Lumbard & Kellner

INSIGHT

S&P 500 2,925 * Dow Jones Industrials 26,362 * 30 year U.S. Treasury Bond 1.98%

BIGGER YIELDS

Why would anybody buy a bond with a negative interest rate?

A client asked us that question recently, and we have no idea. Yes, if you've run out of mattresses and vaults to stuff your money into, you might pay to have somebody hold your cash. But why would you agree to lock in a lousy rate for more than a month or two? Germany just sold *30 year bonds* at a negative interest rate. In Denmark you can even get a negative interest rate on a home mortgage!

They're *paying* you to borrow money. That's a powerful incentive to buy a house, or borrow money to buy stocks with gigantic 2% dividends. Or buy American bonds, because the CEO of Bank of America says that more than 80% of all the bond interest that's now being offered to world investors is in the U.S.A. Our bonds are attractive to Germans, Danes, and the Japanese, and you can bet that the fearful citizens of Hong Kong and Taiwan are clamoring to buy American securities as well.

All this buying is pushing our bond prices up. When bond prices rise they make stocks look like a bargain—stocks should rise as well—and our bond prices are now so high that the dividend yield on AT&T stock is ***twice*** the yield on 10 year AT&T bonds. AT&T's dividends grow over time, but its bond interest doesn't grow at all … There's a bubble in our bond market, and there's a much bigger bubble in the bond markets of other countries.

Of course, doomsayers are spinning the low bond yields as *bad* for stocks. It's a yield curve inversion! But let's not ignore the obvious; bonds are being driven higher in price because foreigners are buying.

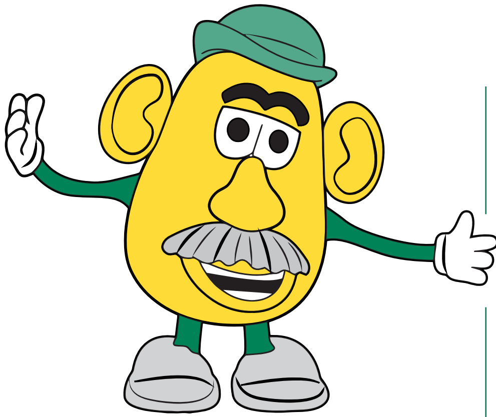
This is *not* an inversion that happened because short-term rates rose sharply. When the Fed thinks inflation is getting out of control it pushes short-term rates sharply upward, knowing that a recession will probably result. The Fed "takes away the punch bowl because the party is getting out of hand".

Party? Today's mood is more like the gloom, suspicion, and fear of 2009! Right now the Fed is lowering rates, not raising them, despite a red-hot job market, rising wages, and narrowing inequality. And Congress just passed The Budget-Busting Bipartisan Budget Act of 2019, which showers money on everybody in an effort to buy votes—for incumbents of both parties!—in the next election. This is a time of stimulus! ■

Our federal deficit is larger than a trillion dollars a year, so each year the debt our children will carry grows by more than a trillion dollars. It dwarfs the problem of student debt. You'd think that this would be a big issue in the 2020 presidential election, but not one of the candidates, in either party, is offering any serious plans.

"The principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."

–Thomas Jefferson, 1816



Mr. Tater Head

TWATTLING

Can we talk ourselves into a recession? Some comment-Taters in the media say we can. If that were true we would have had a recession in the winter of 2015-2016, when the economy slowed, fears ran wild, and the stock market dropped 13%.

Those media-generated fears have a surprisingly small effect on consumer spending. Ask yourself whether the scaremongers are actually cutting back their own spending!

Fear is usually *good* for the economy. The financial crisis was the result of a *lack* of caution on the part of millions of real-estate investors, mortgage lenders, and congressmen. The problems in mortgages and real estate were obvious, but there was euphoria in the public and in the media. The 'Taters in media were eager to teach you how to flip houses, and *stop wasting your money on rent.*

2019 is more like dysania, "a condition in which the afflicted find it extremely difficult to get out of bed in the morning." Remember the words of John Templeton:

"Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

If you see any maximum optimism, please give us a call. ■

A reliable source tells us that illegal-immigrant day labor, paid under the table, now goes for $18 an hour in farm country. Yes, it's harvest time, but this says a lot about our red-hot labor market. Employers are working late into the evening to find ways to get by with fewer workers, and that's been pushing up productivity for more than a year. Higher productivity allows employers to pay higher wages without pushing up inflation, and it allows faster GDP growth.

