STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS SUMMER, 2013

LUMBARD INVESTMENT COUNSELING

INSIGHT

S&P 500 1,651 * Dow Jones Industrials 15,294 * 30 year U.S. Treasury Bond 3.2%

HAPPY DAYS ARE HERE AGAIN

The economy is strengthening. Home prices have jumped 10% in the last twelve months alone, and home equity—the part of the home that the homeowner actually owns, is up an incredible ***25%***. Over the same period the stock market is up 20%, adding another $2.5 trillion to the suddenly-bulging pockets of the average man in the street.

It's about time. The official start of the last recession was December of 2007 (in a newsletter the next month we declared that a recession was underway); and while it ended in June of 2009, consumers continued to reduce their debt until the final months of 2012. The federal government took up the slack, borrowing and spending in their stead; this softened the pain of 2009 and 2010, but there was a heavy price to pay in the following years—above and beyond the burden of trillions of dollars in additional debt.

It's called fiscal drag. Let's say the nation of Fluoristan borrows a trillion dollars and spends it. The GDP of Fluoristan for that year rises by (almost) a trillion dollars, causing the people of that great nation to feel rich and happy. The following year, however, the absence of that trillion dollars in spending would mean that GDP would be a trillion dollars lower. Sadness and tooth decay would spread across the land.

The only way to avoid that bitter decline in GDP is to borrow another trillion, and do the same again the following year. That's what Japan did, year after year, for 23 years . . . The really wonderful news of 2013 is that we've changed course. Two years of bloodshed in the halls of Congress have cut the federal deficit in half—*in half!*—and yet our economy has been able to shrug off the spending cuts and tax increases and grow.

In the first months of 2013 we've had to overcome the fiscal drag of a big increase in the FICA payroll tax, barely mentioned by the media, that's taking $115 billion out of the pockets of the 99%—while a new round of tax increases on the 1% takes $62 billion. The sequester cut government spending by $85 billion. These changes are permanent, but they'll only depress the growth of GDP this year. Growth will resume from a lower level of GDP, and the pace will quicken a bit because government spending is inferior to investment and consumer spending.

In the second half of 2013 our economic engines will be unleashed. Investors are snapping up homes, land, and commercial properties. Auto sales are strong, oil and gas production is booming, and manufacturers from all over the world are building plants in the U.S. to take advantage of our cheap natural gas, plentiful labor, and access to consumers and markets.

With interest rates this low stocks should be twice as high as they are today, and they'll still look cheap even when interest rates have doubled. Corporate earnings are growing nicely—on page 3 Paul Wright explains why—and most of the monsters (European bankruptcies, our own deficit, the sequester, tax

Continued on page 2

HAPPY DAYS ARE HERE AGAIN

... Continued from Page 1

increases, Quantitative Easing) have been shooed out from under the bed.

Wall Street is suddenly brimming with confidence, and that makes us feel . . . uneasy. When the stock market is rising it "climbs a wall of worry"; when you feel like you're riding an elevator to the top, you should worry that you're nearing a top. And this is a time of year when interim tops are common.

The Stock Trader's Almanac says that $10,000 invested in the Dow since 1950—but only in the market from November through April—would have been worth $684,073 at the end of 2011. The same $10,000 invested from May to October for 61 years would have *lost* $1,024. The seasonal pattern exists in stock markets all over the world, and in the US in recent years it's become worse, not better!

Yes, we think that's crazy too. We did trim our oversized equity positions in recent weeks, hoping to reinvest at lower prices in the dog days of September, but we're taking some money temporarily out of stocks, rather than setting cash aside because it's safe. There's nothing safe about a near-zero return if you're living on the income from your investments.

Bonds will eventually lose more money for investors than they lost in the financial crisis; John Convery elaborates below. Gold? The party is over. High unemployment rates are keeping inflation low, and the U.S. energy boom is driving up the value of the dollar. Stocks are the place to be, and we hope to be fully invested again before the first blaze of autumn rises from the valley bottoms. ■

John Convery Jr., CFA

BEWARE OF BONDS

Interest rates have been falling for more than thirty years. That's the same thing as saying that bond prices have been rising, so the track records of bond funds, pension plans, and all things "low risk" or "fixed income" have been terrific. That's about to change.

More wealth will be lost in bonds in the next few years than was lost in stocks in the financial crisis.

The prices of long-term bonds will fall more than the prices of short-term bonds, and they have a long way to fall. In 1981 the yield on a 30 year US Treasury bond reached 16%, which means that a $1,000 bond paid annual interest of $160. Those bonds became more and more valuable as interest rates declined; new ones now pay just $32 a year, or 3.2%.

