

Lumbar
& Kellner

INSIGHT

S&P 500 2,044 * Dow Jones Industrials 17,425 * 30 year U.S. Treasury Bond 3.01%

THE GOLDILOCKS ECONOMY

On a warm day in December we spent a pleasant afternoon up on a roof, helping a couple of former engineers as they stripped shingles and laid sticky sheets of bituthene above the eaves. It's only called bituthene in polite company... The engineers now make their living as roofers. We know several Baby Boomers who are underemployed given their advanced levels of education, and at least half a dozen who have been looking for work for a long time. Add in all the recent college graduates who started their careers at Starbucks, and you can see that there is no shortage of well-educated labor available to employers.

When labor is plentiful, inflation is low. The Federal Reserve has a free hand to stimulate the economy by pushing down interest rates, and it can even throw money out of helicopters without causing inflation to rise. It pretty much did... In the last several years we've seen, again and again, that American Consumer Demand and "easy" monetary policy are enough to keep this economy driving forward—despite crisis and

calamity in Europe and Latin America, and a deep recession in energy and commodities.

Years ago a Wall Street wag coined the term "Goldilocks Economy". *Not Too Hot, Not Too Cold... It's Juust Right.* You might think of this as the Wretched Recovery, but we're already 6 ½ years into an economic expansion—and we still have several years of GDP growth ahead of us!

The misery and the magic are rooted in the same unhappy truth. It's unemployment and underemployment that have allowed the Fed to pursue the most-permissive monetary policy ever. Our central bank is now moving gingerly toward a "normal" monetary policy, with short-term interest rates higher than inflation, but it will take years to get there. "Tight" monetary policy is far down the road.

The real question is why, 6 ½ years after a recession, we still need monetary stimulus to keep the economy moving. And we're *still* running deficits in the federal budget! It's

fashionable to lay all the blame on demographics, and say that we now have more retirees—and fewer workers to support them. But if that's the real problem, why are those workers finding it so hard to find good jobs?

We'll offer thoughts on pages 5 and 6. Meanwhile, the economy and the stock market plod higher. *Neither snow nor rain nor heat nor gloom of night* can stay the American consumer from exuberant consumption, and that means continued growth in sales and earnings.

Someday the "slack" in the labor market will disappear—all our friends will find jobs—and wages will begin to rise at a pleasing rate. But rising wages will spark inflation, and the Fed will aggressively push up interest rates to cool the overheated economy. If you're waiting for a sign, keep calm until inflation threatens to rise to 3%, and the Fed begins to push short-term interest rates higher than inflation. There is no need to panic yet.

Don't worry, be happy!



It's at the far ends of the political spectrum that you see impossible promises. No, we can't cut everybody's taxes to 10%, unless we eliminate Medicare and a whole lot of other things.

And a politician who promises to give money to lots

of voters, and raise taxes on just a few, expects that this will buy him lots of votes and cost him just a few. Even if you approve of the spending programs there is no escaping the ugly truth that there is personal benefit to him... Still, nobody seems to blink any more when a politician claims that he'll "take care of" the poor, the middle class, the young, the old, and families—even though that list encompasses almost everybody!

Venezuela doesn't have enough food because Hugo Chavez seized farms and gave them to the poor, who became his ardent supporters. Electricity is unreliable because he seized utility ownership from the evil rich. The Huffington Post says "The country's 1999 constitution guarantees free universal health care to Venezuelans, who sit on the world's largest proven oil reserves.... Half the public health system's doctors quit under Chavez.... Many patients began dying from easily treatable illnesses when Venezuela's downward economic slide accelerated. Driving the crisis in health care are the same forces that have left Venezuelans scrambling to find toilet paper, milk and automobile parts." ■

OH YEAH, THAT'S PAINFULLY WEAK

"China's economy grew 6.9% in the third quarter from a year ago, beating forecasts for 6.8% growth, but decelerating to its slowest pace since the global financial crisis. The results add to doubts the country can meet its year-end GDP target of about 7%"

– Scarsdale Equities Recap

According to The Japan Times, consumer retail spending in China has been growing at a 10% rate, after soaring 12% percent in 2014. At this rate it will double in 7 years! Boston Consulting projects that overall private consumption in China will rise from \$4.2 trillion in

2015 to \$6.5 trillion in 2020. That \$2.3 trillion *increase* is bigger than the GDP of India, and about as big as Taiwan and Russia combined.

