LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 1,689 * Dow Jones Industrials 8,331 * 30 year U.S. Treasury Bond 4.07%

LORD KEYNES WAS WRONG

May, 1939:

"We have tried spending money. We are spending more than we have ever spent before and it does not work. . . . We have never made good on our promises. . . . After eight years of this administration we have just as much unemployment as when we started . . . and an enormous debt to boot!"

-- Henry Morgenthau, Franklin Roosevelt's Treasury Secretary, speaking nearly a decade after the crash of 1929.

In the popular imagination—fed diligently by a handful of historians—the Great Depression was ended by Franklin Roosevelt's New Deal, a collection of enormous government spending programs designed to boost employment. The spending actually started in 1932 under Hoover, when the federal government took in revenue of $1.9 billion and spent $4.7 billion. Spending increased *30%* that year, and there were plenty of infrastructure projects—including both of the landmark bridges of San Francisco.

FDR got credit for the ensuing expansion, from 1933 to 1936, and used the resulting goodwill to increase spending further; launching, in 1935, the Works Progress Administration and Social Security. This was an era of big government—Marxism and National Socialism were in full flower—which in the English-speaking countries found a cheerleader in the economist John Maynard Keynes. By 1936 Keynes felt confident enough in these new policies to publish his General Theory of Employment, which advocated significant government intervention in the free market.

Then came 1937. By now the economy was addicted to massive deficits, and when Roosevelt reduced them—by raising taxes instead of cutting spending—the illusion of sustainable growth vanished. The unemployment rate rose from 12% to 19%.

That's a shockingly-poor record for an economy that *wanted* to recover from the disastrous Smoot-Hawley tariffs, increased taxes, and tight-money policies of 1930. The Great Minds of Washington, eyes clouded by hubris, were unable to see that all previous economic downturns had ended on their own without the help of government spending programs. It was their aggressive action—boneheaded fiscal and monetary policy, and a global trade war—that turned a deep recession into the Great Depression. And it was aggressive government action that prevented recovery.

Hubris ruled the day. The depression didn't end until World War II, when the government stopped trying to stimulate consumption via make-work projects, and called on Americans to join a passionate effort to *produce*. The Greatest Generation unleashed an avalanche of production that overwhelmed powerful enemies on both sides of the globe.

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LORD KEYNES... *continued from page 1*

Guns, butter, ships, clothing . . . . . and when they were done they rebuilt Germany and Japan.

And they kept right on building, with a confidence that drove the economy for the next 60 years. There's a world of difference between that drive to *produce* and the use of government programs to stimulate *consumption*. Economists Kehoe and de Cordoba, reporting in a Federal Reserve Bank of Minneapolis publication on the work of 24 economists, point out that government stimulus spending usually causes an economy-wide decline in productivity, or output per man hour. Productivity—innovation and "working smarter"—is often described as the engine that drives the growth of our economy, because GDP is nothing more than the product of "hours worked" and "output per hour".

Make-work programs undermine productivity growth, and there's no better way to illustrate the point than a story told by Jerry Jordan, then President of the Federal Reserve Bank of Cleveland. An American businessman in the "old" China was visiting a dam that was under construction by a hundred men with shovels, when he remarked to his host that a single worker with an earth-moving machine could build the dam in an afternoon. The host responded "Yes, but think of all the unemployment that would create!" "Oh," said the businessman, "I thought you were building a dam. If it's *jobs* you want to create, then take away their shovels and give them spoons!"

The same is true of any program that shifts our focus from productivity and growth to consumption and job preservation. When we bail out an unproductive company and put it on life support, we suck investment capital and skilled workers from the rest of the economy to sustain an organization that won't contribute to GDP growth. And the same can be said of make-work programs, earmarks, and the myriad of programs that we refer to as the social safety net.

All the economic downturns that preceded the Great Depression ended on their own, without the help of government spending programs.

Japan's twelve-year recession of 1991-2002 should have buried Keynesian economics for good. In 1991 Japan had about the same amount of government debt that we had in 2004, if you adjust for the smaller size of Japan's economy. The land of the Rising Sun then embarked on a Keynesian program of infrastructure and stimulus spending that looked like a super-sized version of the New Deal. From 1991 to 2001 Japan's government debt grew from 61% of GDP to 131% of GDP—higher than Italy or any other OECD nation. Japan's stimulus programs were HUGE, and they went on for more than a decade.

