

LUMBARDE
INVESTMENT
COUNSELING

INSIGHT

Nasdaq Composite 2,549 * Dow Jones Industrials 11,415 * 30 year U.S. Treasury Bond 3.35%

IT'S DÉJÀ VU ALL OVER AGAIN

In August there was a sickening drop in stock prices in response to a downgrade of the rating on US Treasury bonds to AA+. That was the truth, but the *whole truth* was that the prices of Treasury bonds went up a lot immediately after the announcement. That's the very definition of a tempest in a teapot, so we bought several stocks and added to our holdings of a couple of Asian stock funds.

Then there was another drop on bad news out of Europe, and summer 2011 started to look a whole lot like summer 2010. Problems in Europe, *omigosh we're going into a double-dip recession* . . . Last year at this time investors were so scared that we titled our September letter "How 'Bout A Little Optimism?"

These are just aftershocks from the Wall Street earthquake of 2008. We're *not* headed into a recession—our exports to Europe are less than 4% of our economy—and you sure as heck don't have to worry about inflation. In the 1990s the Japanese responded to the implosion of *their* huge real-estate bubble by printing an ocean of money—they literally

invented the term “quantitative easing”—and undertaking an endless series of spending-stimulus programs. This went on for *12 years* without triggering inflation, because you can't generate inflation when your economy is extraordinarily weak.

The truth is that our economy isn't yet strong enough to withstand a big reduction in federal spending, but otherwise we're muddling along far better than Wall Street seems to understand. The latest stats show that the single-family housing market is finally stabilizing, and there's been a big increase in the construction of apartments in the last year.

Auto sales are up, and for a good reason; the average car on the road today is over 11 years old and has well over 120,000 miles on the odometer, according to Morgan Stanley. And you might as well buy new; have you seen the prices of used cars?

Everybody knows about the recent weakness in manufacturing, but they weren't told that the much-larger service economy is doing just fine. Manufacturing—and exports—

will get a boost with the launch of Boeing's all-composite 787 Dreamliner. The farm economy is strong, and getting stronger. Anything and everything related to natural gas is booming, as is oil drilling in the Eagle Ford and Bakken shales. North Dakota's unemployment rate is just 3.3%.

Those jobs are more-productive than most, because they're pushing down the prices of oil and gas. That means more money in the pockets of consumers, and more of the all-important consumer demand that has been eluding John Maynard Keynes for the last 74 years.

Small businesses are still struggling, but large corporations are doing just fine. They responded to the crisis by cutting costs, expanding overseas, and refinancing their debt at extraordinarily low interest rates.

Consumers have been doing the same thing; have you noticed that you can now get a 30-year mortgage at **four** percent? You can save enough

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IT'S DÉJÀ VU ALL OVER AGAIN

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on a refinancing to buy that new car . . . Lower interest rates mean a lot in this nation of borrowers, and that's a key difference between our situation and that of post-bubble Japan. Our Federal Reserve wields great power, and investors who bet against the old adage "Don't fight the Fed" need to know that they're betting against the house.

The strengthening of balance sheets in a hundred million households and businesses means that our economy rests on a more-solid foundation than it did in 2008. Now we just have to generate enough jobs to offset the ongoing



shrinkage in government. The federal government is as big as ever, but 87% of our government jobs are at the state and local levels—and they're shrinking by 35,000 a month. There's still a lot of bloat, because they're not yet down to 2005 levels.

For investors, the key point is that next year's economy will bring more of the same. Big blue-chip companies have been able to grow in this lousy environment, but their stocks are ridiculously cheap; at this level Microsoft would be able to use its 2012 earnings to buy 12% of itself. Fewer shares would mean that earnings *per share* jump an additional 14% in 2013, on top of the usual growth

You don't need to do the math. Just buy some blue chip stocks and hang on for the ride. It's going to be a good year. ■

Cheer up, dammit! You're living in the most-prosperous era in the history of the world!

LIFE IS A BEACH

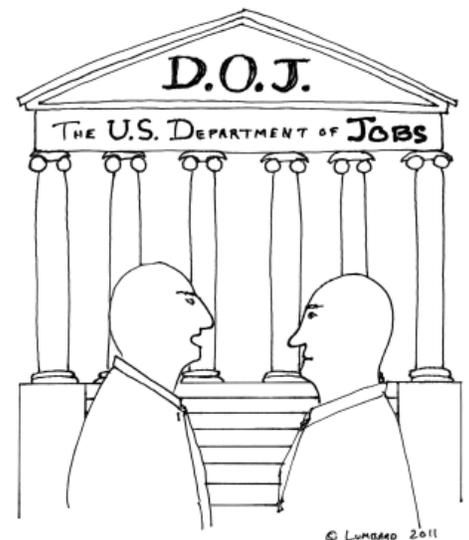
A well-regarded Massachusetts teacher writes: "We spent the first day of school in meetings, in which the administration blamed the state for a heavy load of new paperwork, documentation, and other nonsense. I'll hardly have time to correct papers and plan lessons."

