp has warned of looming bankruptcy.

How did it get this bad? The spending binge started in 1991, in response to the simultaneous bursting of gigantic bubbles in the stock market and in real estate. Stimulus seemed like a reasonable thing in the first couple of years—they said they were “priming the pump”—but the bridges to nowhere quickly morphed into vote-buying and all manner of social spending, undermining the national work ethic even as it pulled ever-greater chunks of the economy under the thumb of bureaucrats and politicians. Year by year Japan's innovation, entrepreneurialism, and drive were slowly crushed by the weight of government, as spending and budget deficits grew larger and larger.

Spending is now twice as large as revenues, but the best idea the political class can come up with is to spend more. The newly-elected government plans to build more bridges to nowhere

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LAND OF THE SETTING SUN

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and increase defense spending to pick a fight with China. Yes, China; Japan’s largest trading partner and home to a thousand Japanese manufacturing plants. Really?

The new prime minister also wants to push up the inflation rate to 2%, to give consumers a reason to buy today rather than waiting for lower prices tomorrow. That might be worth a shot, apart from the fact that a 2% interest rate on Japan’s debt would mean that **more than half** of the nation’s tax revenue would be consumed by interest payments. As debt gets larger, a nation’s options and policy choices shrivel to nothing.

Japan is probably beyond the point of no return, but it didn’t have to be this way. In 1993, as the land of the rising sun was steadily ramping up her deficit spending, Canada’s debt had grown to the point where interest was consuming more than a third of all tax revenue. The Canadian dollar had been nicknamed the “northern peso”, and The Wall Street Journal called Canada an honorary member of the Third World. The nation went on a crash diet under the leadership of Jean Chrétien, a Liberal who was well-positioned to resist the pleas of the many constituencies

created by the overspending of his predecessors.

It was a remarkable act of courage. As time passes, those constituencies—votes purchased by government spending—become larger and more powerful. The debt grows, the interest on the debt rises, and the required spending cuts become more and more severe. Yet Canada’s GDP grew—it accelerated—over the course of the next four years, even as her budget went from massive deficits to surplus.

Yes, they had help from a strengthening US economy, and we’re too large to ask that they return the favor when we tighten our own belts. We’re going to have to do this on our own, but it *can* be done and *must* be done. The first step is to tell the voters the truth. ■

The fiscal cliff deal was stuffed with special breaks for rum distillers, Hollywood, NASCAR, wind power, StarKist Tuna, Goldman Sachs, and other needy recipients. Harry Reid slipped the little pile of pork into the fiscal cliff bill in the final hours of 2012.



John Convery Jr., CFA

YOU GOTTA BELIEVE

There will always be pundits and politicians who say we can’t cut federal spending because the economy can’t handle it. But it’s been 5 long years since the real estate market began to fall apart, and our growing population needs more homes. Autos, similarly, are on an upswing simply because the average car on the road is now 11 years old.

And there’s an energy boom under way in this country that’s rolling right over the many obstacles that states and the federal government have put in its way. We’ll also get some benefit from simply removing the weight of government, which has been crowding out private-sector jobs in a variety of ways. Have courage, Dearheart; it’s going to be OK. ■

“Spain is not Greece”

“Greece is not Ireland”

“Italy is not Spain”

“Neither Spain nor Portugal is Ireland” – Angel Gurría, Secretary-General OECD, Nov. 2010

“Spain is not Uganda”

– Spanish PM Mariano Rajoy, June 2012

“Uganda does not want to be Spain”

– Ugandan foreign minister, June 13, 2012

– Elena Salgado, Spanish Finance Minister, Feb. 2010

– George Papaconstantinou, Greek Finance Minister, Nov. 2010

– Ed Parker, Fitch MD, June 12, 2012

– collected by John Mauldin

IT WAS A VERY GOOD YEAR

Most would be surprised to hear it, but in 2012 the S&P 500 advanced 16%, including dividends. Bond returns were about 5%. Cash was trash, and the price of gold was flat. We didn't quite get the 25% return from stocks that we were looking for, but it was a very good year nevertheless.

Our expectation for 2013 is that we'll see more of the same, but less of it. Stocks should continue as king, perhaps returning 10%, while cash and gold go nowhere and bonds struggle to earn their yield. Residential real estate will continue to improve, unemployment will remain high, and the economy should continue to grow at a sluggish pace that's not fast enough reignite inflation.

Last year stocks were able to shrug off the fears of investors because they were so very inexpensive. If interest rates were to quadruple they wouldn't look cheap any more, but sluggish GDP growth (below 2%) will keep rates from rising.

