STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS JANUARY 2022

Lumbard & Kellner INSIGHT

S&P 500 4,766.18 * Dow Jones Industrials 36,338.30 * 30 year U.S. Treasury Bond 1.91%

# RIDING THE TIGER

It's said that you should only buy Chinese stocks when you're sure that the Chinese government wants the stock market to go up. When you think about it, the U.S. stock market has been rising because our government pushed it higher, intentionally, with outlandishly-powerful fiscal and monetary policy. We've been on a Halloween Sugar High, and the Fed is still forcing the stock market higher by blasting a firehose of money into Wall Street. The fire hose isn't as powerful as it was a couple of months ago, but it's still a fire hose. We'll ride this tiger as long as there's any sort of river, stream, or babbling brook of cash flowing into Wall Street and into the pockets of investors. But the party can't go on forever, and neither can these mixed metaphors.

Of course, this isn't all the Fed's fault. When Congress mailed $1400 checks to 80% of the voters—including people who were very, very comfortable and working from home—they caused a bulge of spending that sparked inflation and shortages. That bulge will subside in the months ahead. On page 3 Paul Wright explains the effect of

"fiscal drag" on the economy of 2022.

Still, the choice to stay in the stock market is made easier by several things. Bonds are a terrible investment, because they will decline as interest rates rise. Bond prices have been declining for 17 months, from all-time-high price levels, because yields were at all-time lows. Cash is still at 0%; the yield on a 3-month U.S Treasury bill is *six one-hundredths of 1%,* even though inflation has been at the highest levels of the last 40 years.

40 years ago the yield on a 10-year U.S. Treasury bond was **14%!**

The dividend yield on stocks has been sliding as their prices have gone up, but they still pay more than "cash". And stock dividends are just the tip of a beautiful iceberg. Companies are now paying dividends of just 1.3%, but that cash payout is only about a third of their earnings. The other two-thirds generally come back to investors one way or another.

We're looking more and more at stocks that pay good dividends, and at companies that provide essential goods or services that will continue to be in demand in a weaker economy. The hot stocks of the last few years might suffer in an environment of rising interest rates. If you have a taxable account with us you'll have another big capital-gains tax bill in 2022, but it's better to lock in good profits than to watch them melt away. ■

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Did you notice higher prices in your supermarket last year? More are coming. The company that makes Oreos and Triscuits says it will raise prices 6 to 7%. Kraft Heinz will raise prices an average of 5%, with some items up 20%. Kraft claims that the cost of producing Grey Poupon, *the mustard that is frequently passed from one limousine to another,* is up 22%; but they're only going to raise the price of a jar by "6% to 13%".

*Drew D. Kellner, CFA*

"Stocks could remain under pressure as the end of the year [2021] approaches, owing to institutional portfolio rebalancing, according to Maxwell Grinacoff, equity derivatives strategist at BNP Paribas. Given the S&P's outperformance, relative to bonds, he estimates that $1 trillion to $1.4 trillion will be shifted out of equities into fixed income."

— Barron's, in early December. An institution might have a goal of keeping 60% of its investments in common stocks, with 25% in bonds and the remaining 15% in cash and "Other Stuff". If stocks perform much better than bonds, the managers will sell stocks and buy bonds to "stay safe". Lately they've been losing money in those bonds, which means that they'll keep buying more of them; and then lose even more money.

The Fed has been keeping the bond market from declining by purchasing trillions of dollars' worth of bonds, but it will soon stop. The result will be carnage in the bond market.

## OTHER STUFF

Some institutions have been investing in bitcoins as a means of diversification. Investments in Beanie Babies and cans of Billy Beer are also a form of diversification. But if they're selling bitcoins in gas stations, the bubble might have reached just about everybody. If "everybody" is in, then there won't be enough buyers to absorb the coins offered by those who want to sell.


*Sign in the window of a gas station in Portsmouth.*

***But Wait***. You're going to need bitcoins to buy a house lot on Crypto Island in Fiji. It's a crypto utopia! To contact a real estate agent go to https://cryptoland.is/. Be sure to watch the animated video! ■

## Novemdecupled

Our Benchmark account now stands at $1,922,181, up from $1,590,597 at the beginning of 2021; and more than 8 times its $217,974 valuation on December 31, 1999, just before the great millennial tech-stock bubble burst. It's an actual fee-paying client account, holding cash and bonds as well as common stocks, whose performance is not distorted by additions or withdrawals. For further information please see our website, www.Lumbard.com. ■

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The economy will slow down in 2022, but there should be enough inflation to help along some producers of food and commodities. The real problem for stocks will be the powerful headwind of rising interest rates.

