STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS JANUARY 2019

Lumbard & Kellner INSIGHT

S&P 500 2,507 * Dow Jones Industrials 23,327 * 30 year U.S. Treasury Bond 3.02%

FACT OR FICTION?

They say that robots and artificial intelligence will put a lot of people out of work in the next few years. True or false?

If it's true the stock market is going to soar. The cost of labor will not accelerate even if wages rise a lot, because companies will be able to produce more without adding workers. The Fed won't need to push up interest rates to strangle inflation and growth. The next recession will recede into the future.

Productivity, or "output per man hour", will grow faster, after dragging along at a 1% pace for decades. A year ago it was still mired in sluggishness, and the accelerating trend of the second and third quarters wasn't enough to cause *any* forecaster to call for improvement. But you have to make a choice. You can worry that robots are going to take your job, or you can worry that productivity is going to continue to stumble along at 1%. ***You can't have it both ways.***

Productivity was the biggest concept in all the economics classes you took in college. It transformed America from a nation of dirt-poor farmers to a place where ditch diggers have smartphones and travel the world. Investopedia says "A country's ability to improve its standard of living depends almost entirely on its ability to raise its output per worker."

Rising productivity causes GDP to rise faster. The growth of our huge federal debt would slow. It would be an "industrial revolution" that lowers costs in factories, but also a Service Revolution that lowers costs in offices and restaurants. If this doesn't happen *too* quickly, wages will rise. Inequality will narrow.

> There will always be jobs. A client reminded us over lunch that **"there is an inexhaustible demand for personal service."**

This is a terrific time to launch a productivity surge. There's a labor shortage! Workers rebound quickly from layoffs, finding jobs with better pay and benefits. And employers are willing to invest time and money in installing new systems because they're desperate for workers.

Robots, artificial intelligence, vision systems, facial and voice recognition, anywhere/anytime access to information … These systems are better, faster, and cheaper than they were just a few years ago.

Are robots going to take jobs, or is that just a fairy tale? ■

Most of our clients would say that the best thing we ever did for them was to sell in 2007. But in truth the most important thing that we've done, and by far the hardest thing, has been to keep them from selling out of stocks during the many painful and scary corrections of the last 10 years.

Old China hands know that when the Chinese government wants the stock market to go up, it's going to go up. You should buy stocks with both hands. Why doesn't that work here?

MR. MARKET: SEER, SADIST, PURVEYOR OF FEAR AND LOATHING

The Christmas Eve Massacre of 2018 reminded us of the winter of 2015-2016, when falling stock prices foreshadowed the great recession of 2017. Today it looks like a couple of small wiggles on the chart, but it was long and deep and frightening. 30 years before that we did some selling in advance of the huge crash of 1987, and we were glad that we'd raised cash before the inevitable contraction in the economy.

Nota bene: *those recessions never arrived*. In the Fall of 1987 our clients derived no benefit from the cash we raised, despite the fact that the Dow had dropped from 2700 to 2200 in a single day.

Nota *even more bene:* That 1987 Dow Jones peak, the highest ever, was 2,700 and not 27,000. Stocks haven't been that low for 30 years.

Mr. Market doesn't care. He'll crank up the fear until millions have fled, screaming, from their stock holdings. Then he'll cause a big rally, and a short-selling panic that drives shares even higher. Pain for long-term investors, pain for short-sellers and hedge funds; pain for as many people as possible.

So, how much does the stock market have to fall to convince us that there's trouble coming, and that we should sell?

The Dow Jones Industrial Average will hit 36,000 on some future day that is already fixed in the cosmos. If tomorrow it drops 4,000 points, the return in the next few years will obviously be 4,000 points greater. How could it possibly make sense to sell after shares decline?

We're willing to sell if we see a recession coming, and we did sell in 2007. Our clients had little more than 40% in equities during the crash, and they made a killing in long-term U.S. Treasury bonds in 2008. But raising lots of cash during an economic expansion, as we did in 1997, will usually hurt you badly. Missing a 25% year will set you back as much as failing to sidestep a negative 20% year.

It's dangerous to your financial health to sell after a big drop. Do it a few times, over the course of a few decades, and you will put your retirement at risk. ■

We often point out that the earnings yield on the average stock is now above 6.5%, and that corporations could pay huge 6.5% dividends if they wanted to.

AT&T pays a 7% dividend, right now! Cash in your pocket! And it's been increasing those dividends every single year for 33 years. Even if the dividend *doesn't* grow, and the stock goes nowhere, your investment in AT&T will double in 10 years if you simply reinvest the dividend.