This spending boom started with labor shortages, which caused wages to rise faster than 11% a year. Chinese wages have *doubled* since 2009. That's a *good* thing; but great swathes of Chinese industry, no longer able to compete with low-wage nations, are suffering bankruptcies and wrenching change.

We're on the cusp of a rebound in the world's better-managed economies, and even in their irresponsible brethren. In just a few months the oil

and commodity-based economies will stop shrinking, and China's consumer economy will become visible to all. Increased demand from consumers in America, China, and India will lift the manufacturing economies of Asia and the world. It's going to be a good year. ■

"U.S. growth stocks have outperformed value ones by nearly 10 percentage points year to date, according to data from Standard & Poor's."

– Barron's, December 7

Wages rose 2.3% in 2015, and home prices rose 5.7%—much faster than the average rate of 1% or 1.5% per year after inflation. The middle class had a much better year than you might have guessed by listening to the TV news!

On Wall Street it was a difficult year. High-yield bonds, hedge funds, foreign stocks, and commodities declined; energy stocks and pipelines declined a lot, and Kinder Morgan—the biggest pipeline company—fell more than 60%.

We're still years away from the end of this economic cycle, which should last 10 or even 12 years. The cycle is so long because it started with a deep downturn, and progressed very slowly. Inflation stayed at very low levels, and we haven't seen any signs of a bubble in housing, debt, or anything else.

Interest rates are still at abnormally-low levels, so bonds look overvalued and risky. Stocks will rise as corporate earnings rise.

In fact, looking out over the next 10 years we see *nominal* GDP growth—not adjusted for inflation—of 4.5% to 5.0%. Corporate revenues always grow at about the same rate. Corporate earnings will grow even faster, because of stock buybacks and other factors, and stock prices will, over time, rise at the same pace as earnings. Then you still have to add in dividends of about 2%; all this totals to an expected return of about 8.0%.

In the last 87 years the stock market returned more than 9.0% per year. U.S. Treasury bonds returned 5.0%—millions of dollars less, for an investor—and Treasury bills returned 3.5%. Those 87 years take us all the way back to the Roaring



Paul K. Wright, CFA

Twenties. The Great Crash occurred the next year, in 1929; and it was followed by the Depression, World War II, Vietnam, the millennium tech-stock bubble, two bubbles in the real-estate market, and the panic of 2008. There were more than enough reasons to quit investing forever, but stocks powered higher.

Stay the course! ■

WAR AND PEACE

If you're feeling a need to identify the leading cause of war and destruction in human history, it's Europe. Seven of the top 15 wars in history (starting with the 58 million deaths of WWII) were caused by Europeans.

It's popular to say that religion has been a major cause of warfare, but of the top 15 only the Taiping rebellion, The Conquests of Timur, and The 30 Years' War (which killed 30% of the German population!), can be characterized as religious. And only the conquests of Aksak Timur (who saw himself as the heir to Ghenghis Khan), involved

Islam. There are two *billion* Muslims in the world—Indonesia is the largest Islamic country—and they've coexisted peacefully with other peoples for 1,400 years.

Few are followers of extremist/violent strains such as Wahhabism, the religious sect which motivated Osama bin Laden and ISIS. Wahhabism was founded by Muhammad ibn 'Abd al-Wahhab, who in 1744 made a pact with Muhammad bin Saud which included a pledge to "perform jihad against the unbelievers". The Saudis took advantage of the fierceness of al-Wahhab's teachings

(condemned from the start by other Islamic scholars) to seize much of present-day Saudi Arabia from the Ottoman Empire. The Ottomans pushed back, and the Saudis made an alliance with the British that allowed them to establish the Kingdom of Saudi Arabia as it stands today. Wahhabism (they prefer the name Salafism) is the Kingdom's official religion, and its influence has spread via textbooks and literature supplied by the Saudis to schools in Germany, other parts of Europe, and around the world. ■