These are the lowest rates the country has seen since the Mayflower landed—pushed down to artificially-low levels by the Federal Reserve. Eventually the yield on 30-year treasuries will rise from 3.2% to 7.2%, which means that the price of the bond will be cut in half. **Down 50%!!**

The really big danger will be the investments that seem too good to be true; the kind that offer a good rate of interest and a guarantee that you can't lose. There's always somebody on Wall Street who is willing to cook up can't-resist financial products for a public that is unable to fully understand the dangers involved.

When the chickens hit the fan, Wall Street firms will insist that they fully informed their customers of the risks. Do your own homework, and remember that investments which seem to be too good to be true are nearly always too good to be true. ■

FAIR WINDS

The Congressional Budget Office now estimates that the 2013 federal deficit will be just $642 Billion. That's still about $4,000 in new debt for every American under the age of 40, but it's a vast improvement over last year's $1.1 trillion. And the deficit for 2015, two years from now, is expected to be just $378 billion.

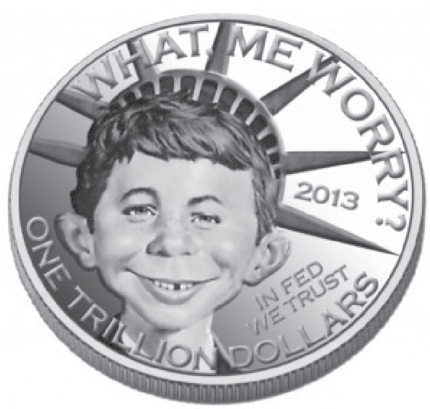
The red ink will climb rapidly again when the bulk of Baby Boomers have entered retirement, but it will be years before investors again worry about the federal debt or a European-style panic. And in those years you can expect moderate inflation (that reflects persistently high unemployment) and solid growth in corporate earnings.

We're now forecasting that the economy will grow at a 2.5% rate in 2014, and that nominal GDP—that is, GDP that hasn't been adjusted for inflation—will grow at a 4.5% rate. It's the growth of *nominal* GDP that matters to investors, because that's how fast the U.S. sales of large corporations grow.

That's not all. These companies will probably see faster growth from their overseas operations, and earnings *per share* will continue to grow a good bit faster than earnings because so many companies have been buying back shares at bargain prices. Put it all together, and the companies of the S&P 500 should be able to produce 6% growth in earnings per share, *and* another 2% in dividends.

The result is our forecast of an 8% annual return on stocks, from now to 2017, even if the price-earnings ratio on stocks stays right where it is. That PE ratio has been far too low for this level of interest rates, because shell-shocked investors have been holding too much in bonds and cash. In the late stages of this long bull market they will almost certainly push stocks *above* fair value . . . Those who were able to overcome their fears the earliest will benefit the most. ■

The S&P 500 index—now at an all-time high of **1,651**—hasn't gone much of anywhere in the last 12 years, but in 1990 it was at 340. In 1974 it was at 63! That is, it's multiplied 26 times in 39 years, and in every one of those years the companies within the index paid dividends.



To claim your trillion-dollar coin, write to:

The Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Paul K. Wright, CFA

A SALUTE TO EL PRESIDENTE

"Venezuela's crumbling bridges, thieving officials, uncontrolled inflation and high crime rates resulted from Mr. Chavez's management style, a kind of chaotic authoritarianism."

–The Economist

Chavez retained his popularity because he knew how to buy votes with Other People's Money. Even now Venezuela buys gasoline in the United States for $2.86 a gallon, and sells it in Venezuela for 18 cents a gallon . . . The subsidies cost $27 billion a year; more than the nation spends on education and health care combined. Food is also cheap, but price controls have driven farmers into bankruptcy and left the shelves of supermarkets bare. This is what "social justice" looks like in practice. ■

The Dow Jones Industrial Average has multiplied *153 times*—not including dividends!!—since 1942.

THE PUNDIT WARS

The economy is accelerating. It's been almost four years since the official end of the 2007-2009 recession, yet New York Times op-ed columnist Paul Krugman is still calling for more stimulus spending! Maybe if we were to pave every road *every* year . . .

Last month the former economist joined a grad student at U. Mass Amherst in attacking data showing that heavily-indebted countries don't grow as quickly as well-managed ones. The study has been interpreted, worldwide, to mean that these countries should temper their enthusiasm for going even deeper in debt. Pundit Paul fired back:

"The drive for austerity has lost its intellectual fig leaf, and stands exposed as the expression of prejudice, opportunism, and class interest it always was."