We do like dividends. Kinder Morgan (KMI - $16) pays 6.8%; ARC Resources (AETUF - $9) pays 3.5%; generic-drug manufacturer Viatris (VTRS – $13.50) pays 3.2%; and we think that AT&T's reduced dividend will still be above 4.5% after it spins off WarnerMedia (T - $25). Lockheed (LMT - $355) pays 3.2%, and Prudential (PRU - $108) gives you 4.2%. Tyson (TSN -$87) was pushing all these buttons until the stock, dammit, went up. That caused the dividend yield to slip to 2.1%. That's still better than the market average, and WAY better than cash, bonds, bitcoins, meme stocks, or lottery tickets ■

"When even one American - who has done nothing wrong - is forced by fear to shut his mind and close his mouth - then all Americans are in peril."

— Harry S. Truman

# THE KINGS AND QUEENS OF FISCAL DRAG

Inflation affects each of us differently. If the cost of *your* purchases and expenses has been rising at 5%, the value of the money in your 0% checking account has been declining at a 5% rate. It's a negative 5% return. That's one reason that consumers have been spending like drunken sailors. They can also borrow at the lowest rates ever for homes, boats, or cars. And they still have a few dollars saved from the government checks they received in the last 13 months.

In the 12 months through November, the CPI rose at a 6.8% rate for an entire year! Wages have been rising at the fastest pace in 20 years, but the Federal Reserve still maintains that inflation, the way they like to measure it, will rise just 2.7% in 2022. Just 2.3% in 2023. We find it hard to imagine that price increases, by any measure, will be lower than 3% unless the Fed raises interest rates sharply, and soon.

And we don't believe they will. There's a lot of magical thinking in the air these days. It is true that the overheated economy will slow sharply in the months ahead, because last year's Congressional spending spree ended with the last child "tax credit" checks in December. Consumers saved part of this windfall, but inflation and spending are slowly emptying their pockets.

Fiscal drag is not an outfit worn by a nightclub entertainer! It's much less fun. In 2021 Congress lifted GDP with trillions of dollars in gifts, to the vast majority of voters. Now the economy has to deflate by a similar amount, unless Congress finds a way to inflate it again. GDP will eventually rise on its own (because growth is the normal state of our economy), but growth in 2022 will be retarded by this "fiscal drag".

In the near term that fiscal drag will be offset by great consumer wealth from stocks, housing, and middle class banking accounts. In the second half of 2022 a stagnant economy is likely. And that stagnation might be better described as stag*flation*, because this cotton-candy Fed has no stomach for the pain that would accompany a serious effort to tame inflation.

We believe that inflation will fall somewhere in the 3% to 4% range in 2022. If GDP is at zero but inflation is at 4%, then nominal GDP (GDP not adjusted for inflation) will be at 4%. That means corporate revenues will rise 4%, and some commodity prices will rise, helped along by solid economic growth in the rest of the world.

Rising corporate revenues might sound promising, especially for commodity producers, but it will be difficult to make money in the stock market in 2022. Especially if inflation is at the higher end of that 3% to 4% range. Rising interest rates are a strong head wind, and we've just enjoyed a remarkable bull market. ■

*Paul K. Wright, CFA*

Socialism is a theory of how to run a government and an economy. Communism, similarly, is a theory. Capitalism isn't a theory. It's what happens, naturally, when buyers and sellers are allowed to interact freely. It's freedom.

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**U.S. $CO_2$ Emissions Have <u>Declined</u> Since 2007, while GDP grew ~50%**

***Primarily due to converting coal power generation to natural gas generation***

— From a presentation by gas provider Kinder Morgan.

## THE 5,000 NIGHTS OF NAPA

Think stocks are expensive? Last May the Four Seasons Orlando resort sold for $610 million, which works out to $1,374,000 per room. Four Seasons Napa sold for ***$2,059,000 per room***. If you bought just one room for $2,059,000, and managed to rent it at an outlandish rate that gave you a ***profit*** of $400 a night, you'd still have to rent it for more

than ***five thousand nights*** to get your money back. That's 365 nights a year, for 13.7 years! ■

"President Biden signed a nearly $770 billion defense bill on Monday, $24 billion more than he had requested … Lawmakers increased spending in almost every part of the military, including new funding to counter China's military expansion, initiatives to bolster the defense of Ukraine and billions in cash for the procurement of advanced aircraft, ships and high-tech hardware."