"Crack-brained meddling by the authorities can aggravate an existing crisis." -- Karl Marx

Now our economy is stabilizing, in response to low interest rates, bargain-basement home prices, and tax rebate checks. Ahead of us lies the Keynesian "spending" portion of the stimulus legislation, and the great question of whether it will actually retard economic growth. Would we then continue to follow the example of Japan, and pile on—in our much larger economy—an additional $20 trillion in spending over the course of a decade? Or would we learn the obvious lessons of history, and put an end to this fantasy about deficit spending that has the potential to bankrupt the country?

THE CHANCE OF A LIFETIME

The fear in the credit markets is subsiding, but even now there are large electric utility companies that can't borrow money at rates below 9%. You, dear homeowner, can borrow money for 30 years at 5%.

That's ridiculous, of course—it's the result of government manipulation of the credit markets that contributed to the real-estate bubble and the mortgage crisis—but it's a huge opportunity for you. You can borrow at 5% (probably the lowest rate you'll see in decades) and lend at 9%. Years from now you'll look back in wonder.

"Most of the bankers are competent and responsible, but there are also some beatniks, pyromaniacs, and gangsters."

-- Franz Müntefering, chairman of Germany's Social Democratic Party, in a comment intended to push German banks to increase their lending.

LOAN SHARKS IN THE WATER

Three cheers for a White House initiative aimed at curbing the usurious interest rates, outlandish fees, and predatory tactics used by credit card companies against the elderly, the inattentive, and the recently-unemployed. Pay a day late and they'll charge a huge fee; do that a few times and they'll jack your interest rate up to 32%. Rates that high are likely to *cause* the customer to default, so you have to wonder about the strategies employed by Bank of America and other card companies . . . . . State governments used to have usury laws to protect consumers against loan sharks, and it's high time that the federal government took over the job.

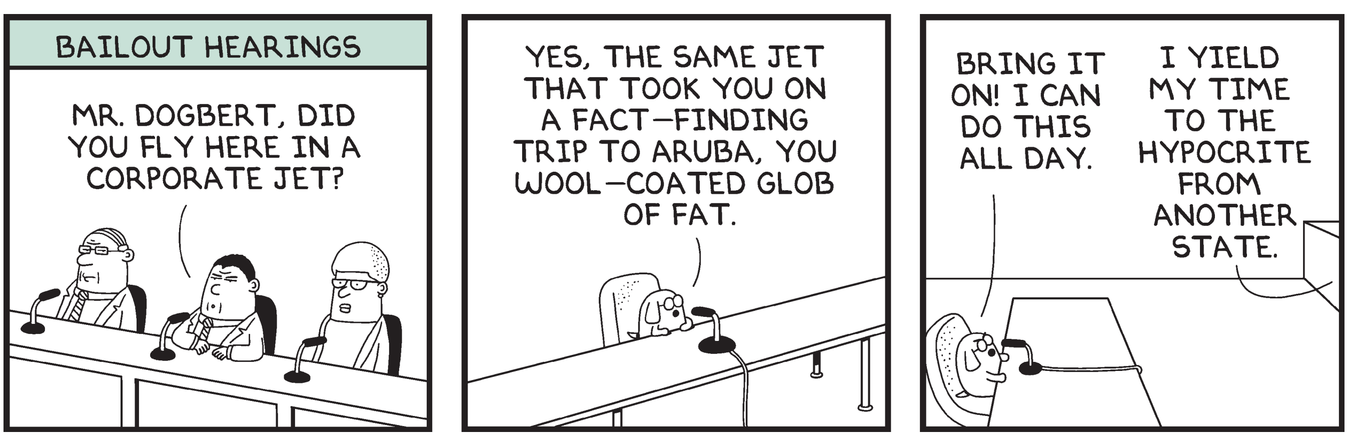
In the last 10 years the S&P 500 declined 38%, from 1286 to 797. Our accounts appreciated more than 90%.

