STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS AUTUMN, 2015

Lumbard & Kellner INSIGHT

S&P 500 1,972 * Dow Jones Industrials 16,528 * 30 year U.S. Treasury Bond 2.90%!

# A WORLD OF PLENTY

China is growing too fast! China is slowing down! The 200-day S&P moving average made a death cross with the 50-day moving average! A **DEATH CROSS!!**

It seems like only yesterday that China was sucking up all the world's resources. Shortages of oil, building materials, and agricultural commodities (*No food!!*) stretched out into the infinite future. The Talking Heads told us to buy oil stocks, copper stocks, gold funds, wheat, and pork-belly futures.

Now we have too much oil, gas, and coal. Warehouses are bulging; there's no room to store all the excess copper, nickel, zinc, steel, corn, soybeans, wheat …. Rare Earths are going to be renamed *Common Earth Minerals*. There's a terrible drought in California, but have you been to the supermarket lately? Food is literally falling on the floor. Why do they have to pile the fruit so high?

The Talking Heads lost money on all these things. Deep down they'd like to see the rest of us feel their pain …. "Doomsday Clock Strikes One Minute To Midnight" read one headline from the UK. "Market In Free Fall!" they said in the U.S. Gold bugs and Peak Oil believers rubbed their hands in glee.

For the rest of us, China's slowdown is just a …. slowdown. China is still growing! And as the panic ended a revised GDP report showed that the US economy had been *accelerating* as the Chinese economy slowed. That 2% currency devaluation? Japan did it, Europe did it, everybody's doing it; and all of them pushed down their currencies more. China is laudably moving toward a free-floating currency, rather than keeping it tied to the US dollar. The Donald is upset the dollar is rising, but that's the same thing as giving every American worker a raise. Your wages just went up! How bad can this really be??

Nobody had a good explanation for the panic. Some thought it was another, *yawn*, round of fear related to an expected 0.25% ("Zero point bitty bit") increase in interest rates. But the interest rates on bonds *fell*, a lot, as fear rippled through Wall Street. Nope, maybe it wasn't about interest rates….

By our reckoning there have been five of these panics in just the last four years. Investors are *still* frightened by the specter of 2008, and are still looking over their shoulders. There is still a **lot** of cash on the sidelines. It's said that millennials own hardly any common stock at all!

Europe has issues. China has issues. We have issues; we always do. But economies grow naturally and grow always, unless something stops them. "Something" is usually the Federal Reserve, concerned that inflation is getting too high. We sure don't have to worry about inflation right now…. When GDP grows, corporate earnings grow, and they grow at least twice as fast. That's partly because their sales depend on nominal GDP rather than real GDP,

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## A WORLD OF PLENTY

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and partly for other reasons…. Over the long term, stock market growth is unstoppable.

Sometime this fall investors will realize that the Fed will raise interest rates again and again, for years; and then bond yields will rise. Bond prices will fall. Investors with bond funds will watch them decline, month after month, and then instruct their brokers to sell. Some of that money will find its way into stocks, seven or eight years into an historic bull run.

There could be a bubble in the stock market. Really. ■

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"China's huge domestic savings rate, which has averaged 29.5% between 2005 and today, left its banks awash with money. Its domestic deposits are now worth $19.5 trillion – *more than that of the US, Japan, and India's combined.* These deposits are growing by around 16.5% per year."

– Mark Haefele, UB

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## TAKE COURAGE!

"Invest at the point of maximum pessimism."

-- John Templeton

"The EPA has apologized for the accident."

– From a Wall Street Journal article about the EPA's release of three million gallons of toxic sludge, laden with heavy metals, into the Animas River—which was crystal clear and stunningly beautiful when we waded across it with Outward Bound (44 years ago!). The sludge traveled down the river from Silverton, through Durango, and into the San Juan River in Farmington, NM; closing all water supply systems and irrigation along the way. From there it flowed to the Colorado River, which slakes the thirst of Las Vegas, Los Angeles, and an amazingly-large swathe of the agriculture in California and Arizona.

Can you imagine the EPA's reaction, if a corporation had done that?

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Some of our clients own shares of Cynosure (CYNO - $31), which sells lasers for all sorts of cosmetic purposes. We're thinking that tattoo removal might, at some point, be really big.