Regulation expands every year at the state, local, and federal levels. It's the natural order of things. And when something goes wrong it expands even faster. We're not just talking about schools, but about businesses large and small--and the rights of homeowners, landlords and parents.

Ask any small businessman, or anybody whose business failed, and you'll hear tales of fear, uncertainty, and added cost burdens. Ask the CEO of any large corporation and he'll show you an entire floor full--or building full--of people who do nothing but shuffle government-mandated paperwork.

"If seven maids with seven mops Swept it for half a year. Do you suppose," the Walrus said, "That they could get it clear?" "I doubt it," said the Carpenter, And shed a bitter tear.

– Lewis Carroll



*I'm fed up with stinking-rich CEOs whining about "the heavy hand of government." Let's just **make** them hire workers! 500 companies, 2,000 workers each. That's a million jobs. Simple.*

JOBS, UNLEASHED

The economy of 2012 should look very similar to the economy of 2011, and we probably won't see any change in this low-growth environment for a number of years. Consumers and corporations have been paying down debt, and while this lower rate of spending restrains growth it also reduces the likelihood that we'll build up the excesses that cause most recessions.

In other words, high unemployment and slow growth are not a reason to worry that we'll slide into another recession. They're a reason to think that we could go for many years in the environment that we're experiencing now.

We still need to address our 9% unemployment rate. The President wants more infrastructure spending, and while I refuse to get aboard high-speed rail it's certainly possible to create infrastructure jobs that have a lasting future impact.

Alternate energy is a sensible area of emphasis, because our foreign trade deficit is almost entirely made up of oil imports. Homegrown energy will create homegrown jobs. But from here forward we should focus on energy sources that don't require government subsidies or mandates. Natural gas is the cleanest of the fossil fuels, and we have trillions of cubic feet of newly-discovered gas that can produce electricity or power cars and trucks, if we can only get it to market. The government's role should be to encourage new uses for gas, and to remove any impediments to its distribution.

A gas pipeline is exactly the kind of infrastructure project that everyone should be able to support. Yet a recently-opened gas pipeline from Wyoming to Oregon was forced to endure years of EPA, BLM, Historic Preservation, and Federal Energy Regulatory review, thousands of pages of detailed regulations, and many miles of detours. Construction was halted from March to May of this year accommodate the mating season of a bird that is not endangered.

When the Chinese want to build a pipeline they draw a line on a map and start digging. Here we've discovered that there is no such thing as a "shovel ready" project. And it's even harder to get permission to produce oil, despite the fact that our consumers are going to burn huge quantities of oil without regard for whether it's imported from Iran or produced here in the United States.

It's true that greater oil production could lower prices and spur consumption, but the nation can respond by simply raising gas taxes and collecting some much-needed revenue. In fact, our tax policy should generally be designed to discourage consumption and encourage savings. The Value-Added Tax has been applied successfully in most other developed nations, and it would have the added advantage of taxing imported goods—while leaving exports untaxed.

The nation's ports are essential to those exports, but today it would be impossible to re-create the ones



Paul K. Wright, CFA

we have. If we want to reduce unemployment we're going to need a nationwide assault—a program bigger than the moon landing—on creeping bureaucracy and regulation at every level of government.

We haven't even mentioned the simplest way to cut the unemployment rate,, which is to address the fraud that has resulted from the decision to extend benefits to 99 weeks. Workers now boast openly about it, including four 20-something men at a golf resort in Oregon who confided to a friend that they've been working under the table "for cash" while collecting unemployment benefits.

Last winter our investment advisory board shared a ski lift with a Boston-based brick mason who told us that he was living in a ski house with several other masons who collect unemployment benefits all winter, every winter. They call themselves the Government Ski Team. ■

— Paul Wright is our Chief Economist, equity-research analyst, and social director.



Drew D. Kellner, CFA

S*XTUPLED

In our last newsletter we said we had pared back equities in April and May, with hopes of buying low in the summer months. We sold too little and bought too soon, but our accounts are nevertheless up for the year at a time when stock market is down 4.8%. The benchmark account now stands at \$647,173, up from \$623,903 at the beginning of the year—and up from \$432,429 in September of 2008. The account opened in late 1990 at a value of \$100,000, is managed without favoritism, and has always paid a 1% fee. For information on fees, minimums, and performance (as well as every newsletter we’ve published since 2002), visit www.Lumbard.com.