In the ten years ended March 31 our "benchmark account"—the one that started in October of 1990 with $100,000—grew from $230,314 to $441,221. We used March 31 data because we couldn't find the statement for April of 1999; but yes, we participated in the recent stock-market rally (and did some buying at the lows in early March). On 4/30/09 the account stood at **$452,134**, up 1.4% for the year to date. It declined just 3.3% last year.

And this account is very much representative of our client portfolios. It gets no special treatment, buying and selling stocks and bonds along with our other accounts—at the same time and price. It has always paid a 1% fee, and there have not been any additions or withdrawals.

We got there by emphasizing dividends and interest—the proverbial "bird in the hand"—and diversification. We've always had big bond holdings, and as the recession approached in 2007 we put as much as 25% of each client portfolio in long-term Treasury bonds. We also focused on recession-resistant stocks such as pharmaceuticals, telephone companies, and electric and gas utilities, although each of the traditional safe havens was challenged by special factors. The health-care stocks were battered by fears that the government would force down the prices of patented drugs; defense stocks plummeted in advance of budget cuts, and fears about the impact of "cap and trade" carbon taxes hammered all electric utilities, coal-fired or not.

Our average common-stock portfolio now yields more than 5%, and we expect to see the shares rise as investors become comfortable with the idea that their big dividends are secure. Corporate bonds offer a similar potential for income and appreciation, with an even larger income stream. Some day we'll become more aggressive, but the bird-in-the-hand strategy looks good for the year ahead.



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John Lumbard, CFA

INFRASTRUCTURE!

Does anybody remember the 2005 highway bill? It was a monstrosity—laden with $24 billion in earmarks—which laid out $286 billion in spending over 6 years. In that bill was Senator Don Young's famed Bridge to Nowhere; a bridge which one Wall Street wag now says was "simply ahead of its time."

The Trade Deficit Is Down!
The Savings Rate Is Up!

A NEW BULL MARKET?

The stock-market averages have been rising in response to signs of economic stability, most notably a sharp rebound in home sales that was triggered by low prices. That's the way it's supposed to work; prices fall so steeply and so far that investors can't help but step in to buy, and they're helped by low interest rates and easy monetary policy.

Stability is not the same thing as economic growth. Consumers have rediscovered the joys of moderation and savings, and we can't expect much from the "spending" portion of the stimulus legislation—which still lies ahead. In mid-2010 the entire $786 billion bag of goodies will begin to empty out, and the result will be a *subtraction* from GDP.

Slower growth means lower corporate profits, and profits will be reduced further by increased taxes, regulation, uncertainty, and other government burdens.

We did some buying in early March, and enjoyed the rally in stocks; but this is a time to reduce equity holdings and wait for lower prices. When you do buy, focus on income. A stock with an 8% yield that goes nowhere is a lot better than a stock with a 1% yield that goes nowhere, and we think that we'll be able to get capital gains from companies that prove their ability to continue to pay big dividends.

We expect to harvest capital gains and income, in the same way, from bonds. 49% of our average account is invested in bonds of various kinds, some of which were purchased with 12% yields.

The current Washington climate favors bond holders over stock holders. If you'd like a more-complete explanation of our unbridled enthusiasm for bonds, see page 3 of our February issue, at www.Lumbard.com.

THE CAPITALIST POOR

Our economy *wants* to grow, because our population is growing—and because constant innovation causes productivity to grow. It's that innovation and productivity growth that has caused our standard of living to grow over the decades; not just in the upper strata of society, but in the ranks of the poor.

25 years ago, fewer than 40% of families living below the poverty line had cars. Today more than 70% do, and 30% own *two* cars. There were literally no cell phones in our inner cities in 1984 . . . . In 25 years the government has shifted its focus from housing the poor to *home ownership*; and from feeding and clothing the poor to accusations that Wal Mart and McDonalds (purveyors of unbelievably-inexpensive clothing and food), are creating sprawl and obesity as they raise the living standards of tens of millions of Americans.

Low prices brought by free markets have done more for the working poor than any government program—many of which drive the unemployment rate higher and undermine the integrity of the family. And now the poor are suffering the aftermath of programs that encouraged them to buy homes with the help of sub-prime mortgages.

If the nation has to pay just 5% interest on $10 trillion in debt, the interest alone will cost $500 billion a year.