Among our holdings Huntington Bancshares yields 4.8%, KeyCorp yields 4.7%, and MetLife yields 4.3%. Prudential yields 4.5%, IBM yields 5.5%, and Singapore Telecom pays almost 6%. Common stock dividends increased almost 11% last year, and they're still growing. ■

Debt free Facebook has more than $40 billion in cash. Alphabet has more than $100 billion. And the piles keep getting bigger.

"A new study shows dogs may become more anxious and possibly suffer from depression when their owners overuse their smartphones."

– ABC News

"In an attempt to save the honor of her dog, which had relieved itself mid-flight, one airline passenger claimed that she herself had had an accident in the aisle."

– The Economist

The year of the dog was **last** *year.*

PROPHETS AND PROFITS

There will not be a recession in 2019. And there won't be "a recession developing as 2019 comes to a close". Every time stocks decline, economic forecasters become more gloomy, as if stock prices have the power to depress the economy. They don't! If you think that there's blood running in the streets, *step outside and look at the streets.*

Emotion can be powerful, but after the madness dies away you always find that stock prices are driven by interest rates and earnings, and little else. Rising interest rates will pull money from stocks to bonds and cash, but otherwise you'll find that stock prices rise when their earnings rise. *Calamities only matter when they affect earnings or interest rates.*

At the peak of the Internet bubble in March of 2000, common stocks sold at 31 times earnings. They had an earnings yield of just 3.2%, at a time when the yield on long-term U.S. Treasury bonds was above 6%. Twice as high! Bonds were obviously a better bargain.

Today those long-term Treasury bonds yield just 3%. Stocks sell at 15 times 2018 earnings, so they offer a yield--an earnings yield—of 6.5%. *Stocks yield twice as much as bonds, and 2019 earnings will be higher still.*

Market timing will lose you money, because you have to make brilliant and courageous decisions to buy back in at the scariest times. The record clearly shows that, from 1970 to 2015, it was **risky** to be ***out*** of the stock market. If you got out, the odds were very high that you'd buy back in at a much-higher level and lose millions in future compounding.

It's actually safer to be in the stock market than to be in cash. The graph below shows that a million dollars invested in stocks in 1970 compounded to **$97 million** in 2015, *as long as you never pulled the money out of the market.*

When stocks are falling every cell in your body screams SELL, in unison with the cells of a hundred million other investors. Prices have dropped, *and they might drop further.* Wouldn't it be better to sell at –15% than watch the market fall further?

No, it wouldn't. To avoid a loss you would have to buy back while pundits are still forecasting a bear market. Hardly anybody, amateur or professional, ever does.

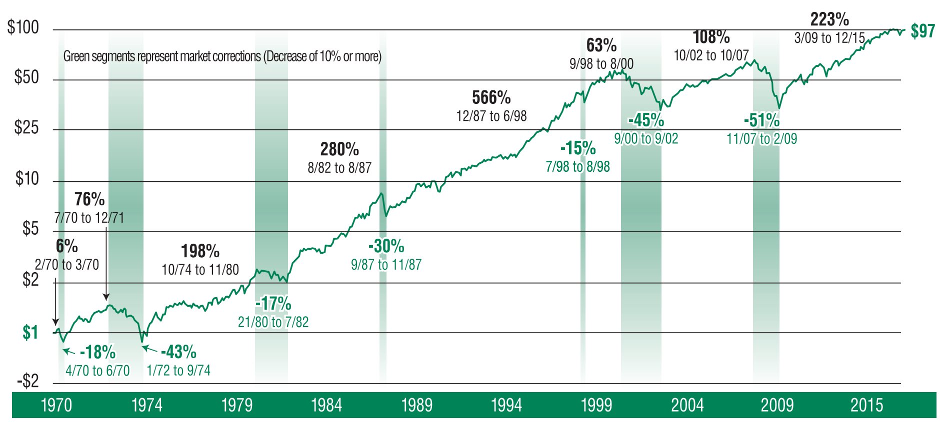
Often the yield on CDs and cash is actually below the inflation rate. You *lose money.* Stocks are volatile, but they're safe. ■

Paul K. Wright, CFA

"The global population living in extreme poverty has fallen below 750 million for the first time since the World Bank began collecting global statistics in 1990, a decline of more than a billion people in the last 25 years."

– The Wall Street Journal, buried on page A16. Talk about burying the lede (aka "lead") … The global population has grown, but the extremely-poor population has been cut in half.