— The New York Times. $770 billion looks smaller than it used to. This year taxes should bring in $4,390 billion. The CBO projects that Medicare will cost $904 billion, offset by just $163 billion in Medicare taxes. Medic*aid* will cost $545 billion *plus* almost $700 billion spent by the states.

We have shares of Northrop Grumman (NOC - $387) and Lockheed Martin (LMT - $355). The earnings hold up well in recessions, and there's strong ***bipartisan*** support for military spending to counter China's buildup. There's also strong demand for F-35s and other American military hardware among the many nations that look to us for protection. ■

The total value of all the shares of Apple is almost at 3 trillion dollars!

"Thinking of it in terms of buying an entire business is helpful. Would you rather own the iPhone maker or all of McDonald's, Walmart, AT&T, Philip Morris, Berkshire Hathaway, Procter & Gamble, JP Morgan Chase, Starbucks, Boeing, Deere, and American Express combined?"

— Barron's

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"The unemployment rate has plummeted dramatically in recent months. At 3.9 per cent, it now sits at its lowest level since before the pandemic."

— The Financial Times

**"We are never offended, and we are never hysterical."**

— German Chancellor Olaf Scholz. If every political activist, right and left, would just repeat these words 12 times a day…

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## 57 YEARS

Hundreds of thousands of children entered the United States as migrants last year. Nearly all of them, perhaps even the 122,000 who entered as unaccompanied children (according to CBS News), have a better chance at success than a child of a single parent in our inner cities. The War on Poverty has been underway for 57 years, and our inner cities are still battered and broken.

Trillions of dollars have been spent on this war, and we will spend trillions more. Ineffectively. Should Washington be focusing on electric vehicle subsidies and free child care for middle class families, or turning its attention to finding better answers?

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"In 1979 the bottom fifth of American earners received means-tested transfers worth on average 32% of their pre-tax income, according to the Congressional Budget Office.

By 2018 the figure was 68%."

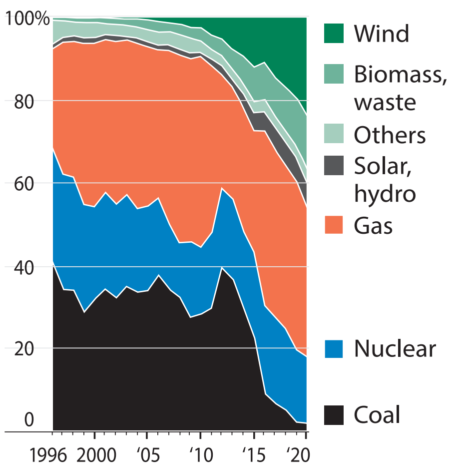
— The Economist.

# CLASSICAL GAS

The price of natural gas in Europe spiked upward in October, as a long spell of windless days slashed the power production of wind towers. By the time cold weather arrived in December, gas storage facilities had been nearly emptied. Gas prices then soared to higher highs despite the resurrection of old coal plants that were headed for the scrap heap.

Developed nations have been moving steadily away from dirty, but "always available" coal power, and towards intermittent, unreliable wind and solar. Batteries can provide power on windless days, but Britain might be 50 years away from building a battery big enough to produce massive amounts of power for a month.

*Share of U.K. electricity generation from different sources*



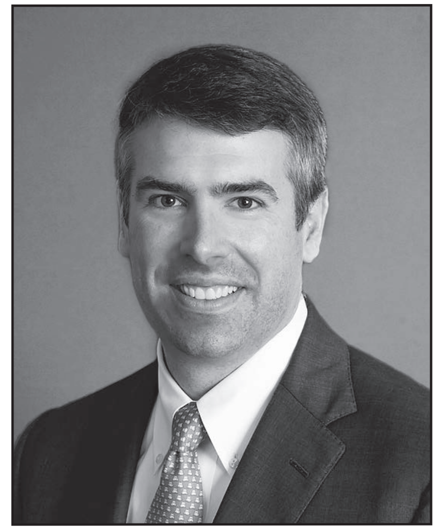

*Source: Department for Business Energy and Industrial Strategy*

Nuclear power could be an answer, but the number of nuclear plants in service has been declining. That leaves natural gas as the next best option. Underground caverns filled with gas really can provide power for a month of windless days.

Investors take note! Some companies in this diverse industry should be able to raise prices with inflation, stay ahead of their increasing costs, and pay solid dividends from large cash flows that grow faster than inflation.