## THE WORLD HAS NOT BECOME A MORE DANGEROUS PLACE!

"For a kid between the ages of 5 and 14 today, the chances of premature death by any means are roughly 1 in 10,000, or 0.01 percent….The overall child mortality rate in the United States has literally never been lower."

– The Washington Post, which went on to detail record lows in child abductions, teenage homicides, and even motor vehicle accidents involving children playing in the street. It's OK to let your children bicycle to school!

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"Commercial aviation has become so safe that pilots routinely go through an entire career without ever experiencing engine trouble serious enough to result in an in-flight shutdown. Based on statistics, taxiing around airports has become the most hazardous portion of flights in this country."

– The Wall Street Journal

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Japan has rejected the winning design for a beautiful new stadium for the 2020 Olympics; partly because of cost, and partly because a Japanese architect—not the winning architect—described it as a giant turtle "waiting for Japan to sink so that it can swim away."

# MORE GOOD YEARS AHEAD

What every new President wants—or ought to want, if the thought ever came to mind—is to have a recession at the beginning of his or her first term, and then take credit for the ensuing prosperity. That gift won't be available to the next President, because this economic expansion has a lot longer to run.

Greece is not going to drag us into a recession, and neither will any of the other nations of Europe. If China grows at 5% instead of 7%, we will not turn into a pumpkin!

Exports are less than 14% of our economy. It's consumer spending, at nearly 70% of GDP, that powers growth. Household balance sheets are in good shape—they've improved a great deal since 2007—so you can expect that consumers will drive economic growth for several more years by *consuming*. Lower prices for energy, building materials, and other commodities are the icing on the cake.

Corporate earnings haven't gone anywhere this year, so it's no surprise that stocks have struggled to advance. Energy companies make up more than 10% of the S&P 500, and their earnings have fallen over 60% in the past year. Energy stocks have fallen by more than a trillion dollars!

Multinational companies make up much of the rest of the index, and the strong dollar has caused their foreign earnings to look smaller. *Domestic* earnings, excluding energy, are up 9% this year. Earnings for the entire index should be higher in 2016, because these modest 2015 earnings should be easy to beat—even if the strong dollar continues to weigh on profits.

We're forecasting that 2016 earnings will grow about 4%, justifying a similar increase in stock prices. You can also count on dividends of 2%, so next year's returns should be quite a bit better than cash (it's not much of a contest!) and bonds (which will probably decline). If the dollar weakens, expect earnings and the stock market to rise even more.

This economic expansion has another 3 to 5 years to go. While the perceived risks of common stocks are high, the real-world risks are low. We're still climbing the famed "wall of worry", and we have several more years of this ahead of us. ■

# COMMODITY CARNAGE

The S&P GSCI index of 24 commodities—energy, food, industrial metals, and gold—has fallen **55%** since 2011. Gold is down more than 40%, copper 49%, wheat 45%, corn 51%, and natural gas 48%. Oil is down more than 66%.

The shares of Freeport-McMoran, a copper and gold producer, and Vale, a producer of iron, nickel, and copper, have declined more than 80% since 2011. Commodities,

*Paul K. Wright, CFA*

stocks, and funds are down trillions of dollars. We haven't yet purchased any commodity producers, as projected earnings are a wild guess.

Most of the common stocks we do hold are truly cheap by almost any yardstick. Prudential, MetLife, IBM, Goldman Sachs, Hawaiian Holdings, Kraton Polymers, and Toyota Motor all sell for less than ten times expected earnings; General Motors sells for less than 6 times! At ten times earnings a company can pay 10% dividends, if it chooses to use all its cash for dividends. Or it can choose to buy back huge chunks of its own stock; 10% of the company every year!

We've hedged our bets by purchasing a few "growth" stocks. Meanwhile cash pays nothing, and bonds will decline for years. We hope that bonds will decline a lot, because we'd like to buy them with enthusiasm before the next recession—and right now the prices are simply unreasonable. ■

## TARGET DATE FUNDS

Target Date funds, close cousins to Life Cycle funds, aim to reduce common stock exposure and increase bond holdings as you age. It sounds very reassuring, and will continue to sound reassuring until those bonds start to show big declines. Higher interest rates will be a modest negative for stocks, but they're a sure ticket to losses for bonds. If the yield on a 10-year U.S. Treasury bond goes from 3% to 5% the price will drop 15%; in the same circumstances a 30-year bond will drop nearly 30%. That's just simple math.