GROWTH OF $1 INVESTED IN THE S&P 500 INDEX FOR 45 YEARS



Source: Morningstar, Inc. Data based on growth of $1 invested in the S&P 500 Index from January 31, 1970 to December 31, 2015, with all dividends reinvested. Performance shown represents past performance. Past performance is no guarantee of future results.

TRUST

China has produced spectacular growth and progress, but there is little trust in Chinese society. The Socialist Revolution attempted to replace the social fabric with the greater good of a socialist government, and then the Cultural Revolution cultivated fear and mistrust. Charity, and concern for others, dwindled. A client, visiting China, watched crowds stream past a man beating his wife in public.

The power of the Communist Party is growing. Cameras are everywhere; facial recognition, data capture, and artificial intelligence are being harnessed to exercise control over the citizenry. Technology is power, and power corrupts. If you want to know where they're headed, try Google-searching for "Organ harvesting from Falun Gong practitioners in China".

We're fortunate to live in a society where people trust and are trusted, and live willingly under a rule of law. We pay our taxes, pay back money that we've borrowed, and look out for the welfare of others. Property rights allow us to save for retirement; without them an investment in stocks, bonds, or property would be little more than a gamble.

Take a moment to feel grateful that you live in this time and this place. ■

115 Million People Are At Risk For An Inch Of Rain

– The Weather Channel.

Today lots of people don't know what a book is. Fortunately, we heard a good description on the radio. A radio is a music streaming app that you can access even when there are no bars showing on your phone and there's no WiFi.

A *book* is a sandwich made of paper, that's hard on the outside and soft on the inside. The paper is covered with words that don't do anything when you touch them. There is no need for cell service or WiFi, and you don't ever have to charge the battery. A book can hold its power forever.

"A third of Mexicans surveyed would choose to live in the U.S. if they had the means and opportunity. Since this question was first asked in 2009, this measure has not wavered by more than 5 points."

– Pew Research, less than a year ago. A third of the citizens in three other nations also say they'd like to move to the United States.

"It is not happiness that makes us grateful, but gratefulness that makes us happy."

– Brother David Steindl-Rast, a Benedictine monk.

RECAP

The Great Recession did not become a depression. The Fed's Quantitative Easing program did not create runaway inflation, and in fact the Fed has done very well for us. Inequality did cause a working-class rebellion, here and in Europe, but U.S. wages are rising—and the unemployment rate is at the lowest level since bubble-year 2000.

The stock-market crashes of 2011, 2012, 2015, and 2016 turned out to be mere corrections. We're not engaged in a global trade war. We're not living in a dictatorship, and we're not fighting World War III. ■

VENEZUELA

"After voting, Katerina Noriega, a street vendor in Santa Rita, was directed by Socialist activists to a warehouse to receive a couple of pounds of rice and beans, worth about ten days of work."

"'They bought our votes," said Mrs. Noriega, who acknowledged supporting the government candidate to get the free food."

– The Wall Street Journal. More than 60% of Venezuelans now live in extreme poverty, as a result of the "redistribution" policies of Hugo Chavez. Nicaragua has gone down the same path, and is using government cash to buy the votes of the poor.

Socialism concentrates power in the hands of one individual. In the United States that one individual would be Donald Trump. ■

THE GUSHER

In the last 3 months the price of oil dropped from $73 to $45, fueling the fears of panicked investors who took it as an omen of a shrinking world economy. But prices aren't falling because demand is shrinking; they're falling because the United States is producing an amazing amount of oil. How can they possibly spin this as a negative for our economy?

What's really happening is that U.S production is gushing through global markets like the 1927 Vermont flood. The head of the International Energy Agency (EIA) says that just six years from now the United States will produce more oil than Saudi Arabia and Russia *combined.* Roughly *twice as much as either of them.* And the United States Geological Survey just announced a new estimate of 46.3 billion barrels of oil in a small region of Texas known as the Permian Basin.