New Hampshire’s 5.2% unemployment rate is the fourth lowest in the nation, and the latest available statistics show that we have the lowest poverty rate. Our combined state and local tax burden is 44th.

HERMAN VON RUMPY

“The ECB was supposed to safeguard the euro’s stability. Instead it is safeguarding the survival of individual euro states that made bad decisions” – [The Week](#)

Europe is at a crossroads. The monetary union has always been destined to fail. They were naïve to think that they could have such a large monetary union without fiscal and political unity, and now they’re faced with the need for radical change.

Imagine a United States without a Federal government to balance the collective economic state. Yes, I’m sure that some of you are excited at that thought . . . Europe lacks the fiscal and political unity that needs to accompany its monetary one; attaining this union (and let’s be honest—it is essentially about collective liability) will require changes to constitutions at a time when a hard-working Volkswagen employee might wonder why he’s paying for a Greek citizen’s early retirement.

The German voters are angry. Even the Bundesbank has expressed public criticism of the Greek bailouts. And Germany’s Finance Minister has publicly opposed allowing Greece to receive any more funds until it has met its austerity targets, knowing full well that the Greeks have no intention of undertaking the draconian cuts necessary.

Herman Von Rumpy is the name used in the English press for Herman Van Rompuy, President

of the European Council. He’s been nominated by “Merkozy”—Angela Merkel and Nicolas Sarkozy—to chair a series of meetings among Euro Zone leaders that would result in the creation of an “economic government for the Euro Zone”.

What they’re driving at is a United States of Europe. As for Greece, they’ll let it default on its debt (rescuing any affected banks after the fact), or wipe away crocodile tears as they watch Greece and perhaps a couple more PIIGS leave the monetary union. Either way, default or departure, the story will soon reach a conclusion. And the certainty of a new structure will remove the doubt that now hangs over the markets. ■

FIXING SOCIAL SECURITY

Right now all of Washington is consumed with the question “how can we reduce the deficit without pissing off the voters?” Generally that’s a tough one, but we’re going to lob a softball to our timid legislators. Fix Social Security! Everybody knows it’s a big problem, and lots of people think it’s really hard. It’s not.

This is a miracle, really. People usually have no idea how bad things are in Washington, and here we have a fearful problem that can be fixed relatively painlessly by raising the retirement age and reducing the cost-of-living adjustments. So let’s get to it!

STOCKS WE LIKE

There are *so many bargains*. Why would anybody buy a CD at 1% when AT&T (T - \$28) is paying a 6% dividend that's supported by huge cash flow? The cell-phone business is growing, the dividend is growing, and eventually the stock price will follow.

Emerson Electric (EMR - \$43, yield 3%) is riding the wave of a long transition towards electric power and increased efficiency. The same can be said for Schneider Electric (SBGSY.PK - \$11, yield 4%) and Johnson Controls (JCI - \$30, 2%). The latter also makes the seats for the Tata Nano—the world's least-expensive car—and recently opened a huge lithium ion battery facility in Michigan with the help of a \$299 million Stimulus gift from the government.

Our society is aging, and we're all going to need Depends. They're made by Kimberly-Clark (KMB - \$68), which pays a nice 4% dividend. Microsoft (MSFT - \$26) only pays 2.5%, but the stock has been declining for ten years while the earnings grew rapidly. The stock sells for *eight* times earnings.

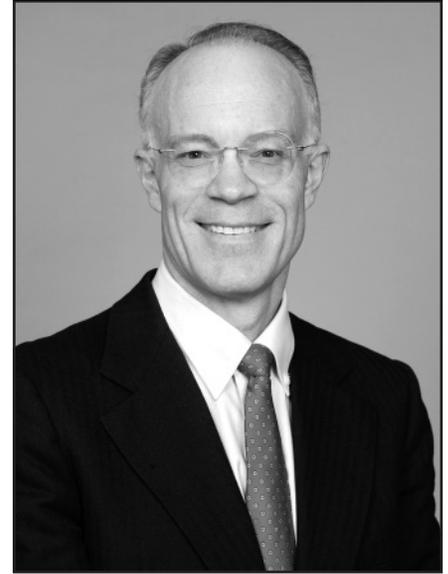
While you're at it pick up some shares of IBM (IBM - \$165, 2%), and then turn your attention overseas with the Matthews Asia Dividend Fund (MAPIX - \$13.5, 3.5%). Singapore Telecom (SGAPY.PK - \$25, 5%) owns a large part of each of the biggest wireless companies in India, Indonesia, Australia, the Philippines, and everywhere in between.