"More of the same" will not be dull. The economy might continue to plod along, but there's a potential for trouble in Japan, California, Europe, and Iran, to name a few places. And you can expect more fireworks over the trillion dollars a year that we're stealing from our children. Our \$16 trillion debt has already breached the debt ceiling, and by late February the Treasury, out of gimmicks, will need to borrow to keep the government running.



Paul K. Wright, CFA

Just as in 2012 we'll see lots of volatility, and the markets will climb a wall of worry. Here's to another good year! ■

"In 1800 it took 75% of our population—men, women, and children—to produce food for consumption and export."

– [Insight](#), Autumn, 2012

Just as the mechanization of farming created unemployment but fed the world, dramatic gains in manufacturing technology have made our poorest citizens wealthier by reducing the cost of goods. The pace of these productivity gains is about to quicken, and we'd better be ready.

There are two trends. The first is that the not-yet-ready-for-prime-time robots of the last decade are suddenly very much ready to take center stage. Robots now have excellent vision (and comprehension of what they're seeing), and they can

handle fine detail work at blinding speed. They can switch tasks in a heartbeat, and lift huge weights all day long without fatigue or injury.

The other is a new generation of machines, not so very different from inkjet printers, that can "print" metal parts in three dimensions, layer by layer. In the future we're not going to need warehouses full of old car parts, because we'll simply call up a computer file and make them on the spot. The cost of these "3D printers" has fallen to \$15,000 or less, and yes they can print metal parts. They do it by printing layers of powdered metals, and "sintering" them with a laser. They can also print layers of human cells, and thereby make body parts for the patients of the future.

The factories of the future will need

very few—highly skilled—workers, and that means layoffs. We can try to fight that trend, briefly hanging onto a few jobs and watching helplessly as Asian competitors lay claim to our recently-revived manufacturing industries. Or we can take the lead, eager to embrace labor-saving technologies at a time when the retirement of the Baby Boomers threatens to create labor shortages in 2025 and beyond. This is an opportunity for us to reclaim industries lost to China, and we need to seize it with both hands.

Innovation means lower consumer prices. That's the same thing—the exact same thing!—as a fat raise for blue-collar workers and the poor. These are not clouds with a silver lining, but rather glad tidings wrapped in coarse paper. ■

The government maintains a website, regulations.gov, that's meant to help citizens stay abreast of the latest federal regulations. The only trouble is that nobody can possibly stay abreast at the current rate. In the last 90 days 1,494 new regulations were proposed or implemented, and that's just the federal government. 50 state governments are hard at work as you read these words . . . Many of these rules and regs make sense, but a tidal wave of good things is still a deadly tsunami. The unemployment rate will stay high until we learn how to get this beast under control.



“We look for people who can quickly adapt to changes in the workplace.”

A client tells us he once received a letter from the IRS that was accompanied by a Xerox copy of a single page from the tax code. The page number was 22,184.



In 2013 you'll be permitted to give \$14,000 to any individual without paying any gift or estate tax.



UNSTOPPABLE

Global auto sales dipped to 59.5 million vehicles in 2009, but they rebounded to 67 million the following year. 71 million in 2011, and nearly 76 million in 2012.

In 2013 global auto sales are expected to rise again, to 79.4 million cars and trucks. For the fourth year in a row US auto sales will rise by more than a million vehicles, to 15.5 million cars and trucks.

THE UNITED STATES OF AMERICA

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www.weelectedyou.org

Debt is slavery; having savings is freedom; live below your means; save until it hurts.

James T. Schaefer, 2012

WHEN MORE IS LESS

In 2011 the top tax rate on British citizens earning a million pounds a year went up from 40% to 50%. The number of million-pound a year tax filers promptly plunged from 16,000 to 6,000. Some of them probably retired while others worked less; some might have moved to other countries and surely a few cheated on their taxes.

Whatever the reasons, it's consistent with surveys in the U.S. that show that people recoil at the idea of having anybody give up more than half of his income to federal, state, and local taxes. The British are now collecting less than half as much tax from "millionaires" as before.

This experiment is going on elsewhere, despite the bitter experience of years past. The French just raised their top tax rate to 75%—lots of luck with that Monsieur Hollande—and right away French actor Gérard Depardieu moved to Russia, which charges a flat rate of 13%.

13.3% is the brand new top income tax rate in California, which also levies sales taxes that can reach 10% in some jurisdictions. Add all that onto the new top federal tax rate of 39.6%, and you have a top combined tax rate well over 50%—even if state and local tax continue to be deductible from your federal tax return.