To those who worry about climate change it's an ugly trend, but we hardly ever hear calls for higher gas taxes or new nuclear plants. Meanwhile the working poor are getting a windfall from cheap gas prices, and inflation is being held down. Automation and productivity gains are everywhere in the oil fields, and wages are soaring. ■

Drew D. Kellner, CFA

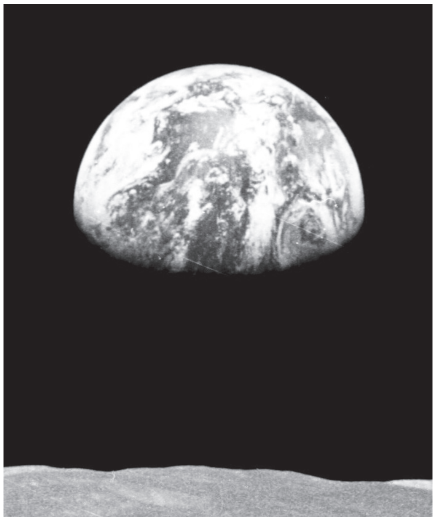
The oil glut *is* bad for energy stocks. And more oil could be on the way, because the EIA says that Venezuela holds the largest "proved" oil reserves on the planet. Hugo Chavez wrecked his "nationalized" oil industry along with food production, health care, and everything else, but now China is stepping in to help. Venezuela needs China's money and expertise, and China needs Venezuela's oil. It's a marriage made in … ah …

FEDEX

Fedex operates the world's largest cargo fleet with nearly 700 aircraft, most of which it owns. It's an investment of more than $20 billion, or $63 a share. Competitors UPS and DHL (Deutsche Post) each own about 250 jets, and charter smaller planes when needed.

Last year's big fear was that Amazon would go into the shipping business, but Amazon was never a huge customer for Fedex. Amazon leases 50 planes but doesn't own any, and it will have its hands full trying to deliver its own packages. The bigger problem for Fedex, announced with otherwise-upbeat earnings in December, is weakness in Europe. Some of the economies of Europe seem to be shrinking, and TNT (acquired by Fedex in 2016) isn't meeting expectations.

Fedex shares plunged, and now sell at 10 times earnings. The market value of the company is just $42 billion. That compares to $84 billion for UPS; $39 billion for Kimberly-Clark, the paper company; $740 billion for Apple; and $65 billion for woeful GE. ■



"From out there on the Moon, international politics look so petty."

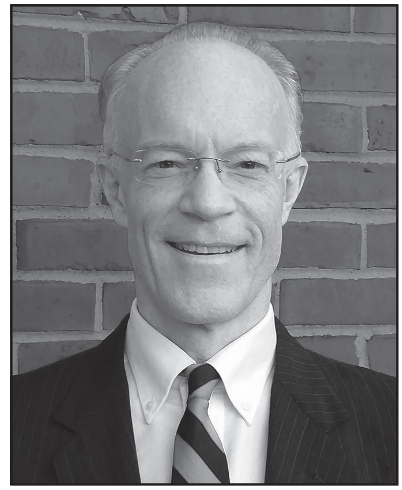
– Edgar Mitchell, the 6th man on the moon.

John Templeton said it best: ***"Invest at the point of maximum pessimism."***

HYPE

In December of 2017 Bitcoin reached a peak of **$20,000**! It now stands at $3,925. The intangible metal never lived up to its breathless hype.

Same for autonomous cars, which now seem Uber dangerous. Blockchain hasn't revolutionized much of anything. "Peak Oil" peaked a long time ago. Amazon turned out to be a hyper-aggressive purveyor of cheap Chinese goods, using its Amazon Web Services profits to try to kill off its retail competitors. Netflix runs at a real-world loss, spending far more on new shows than it earns, because it's trying to kill off its competitors. Google and Facebook have no competitors, and Facebook doesn't censor enough. Except when it's censoring too much. ■



John Lumbard, CFA

January is blueberries and whipped cream month. Blueberries because they fight cancer and Alzheimer's, and whipped cream because Christmas is over and the days are really short. When it's 33 degrees and raining you are permitted to put whipped cream on *everything.*

"If you were to ask most Americans which is the poorest state in the nation, they might say Alabama or Mississippi, with their low average incomes and concentrations of African-American poverty. In fact, the state with the largest share of people in poverty is California. As the most populous state, it also has by far the largest number of poor people, 7.4 million."

– The Economist. McKesson, Core-Mark, and DJO Global just announced that they'll move from California to Texas. 'Fornia has become an over-regulated, overtaxed state with a huge sexual-harassment problem in Los Angeles and the Bay area.

The economy *wants* to grow, says John Convery. It only stops growing when something—perhaps the Federal Reserve, unreasonable regulation and taxation, or the bursting of a bubble in the real estate market—*prevents* it from growing. So don't ask "what's going to make the economy grow?" A better question is "Are there any forces powerful enough to keep the economy from growing next year?"

– John Lumbard, CFA

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