The Federal Reserve needs to get interest rates back to normal levels, so that it can give the economy a jolt of caffeine by lowering those rates in the next recession. Paul Wright believes that it has 3-5 years to get the job done. ■

"Indian managers [such as the new CEOs of Microsoft, Google, Nokia, and Adobe] are future-oriented, and had a 'paradoxical blend of genuine personal humility and intense professional will.'"

– The Wall Street Journal, quoting a study by Southern NH University. India is growing at the 7%-plus rate that China used to grow at; our clients hold shares of a couple of India funds, and Singapore Telecom owns about a third of India's largest wireless provider.

## ODDS & ENDS

DTV has been acquired by AT&T, which has a 5.5% yield. Broadcom will be acquired by Avago. Tyson has moved higher because of the successful acquisition of Hillshire Brands. Immunogen is back at 2013 levels, after a deep slump that was largely the result of a Wall Street analyst's skepticism about the company's cancer drugs. A promising clinical trial caused him to reconsider, and we're pleased to say that we added shares near the lows.

We bought more shares of the Poland Fund, in the depths of the latest Greek crisis, because Poland is doing just fine. GDP is growing at 3.5%, and fully a quarter of exports are sold to Germany. Only 6% go to Russia …. Poland's currency is not tied to the euro.

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"Europe's single currency, designed to foster unity and ease trade between its members, has become a ruthless generator of misery for almost all of them."

– The Economist.

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"All drugs are poisons. That's how they work."

– Pharmacology professor David Ferguson, PhD, every year, to his students.

One of the key principles of making the banking system safer is to reduce the number of giant financial institutions that are so important that we have to bail them out. But the big are getting bigger, and no new banks are forming. Small banks—community banks—were credited with saving a lot of businesses during the financial crisis, because they knew their customers well enough to lend to them at a scary time.

The FDIC says that federal charters were awarded to 178 new commercial banks in 2006. 175 were launched in 2007. Ninety in 2008, and 24 in the depths of 2009. Just five in 2010 …. There were **zero** in 2011. **Zero** in 2012. Just **one** in 2013. **Zero** in 2014, the fifth full year of economic expansion.

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"The productivity slowdown to 0.3% year-on-year likely reflects the reams of new regulatory requirements put on US companies since the financial crises. In banking, for instance, the Fed's stress tests alone have added thousands of non-productive worker hours of labor every year. Now multiply that by each phone-book sized section of Dodd-Frank rules and then extrapolate across finance, healthcare and energy companies and it's no wonder productivity has stalled."

–Christopher Low, FTN Financial

# THE BOUNTY OF THE OCEANS

Can anybody explain to us why bottom trawling—tearing up the seabed in our richest fishing grounds—is still permitted? How could it possibly be a good idea to allow a small number of fishermen to bulldoze the sea floor, killing everything in the nursery?

And why don't we close off the middle of George's Bank to all fishing, and let it function as a nursery for the benefit of everyone? These changes would bring vast improvement, but they'd still be half-fast regulatory solutions for a classic economic problem called the Tragedy of the Commons.

*Boston* Common, that is. In the 1630s it was available as free, common grazing pasture to anyone who wanted to keep a cow. Of course, the number of cows quickly overwhelmed the ability of the land to feed cows. A resource that belongs to everybody—or nobody—is doomed to over-exploitation.

In the 200 years that followed, property rights and the Rule of Law became firmly established. Farmers had an incentive to care for their land, and they began to invest in techniques, tools, and education. Output per acre soared. But in the 20th century property rights in the Soviet Union, China, Czechoslovakia, Hungary, and North Korea were destroyed. Land was seized and redistributed. Food production plummeted, sometimes causing starvation.

Today American farmers produce many times as much food per acre as the best farmers of 1800. If they hadn't improved the productivity of each acre, by now we would have cut down all our forests to feed ourselves. No more national parks, state parks, or national forests ….