The demand for Liquified Natural Gas (LNG) is rising quickly in India, China, and Europe, which needs to import LNG to reduce its dependence on Russian gas pipelines. That should bestow pricing power on Golar LNG (GLNG - $12) which is one of the lowest cost providers of liquification and regasification services. Their fleet of LNG tankers should also be in high demand.

Kinder Morgan (KMI - $16) has the largest network of natural gas pipelines in North America and is expanding its LNG export facilities. And ARC Resources (AETUF - $9) is a large Canadian natural gas producer that expects to generate free cash flow yields of 18% over the next few years. Management plans to use that cash to pay down debt, buy back stock and increase the already healthy 3.9% dividend yield. ■



*Jay Conway, CFA*

# CENTRAL PLANNING

This really happened:

1. The UK aggressively invested in wind power, even as it de-emphasized natural gas and gas storage.
2. The wind stopped blowing in September.
3. Natural gas prices skyrocketed, as utilities struggled to keep the lights on.
4. The soaring price of gas caused fertilizer plants shut down, because they could no longer afford to make nitrogen fertilizer from natural gas
5. A by-product of making fertilizer from natural gas is $CO_2$, which is captured to make dry ice.
6. Suddenly there was a shortage of dry ice, and the UK realized that the frozen food supply chain was about to collapse.
7. Emergency funding was given to fertilizer producers so that they could continue to buy natural gas at ridiculous prices so that the country wouldn't run out of dry ice.
8. It turns out central planning is REALLY hard to do well.

## CIRCULAR LOGIC

Morningstar says that the average mutual fund investor gets much worse performance than the mutual funds that he, or she, invests in, because investors switch funds at bad times. Switching from a fund that has recently performed poorly to a hot fund might be described as selling low and buying high. And investors drive their performance down even further by switching money out of stock funds, and into bond funds, at the wrong times.

The Janus Twenty fund invested in the 20 hottest big technology stocks, which led the Nasdaq Composite as it rose from 1,400 in 1995 to 7,000 in early 2000. Janus Twenty was near the top of the Morningstar mutual fund rankings, so investors flocked to it. They invested tens of billions of dollars in it, and they were very sure that this was the right thing to do. All their friends agreed. The fund invested those tens of billions into its favored 20 stocks—which naturally soared. In 1998 the fund rose 73%!

In March of 2000 the tech stocks stopped rising, and began falling. Janus Twenty declined *almost 70%*. A $100,000 investment shrank to $30,100.

**The rest of the story:** At the *peak* of the bubble a good part of the stock market was beaten and battered, *low* rather than high. As Big Tech fell these stocks rose, and rose, for years. We had a real estate investment trust whose yield reached 15% simply because the price fell again and again. When the Nasdaq 100 fell 75%, this stock, Healthcare Realty, went up more than 100%.

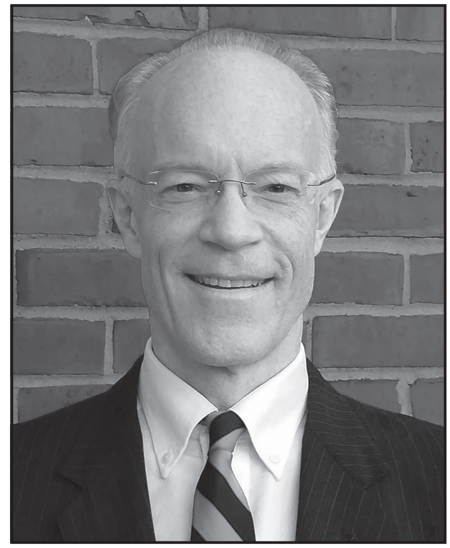
Growth stocks have enjoyed an unusual dominance. Value stocks probably have further to run. ■

"Of the 47 countries in Europe today, 46 of them currently require government-issued photo IDs to vote ...35 of the 47 European countries—including France, Italy, the Netherlands, Norway, and Sweden—don't allow absentee voting for citizens living in country."

— John R. Lott, an expert on election integrity, in Imprimis. Ensuring that it's easy to get an I.D. should be a top priority.

***If it seems to good to be true, it's probably…***

***too good to be true.***



## WEALTHY AND WISE

"What matters a lot more than a big income is *how* people spend it. For instance, giving money away makes people a lot happier than lavishing it on themselves. And when they do spend money on themselves, people are a lot happier when they use it for experiences like travel than for material goods …. And yet we still keep on buying material things, because they're tangible and we think we can keep on using them."

— The Wall Street Journal.

Well, that's *NOT* what Americans did in the pandemic. No wonder everybody was so crabby.

— John Lumbard, CFA

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