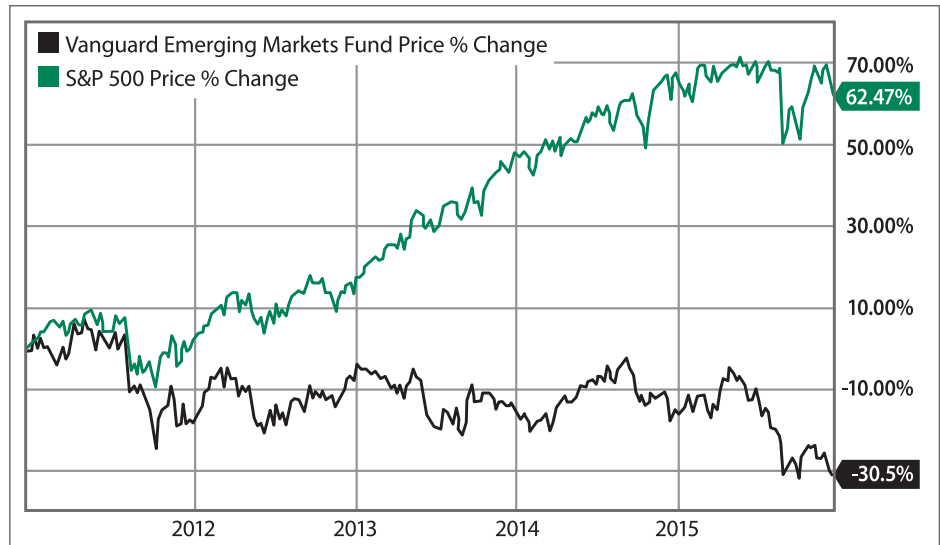
STOCK ROUNDUP

We just learned that three of our stocks are among the top-ten holdings of Warren Buffett. That's not as happy a coincidence as you might think, because Warren had a bad year in 2015. All three of the picks—Goldman Sachs, IBM, and Walmart—declined.

The first auto company to use Corning's Gorilla Glass in windshields will be Ford. And Corning's television display glass is looking good, because the latest "4K" televisions are selling like hotcakes.

Verry interesting: The CEO and other insiders of FMC bought a large number of shares of their company just weeks before an earnings report that they surely knew would be disappointing. The company has made large investments in biological (that is, non-chemical) pest control and herbicides.

Bombardier finally received certification for its quiet and fuel-efficient C Series 100. Delivery of the first planes to Lufthansa should occur by June. ■



Vanguard Emerging Markets is an index fund that holds 3,106 stocks in countries all over the world: from the BRIC countries (Brazil, Russia, India, China) to Taiwan, South Africa, Malaysia, Thailand, and Indonesia. The price has fallen below \$32, down from \$45 in April; the last time it was this low was in June of 2009!

That decline is so striking that we've decided to keep the fund, despite our growing disenchantment with "index" investing overseas. More and more money is pouring into funds that buy every stock without consideration, and that means that there is ever more opportunity for

research analysts to add value by finding undervalued gems.

For years we've owned shares of the Matthews Asia Dividend Fund, which is now closed to new investors but still open to our new clients. And recently we made smaller investments in two of their other funds, because Matthews is a bottoms up, stock picking, value-oriented shop that focuses on the rise of consumers in Asia. Their analysts speak the local languages and fly to Asia to meet with management and see how products are actually selling in the stores. They are outperforming for a reason. ■



GAS-GUZZLER PARADISE

Consumers railed about the injustice of oil-company "windfall profits" for years, but we haven't noticed *anybody* shedding tears over oil-company bankruptcies and Windfall Losses. Also haven't noticed many people bicycling to work, or calling for higher gas

taxes... Lower prices for gas, jet fuel, and heating oil mean lots more money in the pockets of consumers, who thus far have used part of the extra cash to pay down debt. Expect bigger spending in 2016!

INSECURITY

There were lots more data breaches in 2015, including 80 million medical records with Social Security Numbers (why do we use SS numbers to identify patients?) stolen from Anthem. Sensitive information was also lost by the IRS, Harvard University, iPhones, and Starbucks. You can't even get a cup of coffee without losing your identity!

Corporations have been moving your precious data onto "the cloud" (the Internet) because of cost savings, and because they've heard that the Internet is a really, really safe place. IBM, which has grown from the eighth-largest security company to #3 in just five years, helps clients identify their most-valuable data and keep it onsite, isolated from the outside world—while offering Cloud Centers in dozens of countries to hold data that is less valuable. Videos of IBM's embattled CEO Ginni Rometty can be found online. They're worth watching. ■

36 million Americans still lack health insurance. That's down from 48 million in 2012, as measured by the US Census Bureau; but WSJ.com and Statista.com says that 11 million have gone on Medicaid in that time.