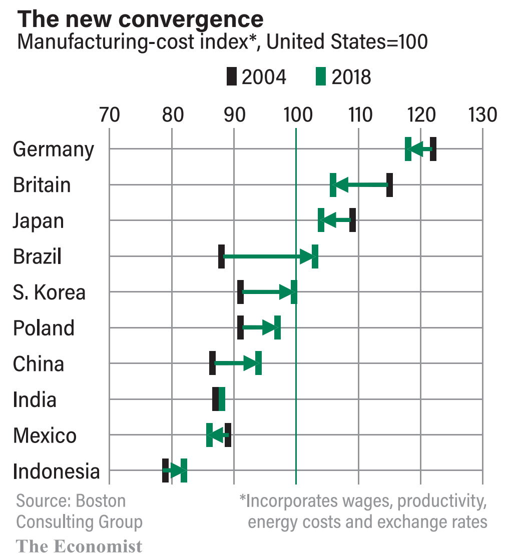
Last year's headlines about wage stagnation and growing inequality were being left in the dust even as the 'Taters were bloviating about them. Low unemployment rates change everything.

The United States is now the world's largest producer of oil. When OPEC and Iranian missiles push up the price of oil we no longer need to plead, bully, or cajole.

GOOGLE

Google got so large that its growth just *had* to slow down, and it has. Now it's growing at just ***nineteen percent!*** And the company, a.k.a Alphabet (GOOG - $1,193), has $121 billion in cash. The stock should be far more expensive than it is.

It now costs a lot more to manufacture in China than in India, Mexico, or Indonesia. American companies have good reason to look south of the border! And within Europe Poland is still a bargain. Germany, not so much.



The dividend on **Goldman Sachs** (GS — $203) is 2.4%, and the PE is just 7. Germany's Deutsche Bank has just withdrawn from equities trading and some bond businesses, and Goldman will benefit. Back in 2010 Deutsche was the top investment bank in Europe, but today the top five are all American firms.

WAGES ARE SOARING

"Everyone says work is miserable. Today's workers, if they are lucky enough to escape the gig economy and have a real job, have lost control over their lives. They are underpaid and exploited by unscrupulous bosses. And they face a precarious future, as machines threaten to make them unemployable.

There is just one problem with this bleak picture: it is at odds with reality. In America the unemployment rate is only 3.6%, the lowest in half a century … Tight labor markets lead firms to fish for employees in neglected pools, including among ex-convicts, and to boost training amid skills shortages. American wonks fretted for years about how to shrink disability-benefit rolls. Now the hot labor market is doing it for them."

— The Economist

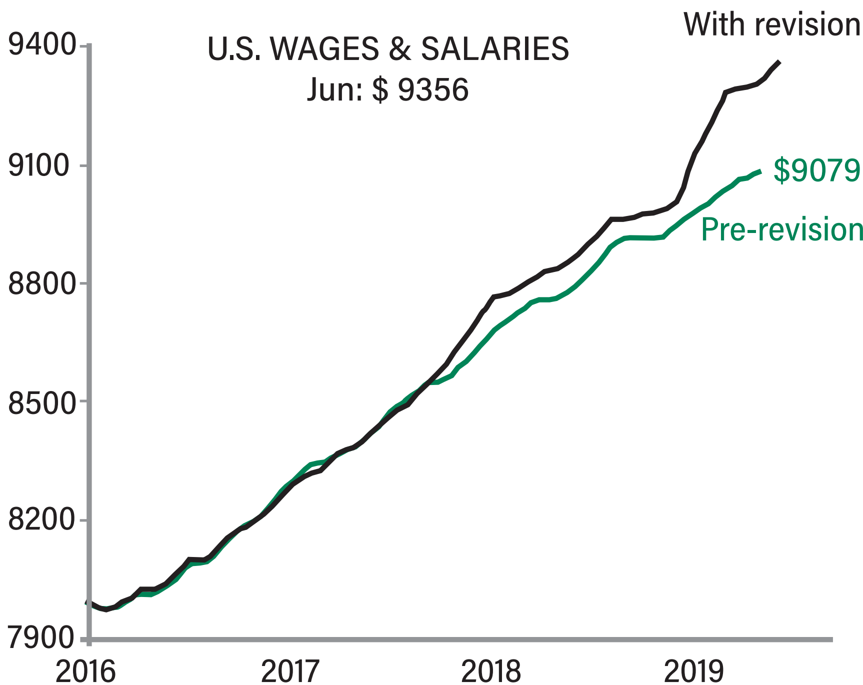
Earlier this year economists wondered why, with an unemployment rate below 4%, wages weren't growing faster. The answer came from the Bureau of Economic Analysis in July, with big upward revisions of wage and personal income data.