Want to reach for a huge dividend? Seadrill (SDRL - \$30), headquartered in Bermuda and Norway, owns the newest and best fleet of deepwater drilling rigs—and pays 9%. And Telefonica—yah, it's headquartered in Spain—shows every sign of continuing to pay its 10% dividend from the cash generated by its Latin American and European wireless businesses (TEF - \$19). ■

“The surface of the sea, which was perfectly smooth and tranquil, was covered with a thick, slimy substance The light breeze, which came principally from the shore, brought with it a strong smell of tar, or some such resinous substance.”

—*George Vancouver, Captain Cook's navigator, describing naturally-occurring oil seeps in the Santa Barbara (Calif.) Channel in 1792. The seepage has been reduced by oil drilling.*

The economy of North Dakota, home of the massive crude-oil-producing Bakken Shale, is on fire. The state has an unemployment rate of just 3.3%. For many years we've been outsourcing jobs by importing oil, but shale oil is putting people back to work; and the same magic will touch other states when deep-water drilling is allowed to suck the oil out of the natural seeps that are polluting the Gulf of Mexico.



John Lumbard, CFA

A LATTE, A MUFFIN, AND A MILLION DOLLARS

If you save \$7 a day (the equivalent of “one latte and one muffin” in the words of James Schaefer, a blogger for WeElectedYou.org) in an IRA account starting at the age of 22, you'll have \$1,028,829 by the time you turn 67. Schaefer assumes that your IRA will return just 6.29%, and that you'll save a little more each year to keep pace with the rising cost of the coffee and muffin. A million dollars, tax free if it's a Roth IRA, and all you have to do is start young and stick with the plan.

Schaefer's advice to high school students:

***Debt is Slavery
Savings Are Freedom
Save 'til it hurts***

HAPPY DAYS

A few economists still seem to believe that we should have doubled the size of the Stimulus Program in 2009, despite projections—by the same economists!—that the end of the program will *subtract* 1.5% from GDP in 2012. Stimulus pumps our GDP up to a bigger number; and when the spending ends, GDP subsides.

Thus, if we had doubled the size of the stimulus program, the end of that stimulus would subtract 3% from next year's GDP instead of 1.5%. That really *would* cause a recession! And that's exactly what happened to Japan in her Lost Decade of the 1990s; the end of each stimulus program caused fears of recession that launched yet another stimulus program. Debt spiraled

higher and higher as government sucked up the best workers and resources, and businesses reeled from one government-imposed crisis to the next. The Japanese now have the largest debt, as a % of GDP, in the world—comfortably ahead of Zimbabwe and Greece.

The good news for Japan is that most of her debt is held by her own citizens, who accept near-zero interest rates on their savings. We owe a *lot* more money to foreigners than Japan ever did, but they're still willing to lend to us at low interest rates---and we will have the luxury of gradually shrinking our gigantic deficits if we can just persuade them that we really, really *are* going to balance our budgets before the end of this decade.

This year we'll raise \$2.4 trillion in taxes and spend \$3.7 trillion, or nearly 25% of GDP—the most ever, apart from the peak spending years of WW II. Spending averaged 19.6% of GDP in the Clinton years, 19.8% in the Bush years, and 19% of GDP in 1962, when JFK spent a whopping 54% of his budget—three times the current figure—on Defense.

Even as Japan wallowed in profligate misery in her Lost Decade, Canada was embracing a fierce austerity that sparked an economic boom. The contrast was crystal clear; and there's a hopeful example of austerity in our own nation's history. After World War II Harry Truman shrank government spending from 43.6% of GDP—almost half the economy!!—to 11.6%. Scary stuff, and there were indeed two sharp recessions between 1945 and 1950, as we struggled to create jobs for millions of servicemen who had been laid off from government employment.

Then our economy began to grow, powerfully. GDP grew 9% in 1950, and 8% in 1951. Over the course of ten years the output of the entire nation grew by 50%. Happy Days were here again.

— John A. Lumbard, CFA

LIGHT AT THE END OF THE TUNNEL?

The housing bubble started to burst way back in 2007, and that was also when we saw the first signs of distress in the banking system and the mortgage markets. If you see this great malaise as a 7-year process—and many analysts of worldwide banking crises do—we're more than halfway through!

Right now a midday ticket on Amtrak's sparsely-populated Acela, from Boston to New York, will cost you \$131. The Silver Star bus will take you and the rest of the world there for \$15. High speed rail—in the U.S. and also in China—is for rich people and railroad buffs. It isn't an answer to the nation's transportation needs, but rather the answer to the guilt-laden question:

“What would it take to get me out of my Mercedes?”

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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