Researchers in Chicago, California, and Japan have concluded that laughter can boost your immune system significantly, and suppress the aggressiveness of an overactive immune system.

CHOLESTEROL IN THE ARTERIES OF THE NATION

Three or four years ago we went looking for estimates of the number of pages of regulations and laws the United States has at the federal, state, and local levels. No one really knows, of course; the best estimate we could come up with was "about a million".

In 2013 federal agencies issued 80,000 pages of new regulations. The Affordable Care Act is now up to 10,535 pages, and The American Banker says that Dodd-Frank stands at 13,789—and it's only 40% finished. Each of these laws called for the formation of scores of committees and commissions that will create new regulations in the years to come.

It's not as if we're eliminating old laws and regulations as we go along. That's hard and thankless work! But if we add 80,000 pages of regulation and law each year, in the next "four score and seven" the federal government alone will add 7 million pages of burdens.

There are now 40 federal agencies that have to be consulted before you can export an item overseas. Is it any wonder that less than 63% of our working-age population is employed—a level last seen in the late 1970s when millions of women entered the work force? ■



Drew D. Kellner, CFA

"You shouldn't be exposed to things you don't want to hear, you know? That's not right."

— Satirist and comedian Ami Horowitz, persuading a Yale student to sign a petition to abolish the First Amendment to the United States Constitution (which protects our freedoms of speech, religion, assembly, journalism, and ummm, petition).

"I decided to take this campus free speech debate to its logical conclusion," said Horowitz, who in less than hour persuaded fifty Yale students to sign a petition calling for the First Amendment's repeal. Many expressed enthusiastic approval for his anti-First Amendment efforts. "I think this is fantastic!" "I absolutely agree." "Love it!"

The December 31 value of an account we often reference in our newsletter was \$900,652. If you'd like further information or context please go to www.Lumbard.com, and click on the "Performance" tab.

THE NEWS FROM EUROPE

PBS says that more than a million migrants entered Europe in 2015. Europeans worried that a big influx of workers would depress the wages of unskilled and lightly-skilled workers, increasing inequality and straining welfare systems. Population density would increase... How would they cope?

Well, there are 508 million people in the European Union (almost 60% more than in the U.S.), so adding another million only increased the population by 0.2%. And a million is less than a twentieth of the 22 million people in Syria. If you were a citizen of Syria, would you choose to stay there or move to Germany? Syria is only one of many donor countries We could be talking about 10 million! This migration is only just getting underway; Europe will be forced to do some hard thinking about how many refugees it is willing to take in, and what sort of immigrant it wants.

By contrast the United States accepts about a million legal immigrants *per year*; during the construction-job bonanza of the real-estate bubble we absorbed more than a million legal immigrants, plus perhaps 1.5 million illegals, each year. Our Dept. of Homeland Security says that the total population of *illegal* immigrants has recently declined to about 11 million

(from 12 million), and the Census Bureau says that there are 41 million immigrants, legal and illegal, in the United States.

So how big a population do we want? How many people does Europe want? The populations of all developed countries are aging, and some countries are already facing a bleak future of too many retirees and too few workers. If we'd been clever we would have restricted immigration in the last 30 years, and then ramped it up a lot as the Baby Boomers retired and labor shortages began to appear... We are not clever.

Many immigrants actually *create* jobs rather than take them from others. It's not easy to identify talented and highly-motivated entrepreneurs, but we should stop and think before we deport graduate students from elite American universities—we send most of them home—so that we can bring in more unskilled workers.

The tens of millions of unskilled workers who have already arrived have depressed the wages of native unskilled workers. The same is true of workers with skills; bring in a hundred thousand manicurists, and the wages of manicurists will decline. A \$15 minimum wage isn't going to hold back that tide, and neither will



John Lumbard, CFA

laws barring non-union workers, or licensing regulations designed to keep new entrants out of nail clipping.

Our current policies harm Americans at the bottom of the ladder, create unemployment, promote wage stagnation, cause inequality to increase, and swell the ranks of the 45 million Americans on food stamps. Meanwhile we have a serious shortage of primary-care doctors in some parts of the United States. The Association of Medical Colleges says that ten years from now we'll have a shortage of some 31,000. ■

– John Lumbard, CFA

History Informs The Future

– Eliot H. Lumbard

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