In 2017, American employees earned $8.5 trillion in wages and salaries. In 2018, that number rose to $8.9 trillion, and in the second quarter of this year compensation jumped to an annual rate of $9.4 trillion. That's $277 billion more, in employee pockets, than the statisticians had previously estimated. Prior to the revision they thought that wages and salaries were growing at 3.6%, and now they believe that they're rising faster than 5.5%!

Workers are saving more money than anyone expected. The personal saving rate was revised up from 6.7 percent to 7.7 percent for 2018, and it's now running at 8.1%. By comparison, in 2005 the personal savings rate hit a low of 2.2%.

Meanwhile inflation is below 2%. Workers are seeing big income gains, and they're losing very little of that to inflation. No wonder consumer confidence is so high. ■

Paul K. Wright, CFA



– Ed Hyman, Evercore ISI

THE PERFECT POLITICIAN

"Because he is all but empty of political convictions, people use him as a repository for their own."

– The Economist, describing the success of Boris Johnson of Britain. It's now obvious that Europe is going to be hurt badly by its insistence on "a bad deal for Britain". It's time to wake up and smell the coffee.

CHINA

"The reintroduction of Marxism is part of Xi's grand scheme to offer a new governance model based on authoritarianism and economic progress, as compared to that of Western democracies."

— South China Morning Post

And why not? In America, citizens can vote money into their own pockets, and they do. Politicians are more than happy to win office by promising more spending … Rising debt will cause us to reduce defense spending, and China will rule the seas. They'll annex Taiwan, bully their neighbors, meddle in our elections, and take control of the governments of nations that produce the raw materials they need.

Not this year. In 2019 Mexico's trade with the United States has been *larger* than our trade with China, and Canada was second. China derives 4 percent of its GDP from exports to the United States … Our exports to China fell 19%, but they're only ½ of 1% of our GDP.

The Hong Kong protests probably keep Xi Jinping up at night, but a bigger problem is that in the last decade China's growth has been fueled by debt. The assets of Chinese banks (that is, the loans) are now $40 trillion, ***four times*** the level of ten years ago. The assets of America's banks, all of them, total just $17 trillion.

Chinese banks are controlled by the government, and they mostly lend to government-controlled companies. The latter perform poorly, as you would expect, and the banks hold lots of bad debt.

Private companies in China have little access to bank loans, so they raise funds from friends, family, and private financial companies. Last year this "shadow" lending grew to $10 trillion, and the authorities moved to shrink it.

In less than a year these loans had shrunk by a *trillion U.S. dollars!* The intentional shrinkage came at a time when American multinationals were pulling manufacturing orders away from China and giving them to factories in Southeast Asia. Many Chinese companies went into bankruptcy.

Eventually the Communist Party moved to stop the carnage, but let's be clear: our notion of property rights has no place in China. Private industry is tolerated as long as it serves the goals of the party. Foreign investment is encouraged as long as money flows into the country, but the notion that Americans sitting in armchairs might harvest *profits* on their investments is distasteful. And it's not just property rights; Bloody Harvest and the China Tribunal insist that China is a world leader in organ transplants because it uses the prisoners in its jails as an organ bank.