Fiscal responsibility and good government; it's just another form of class warfare, racism, and greed! The growing debate became even more entertaining when talking head Henry Blodgett, banned for life from the securities business for pumping internet stocks at the top of the 1999 bubble, jumped in to declare Krugman the winner. Then Partisan Paul offered up ***Japan*** as a reason why we could afford to take on a lot more debt!

Japan has been following the Krugman program since 1990, with nothing to show for it other than a moribund economy and the world's largest debt. Japan's government *now spends twice as much as it raises in taxes,* because each year it takes more and more caffeine to give the same jolt.

No worries! The new plan is to print vast quantities of money to buy up the government's debt, drive down the value of the yen, and push inflation to 2%. So far it feels great, but 2% inflation will surely push the yield on Japanese debt to 2% or higher. At 2% the interest cost on the bonds will consume half the nation's tax revenue. ■

TOO BIG TO JAIL

"Attorney General Eric Holder, the top U.S. law-enforcement official, finally admitted this week that bank executives truly are above the law and may commit crimes with virtual impunity."

– MarketWatch

If you ever wondered why banker bailout beneficiaries were treated with kid gloves after the financial crisis, it helps to understand that the bankers and the people who regulate the bankers are the same people.

For two years before and during the financial crisis our new Treasury Secretary, Jack Lew, was the COO of Citigroup's "proprietary trading" group, which engaged in risky trading for the bank's own account, sometimes in conflict with the bank's customers. In those two years he received bonuses of $900,000 . . . Soon after his departure Citigroup failed, and was rescued with $45 billion of taxpayer funds.

A ban on proprietary trading—they're calling it "Glass-Steagall Lite"—is said to be the only good part of the bloated and ineffective Dodd-Frank legislation. Glass-Steagall, repealed in 1999, used to prevent banks from entering the risky and lucrative businesses of Wall Street, and its repeal is often cited as one of the many causes of the financial crisis. The Treasury Secretary in 1999 was Robert Rubin (banks are regulated by the Treasury Department), and the Director of the White House Budget Office was Jack Lew.

Rubin left Washington soon after, to become a director of Citigroup; chairman of the executive committee and even chairman of the board for a short time during the crucial months that preceded the financial crisis. Bloomberg News says that Rubin received total compensation of $126,000,000 from Citigroup between 1999 and 2009. ■

"Nobody on this planet represents more vividly the scam of the banking industry. He [Rubin] made $120 million from Citibank, which was technically insolvent. And now we, the taxpayers, are paying for it."

– Nassim Taleb, author of The Black Swan.

THE OBAMA TAX CUTS

In the final days of 2012, as the Bush Tax Cuts were about to expire forever, the sitting President pressed to make them permanent for nearly every American. There was a brief debate about whether "nearly every" meant 98% or 99% of all taxpayers (in the end 99% prevailed, with the support of heavily-taxed urban Democrats), but *no discussion at all* about whether the Clinton tax rates might be a good idea for the other 98% of the population—either now, or at some point in the future when the economy is stronger.

That made no sense, in the context of the media's endlessly-repeated assertion that the Bush tax rates were a Giveaway To The Rich, so a confused client asked us what the heck was going on. Weren't the Clinton rates better?

The Clinton rates *were* better at collecting revenue, and we're going to have to return to those levels (and add some European-style taxes on top) if we're going to pay for the higher spending levels of today and tomorrow. We're spending more than we've *ever* collected in taxes, so it's utterly clear that these tax rates mean deeper cuts to Medicare and other entitlements . . . We're reaching the point where the only way to deal with the entitlement crisis is to tell the Baby Boomers that they're not allowed to retire. Ever.

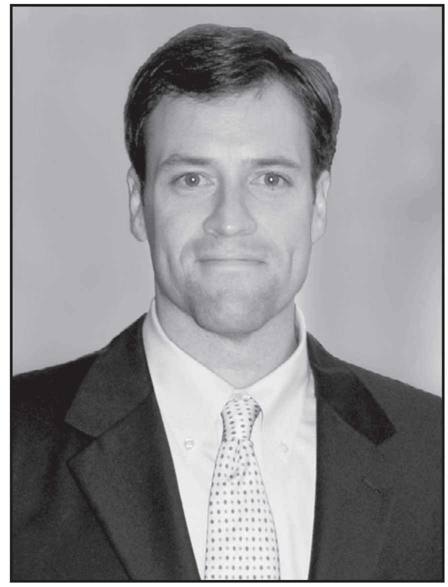
So how did this happen? The answer is that the Bush tax cuts were not, after all, a giveaway to the rich. If we had gone back to the Clinton rates in January the workers in the lowest tax bracket would have seen a huge tax increase.