THE FIRE NEXT TIME

Forest fires are a natural phenomenon. They consume pine needles, dead wood, and other debris that have accumulated on the forest floor. Our efforts to suppress fires have left our forests loaded with fuel that has accumulated over the course of 50 or even 100 years. We've created a potential for catastrophe all across the American West.

The same can be said of our economy. For decades we've been snuffing out recessions as if they were brush fires, and thus creating a potential for much larger, deeper, and more damaging downturns in the future. That's because recessions play an important and natural role in free markets, punishing individuals who make poor decisions and burning away greed and recklessness. They clean out the overhead of bad debt that burdens the economy, and punish overconfident lenders. As the economy contracts, prices and interest rates decline to irresistible levels that encourage investors and businessmen to make sensible long-term commitments to growth.

Voters don't like recessions, and the average congressman will go to great lengths to ensure that the economy is growing as he approaches his next election. The Federal Reserve has been happy to help, and the result has been a quarter-century of steady growth. Government intervention encouraged overconfidence and greed among investors, and overconfidence in the watchdog agencies that are supposed to protect the financial system and the public. We have thousands of regulators on Wall Street and in the insurance, banking, and mortgage industries, but by last fall they had been lulled to sleep by decades of steady growth. Like everybody else, the regulators believed that real estate prices never fall, that homeowners never default on their mortgages unless they lose their jobs, and that we had entered a new era in which recessions are mild and rare and rarely worth considering.

We have hundreds of years of economic history available to us—

Drew D. Kellner

all the way back to the Tulip Mania of 1637, and the great economic downturn that followed the South Sea stock bubble of 1720—which shows that free markets are self correcting. Yes, they go through booms and busts, but the busts serve an important purpose in reminding investors and consumers of the dangers of excessive debt. When government attempts to remove this fear and stabilize the economy, it sets us up for calamity in future years.

THE 17% SOLUTION

When Americans talk about alternatives to capitalism, they're usually thinking about the European model. Yet the nations of Europe suffer from sluggish growth, dramatically higher unemployment, and a standard of living that is about two-thirds of the GDP-per-person that we enjoy here in the United States.

Europe's recession is expected to be longer and deeper than our own. The land of big government and heavy regulation has seen its banks and financial markets implode for reasons—reckless lending, real estate bubbles, bad mortgages, over-reliance on credit-rating agencies—that are very much like the problems experienced in our "deregulated" markets.

This nightmare is unfolding in countries that have willingly surrendered growth and jobs in exchange for large social safety nets and free medical care. Higher unemployment benefits and higher unemployment go hand in hand. Unemployment rates were high before the crisis—Germany's jobless rate only dipped below 8% once in the last 15 years—and now they're rising fast. Spain's unemployment rate is now 17%. Yes, *seventeen* percent.

Bureaucracy, Inefficiency, and the Most Expensive Health Care the World Has Ever Known

Government-run health care consumes more than 8% of our nation's GDP, and it doesn't even cover a third of our population. That's far and away the worst performance on the planet; by comparison the average western European nation spends 10% of its GDP to cover *all* its citizens.** Our government is not competent to manage health care at any level.

The problem is even worse than it sounds. Medicare keeps its costs under control by demanding gigantic discounts that push up the cost of health care for all other patients. Hospitals can't give a 50% discount to Medicare unless they have a posted price that's twice as high as the Medicare rate. That posted price is the price that uninsured patients have to pay.

In fact, the federal government is such a big dog in health care—it pays more than 46% of all the nation's health care bills—that it's fair to say that all other patients are paying a big surcharge that subsidizes Medicare and Medicaid. And that's just one of the many ways that government has pushed up costs, via perverse incentives, unworkable payment systems, and subsidies that are in all the wrong places.

When Medicare was launched in 1965 Congress projected a total cost of just $10 billion in 1990, 25 years later. The actual cost was nearly *$100 billion*, or about a third of the nation's defense budget in that year. Medicare will be a good bit *bigger* than defense in five years; it will cost $690 billion in 2014, and an incredible $730 billion the year after. That's *$5,290 for you, and every other American taxpayer, to cover just 18% of the population.* The Congressional Budget Office figures that Medicare's total future liability—the amount that we "owe" according to today's rules for payment—is $34 trillion. And now we're going to try to give Medicare to everybody?