It's all about incentives. If we were to allow fishermen to each lease a square mile of ocean, and sell that lease at retirement, you can be darn sure that their waters would become the most productive on earth. If we also refused to allow pens or feeding, they would strengthen the ecosystem from coral reefs to seaweed to plankton to krill to bait fish.

If consumers will pay more for fish that are high in omega-3 fatty acids, fishermen will find a way to produce more of them. Give them a financial interest in protecting the oceans from pollution and overfishing, and they will. In fact, we'd see fish stocks rise *far* above their historic—before man arrived—levels:

"Since about 1940 American farmers have quintupled corn [production] while using the same or even less land. Crucially, rising yields have not required more tons of fertilizer or other inputs …not just cropland but nitrogen, phosphates, potash, and even water."

– Jesse H. Ausubel,
The Rockefeller University

The way we manage our fisheries today looks like Soviet collective agriculture, whose unimaginably-vast wheat fields failed to even feed the nation. "Before the Russian

*Drew D. Kellner, CFA*

Revolution and the subsequent forced collectivization of farming under Stalin, it was the largest grain exporting nation in the world," says the New York Times.

Farmers have been given the freedom to benefit from working smarter and harder, and the results have exceeded the wildest dreams of Thomas Jefferson. Let's stop trashing our ocean resources, and give fishermen the same opportunity. ■

## We're Here For You

Life can be confusing, especially when a family member passes, a baby is born, or there are sudden demands on your finances. We're here for you; just pick up the phone and call us.

The August 31 value of an account we often reference in our newsletter was $887,809. If you'd like further information or context please got to www.Lumbard.com, and click on the "Performance" tab.

## The Biggest Economic Problem In America

"You need only do three things in this country to avoid poverty; finish high school, marry before having a child, and marry after the age of 20. Only 8 percent of the families who do this are poor. 79 percent of those who fail to do this are poor."

–William A. Galston of the Brookings Institution

40% of all American babies, and 71% of African-American babies, are now born to unmarried mothers.

The Economist: "In some American inner cities there are only 50 men with jobs for every 100 women, calculates William Julius Wilson of Harvard University."

Galston: "As my Brookings colleague Richard Reeves has shown, fully 50% of the children born at the bottom of the income ladder to single mothers end up there as adults, versus only 17% of children born poor but raised by married parents." Also: "A substantial body of research suggests that the absence of fathers is an independent source of disadvantage for children, especially boys."

The Economist points out that a single working mother who marries a man with a job will lose her food stamps and lots of other benefits. And thus the poverty rate has defied the War on Poverty, and risen to 15%; up from 12% in 1970. ■

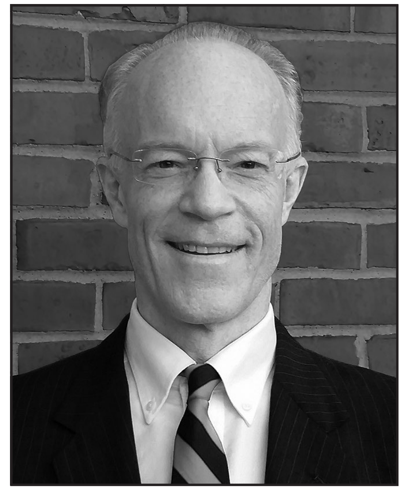
"We are literally required to make loans that we know are going to fail."

– Vernon Hill, founder of England's Metro Bank and America's Commerce Bank,, commenting on the Community Reinvestment Act—which was one of the many factors that led to the mortgage crisis of 2008. He also says, in talking about building permits and other local red tape: "I can build 100 branch banks in Britain before I can build one in the U.S., thanks to regulators."

## BENEFITS

"Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 2033, the payroll taxes collected will be enough to pay only about 77% of scheduled benefits."

– The fine print on the benefit statement you just received from the Social Security Administration.



*John Lumbard, CFA*

## CLEAN AIR!

Japan has re-started the first of its many nuclear plants. Coal plants are shutting down! No one has yet been able to identify a radiation death that resulted from the Fukushima disaster, but coal kills people, plants, and animals alike. This is a clear win for safety and the environment. ■

## A BLAST FROM THE PAST:

"Oil prices will exceed $200 a barrel, as China and other emerging economies drive demand higher. 'The message is clear, the price will go up.' IEA Chief Economist Fatih Birol said."

– National Geographic, November 2010