China still has lots of ways to stimulate growth. But every time they solve a problem in the economy they create a new one, which then requires a new solution. It's ***whack-a-mole government***. Centrally-planned economies rarely succeed, because it's hard to incentivize workers and management in appropriate ways.

In July we sold our shares of the Matthews Asia Dividend fund, which had increased its mainland-China holdings. And suddenly the fund's Hong-Kong-listed "H" shares didn't seem much safer. We used the proceeds to buy funds that invest in Taiwan, South Korea, Indonesia, Thailand, Malaysia, and other emerging markets—which have fallen 23% since the beginning of 2018. These free-market economies are enjoying solid growth, and we hope they'll benefit from the urgent efforts of American firms to source manufactured goods from places other than China. ■

"China's Central Committee did not appoint a dictator because China was doing well; it appointed one because it was not doing well. It needed radical change, and entrenched interests resisted measures that would introduce such change. Dictators arise in times of crisis, not in times of glorious vistas."
– George Friedman, Geopolitical Futures.

SELL YOUR RETAIL STOCKS

The International Council of Shopping Centers says that Germany has 2 square feet of retail space per person. The stores of France offer 5 square feet of space to every citizen. The United States has ***twenty-three*** square feet of space. Amazon plans to shut most of it down.

WHAT'S IT WORTH?

The revenues or "sales" of corporations grow at the rate of GDP, plus the rate of inflation. If GDP grows at 3% and inflation is at 2%, corporate revenues will grow at 5% or so. This has been going on for centuries, and will continue in the future to Warren Buffet's "Dow 36,000" and far beyond.

Stocks sell at 17 times earnings. That's a lower PE than we had in 2015, 2016, 2017, or most of 2018. It's an earnings yield of nearly 6%. Companies will pay out about a third of that, 2%, as dividends, and those dividends will grow over time. The 1.58% yield on 10 year U.S. Treasury bonds never grows at all. Meanwhile, corporations are using a big chunk of their earnings to buy back shares, which means that next year fewer shareholders will divvy up the same big pool of earnings. Fewer shares will allow bigger earnings for each share.

"Value" stocks have become cheaper and cheaper, relative to the overall market. The earnings yield of Prudential (PRU- $83) is almost 15%, and it pays a 4% dividend. AT&T and Singapore Telecom yield 6%, cash in your pocket. Eventually value stocks will again outperform the market, for a long time.

In the last half century stocks have gone up so much that it's been risky to take money out of the stock market. Yes, we avoided big losses in 2008 by raising cash in 2007. But the money that investors "make" in trying to avoid losses is dwarfed by all the money that is lost by fleeing to safety at the wrong times. That's when most people flee to safety.

If investors ever learn to flee to safety at the right times, they'll buy low and sell high. The stock market won't be volatile at all. ■

Drew D. Kellner, CFA

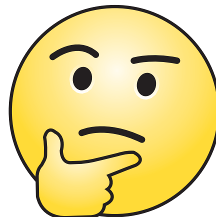
For decades we've been publishing the performance of an account that pays fees and never adds or withdraws money. It's currently valued at $1,204,073 up from $1,089,798 at the end of December, when fears of recession ran wild. Why did the panicked low have to come at the very end of a month that happened to be the very end of the year?

These years have been hard on value investors, and hard on those who invest overseas, but the portfolio is worth nearly six times its value at the peak of the stock-market bubble, on December 31, 1999: $216,635. For further information please see our website, www.Lumbard.com.

WURST

Jimmy Buccellato, a professor of criminology and criminal justice at Northern Arizona University, speculating last year about the disappearance of Jimmy Hoffa:

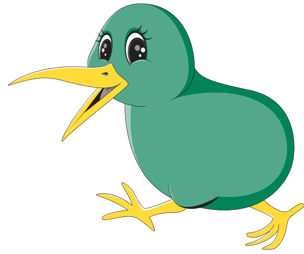
"I believe he was taken immediately, his body, to either a funeral home on the east side — I don't want to mention it because it's still a prominent funeral home on the east side that was once upon a time owned by the mafia," Buccellato said, "or possibly to a sausage factory in Detroit."