***Yes, we know that these numbers seem incredible. The World Health Organization offers 2005 numbers for health-care spending as a % of GDP, with the US at 15.2%, Spain at 8.2%, Denmark at 9.1%, Germany at 10.7%, and France at 11.2%; we struggled to find a credible source to confirm that health care is now 17% of America's GDP, but the number is plastered all across the World Wide Web. The Wall Street Journal and other credible sources say that federal health-care outlays are 46% of the nation's health-care spending (and that government at all levels is responsible for 55%). The L.A. Times says that 67.5% of Americans are now covered by private health insurance, and the US Census says that just 26.6% of Americans were covered by government health insurance programs in 2003.*

The pundits are right. Washington should re-establish sensible rules and regulations—starting with a return to the old-fashioned requirement that a homeowner put 20% down in buying or re-financing his home. That simple requirement, all by itself, would have prevented the Great Financial Panic of 2008.

SPEAK NOW, OR FOREVER HOLD YOUR PEACE

The twin legacies of Lyndon Johnson were Medicare and Vietnam. The nation is still struggling to come to terms with both of them. As we plunge headlong with great hubris into Afghanistan and Pakistan, the nation should stop to consider whether we really want to enlarge this war. Afghanistan is one of the most warlike nations on earth, and it's so remote that everything (*everything!*) has to be airlifted in at great cost. The 173 million people of Pakistan possess nuclear weapons . . . . . . Now would be a good time to reconsider, before we reach the point where withdrawal becomes a failure, and failure encourages terrorism around the globe.

John Lumbard, CFA

Inflation, Deflation, and the Magic of Banking

Americans have come to expect a steady 4% rate of growth in our economy, and a 4% rate of unemployment. That's not possible in an enormous and mature economy like ours, but in the last 25 years we were often able to produce those 4% numbers for years at a time—by juicing up the economy with consumer debt, government debt, and massive leverage in the financial system.

In fact, the growth of banking and lending turbocharged the economies of the last 200 years, but the price of that growth was increased risk. We traded stability for growth.

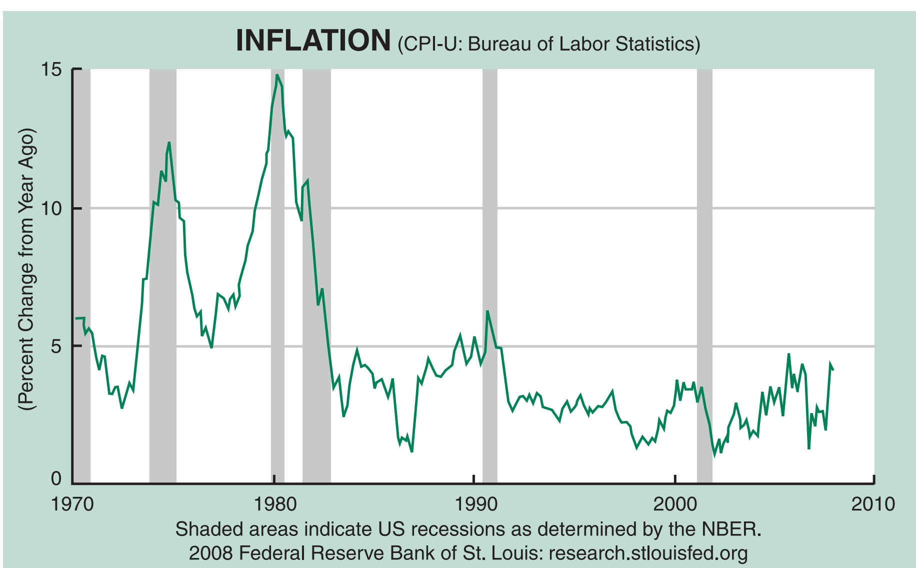
Today's financial institutions are towers of debt. If a new bank opens with a million dollars and takes in deposits of $10 million, it might then lend out $9 million. That sounds fine, until you realize that most of the bank's capital will disappear if just 10% of the borrowers default.