That's a recipe for financial disaster for the state of California, because wealthy Californians can just leave.

They don't have to move to Russia, or choose some other scary foreign jurisdiction like Bermuda. They can simply move into the ski house on the Nevada side of Lake Tahoe. It's reasonable to guess that 10% of California's citizens pay 70% of the tax, just as they do at the federal level, and that losing half of them would mean that the state *loses a third of its revenues*.

The migration has been under way for some time, but should gather steam in 2013. Texas, which like



Nevada has no income tax, has received 225,000 (net) Californians in the last decade. Here in New England the most likely "donor" state is Rhode Island, with a top income tax rate of 9.9% and a 7% sales tax. They might as well drive people out with cattle prods . . .

Washington and the states need to smarten up if they're going to maximize the tax revenue collected from the wealthy. Instead of shooting from the hip with new taxes (such as the new 3.8% Medicare tax), our legislators need to take a thoughtful and scientific approach. Here's a hint; since World War II we've never collected more than we did with Bill Clinton's tax rates, despite trying top tax rates of 28%, 35%, 50%, 70%, and even a chuckleheaded 92%. ■



Drew D. Kellner, CFA

SEPTUPLED

We now have \$110 million under management, but we're still a small and old-fashioned firm, in a small town in New Hampshire. We're still waiting for some of the year's performance numbers, and that's just one reason that we're fortunate to manage a client account that's been with us since our first year in business. The account has never had additions or withdrawals, and pays a consistent 1% fee.

The portfolio ended 2012 at **\$758,218**, up from \$100,000 in 1990. In the past year it grew 15.7%, despite holding bonds and cash as well as stocks, and it's up **64.3%** since the first day of 2008.

For information on fees, minimums, and performance (as well as every newsletter we've published since 2002), visit our website:

www.Lumbard.com

THE MADNESS OF CROWDS

How did we do so well in the past 5 years? A lot of clues can be found in past issues of *Insight*, because our goal is to tell you what's coming up in the future—whether that's a financial crisis (have a look at our 2007 and 2008 issues, on www.Lumbard.com), an energy revolution (Summer 2012, Autumn 2009), or a bull market in deeply-undervalued stocks (Autumn 2009).

We're always invested for value and diversification, but we're not shy about betting against the herd when it seems to be running in the wrong direction.

For some time now we've liked companies that buy their own shares back at very low prices. As with everything else, it makes lots of sense for them to buy their shares at low prices, but not so much sense when they buy at high prices . . .

A company that's doing it right is DirecTV (DTV - \$50). The stock sells at less than ten times 2013 earnings, so they'll earn enough this year to buy back 10% of the company. And they will; DTV doesn't pay a dividend, but it has purchased more than half of its shares since 2006. Half the shareholders now own the whole company, which has meanwhile doubled in size. Earnings per share have almost quadrupled

The herd has made some spectacular blunders in recent years:

- The real-estate bubble of the late 80s, after which real estate prices in this area fell by 30%.
- The tech-stock bubble of the late 90s. Tech stocks still haven't recovered . . .
- The real-estate bubble of 2000-2007. Did we say real estate bubble? Again?
- The mortgage bubble of 2000-2007. Liar loans, no-money-down NINJA loans . . . Investors couldn't get enough!
- The recurring belief that it's OK to run deficits when the economy is expanding.

At the other end of the scale is Seadrill (SDRL - \$37), which pays a 9.1% dividend that's actually larger than earnings. We like it anyway, because the company has a dozen top-of-the-line deepwater drilling rigs under construction. Each will command a long-term contract worth tens of millions of dollars a year.

In the middle is Microsoft (MSFT - \$27), which pays a nice 3.4% dividend and still has plenty of cash to buy back shares. And it does. The stock sells at 8.4 times earnings, which means that it has an "earnings yield" of 11.8%; if they dropped the dividend they'd be able to buy 11.8% of the company next year.



John Lumbard, CFA

- The insistence, back in 2007 by popular demand, that stocks return 10% a year.
- The pervasive fear, two short years later, that stocks are too risky for retirement savings.
- The commodity bubble, fed in part by a repeated assertion that US oil production was inexorably shrinking. A year later they told us that the US will soon become the world's largest oil producer!

You'll be pleased to know that we bet against all of these things, to the extent that it was possible to do so. You have to question the usefulness and objectivity of news organizations that enthusiastically feed these manias, so let's all resolve to be more skeptical in 2013.

— John A. Lumbard, CFA

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.

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