There's been a lot of fear, expressed in the stock price of Fedex (FDX – $158), that Amazon plans to pick up packages as well as deliver them. It doesn't make a lot of sense. Anthony Chukumba of Loop Capital suggests that if Amazon, with its $900 billion market capitalization, really wants to do this it can simply buy Fedex, which trades in the stock market for a mere $41 billion. UPS would cost almost exactly twice as much.

The Goldilocks Economy

"No one likes room temperature tea", says Phil Bak, founder of the Reverse Cap Weighted U.S. Large Cap ETF. "They either want hot tea or ice tea."



It happened in New Zealand in 1984, in Sweden in 1994, and in Canada in 1995. Each of these nations suffered a painful financial crisis, slashed the size of its overgrown welfare state, and returned to health.

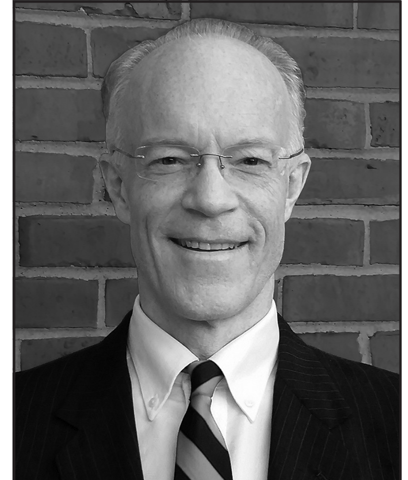
That's where we're headed in the next decade. We're running trillion-dollar deficits, and Medicare runs out of money in 2026. Less than 7 years from now! Medicare is just one of many social-safety-net programs that have been growing faster than the economy, and faster than the federal budget, for decades. Dozens of nations are in the same fix, so it's extremely likely that one of them has a better idea about managing the resulting funding problems, and the negative effect on work ethic and family structure.

Sweden now balances its budgets every year, and provides a welfare system that covers anything and everything; but $15-an-hour workers pay income tax at 32%, and pay a 25% sales tax on many items. The government owns less than a quarter of the nation's wealth, so this is *not* a socialist country, and Sweden.se, a government-funded website, wants you to know that. It insists that Sweden is "an example of how to optimise market capitalism", and points out that it "scrapped inheritance tax in 2005 and a wealth tax in 2007." The Swedes learned, through trial and error, that there's a limit to the tax revenue you can squeeze from the rich, and from corporations. The corporate tax rate is only 21.4%.

The U.S. collects about 27% of GDP in taxes, while Sweden collects 44%. In between are Canada and New Zealand, at about 32% of GDP. Canada's debt has been rising lately, but New Zealand's is among the lowest in the world—despite a top tax rate of just 33%.

So let's see why the Kiwis are doing so well. The big, obvious thing is that New Zealand spends only 8.7% of GDP on health care. Three-quarters of that is spent by the government. The rest comes out of private pockets and is spent at private hospitals and clinics.

So they have a big ***private*** system, *and* coverage for all citizens, *and* they spend literally half of the 17% of GDP that we spend. Even more shocking is that our government spends 11% of GDP on health care; nearly twice as much as Americans spend on ***private*** health care, and nearly twice as much as New Zealand's ***government*** spends.



Our federal, state, and local spending on health care is ***two trillion dollars*** a year; far more than any other government in the world. How big is two trillion? The IRS now collect $3.4 trillion a year in taxes, and that's the most that the IRS has ever collected in history.

If we could emulate New Zealand we could actually *reduce* our government spending, *and* have a robust *private* system that is free of the heavy cost burdens of Medicaid and Medicare, which have been driving up health care costs for decades.

Medicaid, Medicare, the Veterans Administration, Obamacare, SCHIP, and IHS are gobbling up the federal budget. If we can fix health care, Social Security and the other problems get easier. ■

– John Lumbard, CFA

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