The purpose of the Federal Reserve System is to allow us to manage the instability that the growth of banking has brought us. Yet in recent years *most* of the lending in the economy—from mortgage loans to car loans to credit cards to business lending—took place on Wall Street, where investors (mutual funds, pension plans, and insurance companies) purchased these loans with hare-brained enthusiasm. And no one even noticed that Wall Street's investment banks were borrowing $30 million for every $1 million of capital.

Instead of sounding an alarm, the Fed and the Congress increased the risk further by removing the fear that prevented lenders from becoming careless, lazy, and greedy. They prevented recessions, guaranteed loans, created safety nets, and otherwise created the illusion that there was never any risk at all.

The other interesting thing about the banking system is that banks actually *create money*. If you go into a bank and deposit $100, the bank will keep $10 in its vaults, and lend out $90. The recipient of that loan will temporarily deposit the cash in his checking account at a second bank; he'll "have" $90 and you'll have $100. Of course, the second bank will lend out $81 and keep $9 in its vaults . . . . When all is said and done, your $100 has multiplied ten times over. We now have *$1,000* floating around, boosting economic growth and making people feel wealthier than before.

Thus, the banking system—without any help from the Fed—creates money. The same is true of the lending that takes place in the larger world outside the banking system.



Inflation tends to bottom well after the end of a recession.

When Wall Street crumbled, money was destroyed. The Fed has replaced that money, and in the process it has driven interest rates down to a low level that has already re-ignited lending and stabilized the economy. That's a good thing, and it's also good that the government stepped in when the mortgage market froze. Fixing broken markets, replacing money that has been destroyed, and rescuing the banking system are all sensible roles for government.

Still, there's a big difference between "rescuing the banking system" and bailing out individual banks. Most of the banking system could have been rescued by simply buying a trillion dollars' worth of mortgages, and that sure looks like a bargain now . . . . . Instead we opened the Pandora's Box labeled "Bailouts", and soon discovered that it's impossible to shut the lid. We're bailing out *car* companies and *insurance* companies, and making it up as we go along. Credit-card loans, auto loans, hundreds of billions of dollars in new sub-prime mortgage loans . . . . Congress is *still* pushing financial institutions to lend to the poor . . . . They'd like to rebuild all the nation's towers of debt as soon as possible, to get the economy growing in time for the 2010 elections.

You can be sure that the Congress and the public will be dissatisfied with any rate of growth that the economy can produce by then. They'll push Ben Bernanke to keep printing money long after the economy stabilizes. Inflation lies somewhere in our future, but it won't arise soon enough to satisfy the investors betting on it today. They're betting on the emergence of a bubble, hard on the heels of the bursting of bubbles in oil, other commodities, real estate, mortgages, tech stocks, emerging markets, currencies . . . . How many times do we need to be knocked to the canvas to learn the lessons of our own recent history?

A Stimulus Program That Worked

The government's stimulus package is just beginning to ease its hefty girth onto the ship of state, and the economy is already showing signs of stability. That's not because of stimulus *spending*, which is still in the future, but we probably received a lift from the tax reductions and rebate checks that started in February.

We say that because last year the government borrowed $152 billion—less than 20% of today's stimulus legislation—and mailed it to consumers at the rate of $600 per adult. It wasn't a lot of money, but it nevertheless caused our GDP to rise at a very-healthy 2.8% rate in the second quarter of 2008---in the middle of a recession, and in the face of skyrocketing (*$4!*) gasoline prices. Adjust those rebates to the size of the Stimulus Package—$7,200 for each American household**!!**—and the economy might have been lifted 5 times as long, for 15 months.

Economists Romer and Romer of Berkeley looked into the phenomenon, and found that a dollar of tax cuts raises GDP by $3, even when taxpayers put a good part of the money into their savings accounts. Tax cuts work because they allow real people to buy goods and services that real people really want, from companies with rising productivity and a sustainable contribution to GDP. And they don't create an addiction to further stimulus by depressing innovation and entrepreneurship.

It's really very simple. If you want to discourage gasoline use, raise gas taxes. If you want to discourage coal and tobacco consumption, raise coal and tobacco taxes—and consumption *will* fall. If you want to discourage people from earning income, raise income taxes; and if you want to *encourage* income and GDP growth, cut income taxes. Income, after all, is a very large component of GDP . . . . It's really very simple. Anybody but a congressman can understand it.

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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