In fact, the tax on the first $17,850 of income (married filing jointly) would have gone up *fifty percent*, from 10% to 15%. At higher rates the Bush cuts were actually less dramatic; a return to the Clinton rates in January would have meant that the portion of your income that is between $146,000 and $223,000 would have ticked up to 30.5% from 28%. There would have been an even-smaller increase from 33% to 35.5% on income earned in the bracket that runs from there to $400,000.

Didn't happen. And there didn't seem to be anybody in Washington who wanted to allow the automatic return of the Clinton tax rates for taxpayers who earn *five times* the median household income of $50,054.

What did the media have to say about all this? The silence was deafening. ■

Our first article on the (then-unrecognized) shale gas boom was in our Fall 2008 issue. It was nice to be able to offer a bit of good news in the middle of the financial crisis, and the better news was that we were sitting on many millions of dollars' worth of long-term U.S Treasury bonds. Look for the "Decline and Fall, 2008" issue on the "Archives" or "Hindsight" tabs at www.Lumbard.com.



Drew D. Kellner, CFA

OCTUPLED

A few months after we opened our doors in 1990, a client opened an account with $100,000**. She never made any additions or withdrawals, and has always paid a full fee.

We manage the account without favoritism, diversifying globally and conservatively among stocks, bonds, and cash. Over the course of 22 ½ years the portfolio **has doubled three times, growing to $850,801**. If you'd like further information, please call us at 800-Lumbard, or visit our website:

www.Lumbard.com

***Our current minimum is $1.5 million*

"It is much more important to kill bad bills than to pass good ones."

– Calvin Coolidge

THE FUTURE OF MANUFACTURING

The products of the future are being developed right here in New Hampshire. On one side of a room crammed with factory-automation wizards and machines is an assembly line for an inexpensive device that will do a battery of diagnostic tests—heavy metals, bacterial and viral infections, blood sugar, etc—for the doctor-starved patients of the future.

On the other side of the room is a future manufacturing line on which products travel, via monorail-style magnetic propulsion, to nine stations on a track—where they're sized up by robotic vision and then shaped by lasers. Each station has a separate logic chip that can be programmed independently, and additional stations can be inserted if needed. This flexibility means that changes can be incorporated much faster than in the manufacturing centers of China . . . CEO Jim McClellan is very much focused on bringing manufacturing back to the US, and argues that the labor cost in many goods is now so low—or *can* be so low—that there is no reason to go to the trouble of going to China, dealing with language and cultural barriers, and taking giant risks with intellectual property.

We've steered our clients through bubble and bust by differentiating between the things that matter and the things that don't.

For the most part these new technologies are separate from—in addition to—the burgeoning field of robotics, and the 3D printing of prototypes and actual metal parts. The need for cheap labor is shrinking rapidly. It might be that the cheapest-labor countries (Vietnam, for example) won't be affected for a long time, because there are still industries where cheap labor is still the best way to get things done. And there won't be many layoffs in the U.S. or Japan, which have already migrated to the high end years ago. It's the countries in the middle that have a lot to lose, and that means China.

There's a lot of potential for American firms here; but McClellan says that we've driven many of his customers, and all of the nation's medical-device manufacturing, overseas. We've done that with excessive FDA oversight, OSHA and EPA red tape, mandates for the Affordable Care Act, and corporate taxation

"The NHTSA, in a study of crash data harvested from black boxes installed in cars, found that just 1% of drivers involved in the collisions applied the brakes at full force before the collision. About 33% of the drivers didn't apply the brakes at all."

– The Wall Street Journal

John Lumbard, CFA

that is nothing at all like the General Electric examples you see on the TV news. *Lots* of companies pay at a 35% rate, or used to pay at that rate before they moved the corporate headquarters to friendly Switzerland, Ireland, or Bermuda.

It's a normal and natural thing for paperwork and complexity to grow. More laws, more regulations—everybody has an idea, and a chance to put his stamp on eternity—and more burdens on economic growth. Politicians like to announce targeted tax breaks, and invest taxpayer dollars in green companies that later turn brown. But what we need to create jobs are simple and fair rules and regulations, which offer a predictable and friendly environment.

– John A. Lumbard, CFA

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.

General Disclosures:

Statements in this communication are the opinions of Lumbard & Kellner, LLC and are not to be construed as guarantees, warranties or predictions of future events, portfolio allocations, portfolio results, investment returns, or other outcomes. None of this material is intended as a solicitation or offer to purchase or sell a specific investment. Readers should not assume that all recommendations will be profitable or that future investment and/or portfolio performance will be profitable or favorable.