STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS JANUARY 2023

Lumbard & Kellner INSIGHT

S&P 500 3,840 * Dow Jones Industrials 33,147 * 30 year U.S. Treasury Bond 3.98%

CAFFEINE AND CANDY

In the 2nd quarter of 2020 the pandemic caused GDP to go into freefall. It shrank at a 29.9% annualized rate; faster than in 1930-1933, but only for 3 months. The natural rebound, swelled by $2.2 trillion in stimulus-spending legislation, caused GDP to climb at a **35.3%** annual rate in Q3 of 2020.

After that roller coaster the economy probably needed a breather; but instead it got a trillion-dollar Transportation bill in November and another jolt of stimulus (the "skinny package") in December, quickly followed in March by the third stimulus bill, for $1.9 trillion. Inflation jumped from 1.7% in February to 5% in May, 7% in December, and 7.9% in February.

You know how an overdose of candy can cause children to bounce off ceilings? Afterwards they crash. GDP *declined* in the first half of 2022. Yet inflation was still roaring. Real wages were falling, and politicians love fossil fuels. So they pumped 220 million barrels of oil out of the Strategic Petroleum Reserve. 42 million gallons every day! And they pumped $450 billion of stimulative cash into the economy from the U.S. Treasury General Account. In August, with the elections approaching, they delivered another huge shot of caffeine and candy in the form of the "Inflation Reduction" Act and the Chips & Science Act. GDP went up!

Consumers are beginning to show signs of exhaustion. Consumer debt is rising.

Never fear! ***The Ghost of Christmas Present is here!*** The Omnibus Spending Bill (7,200 porky earmarks, 4,155 pages of text, 2,670 pages of mansplaining documents) *prevented a government shutdown* by raising the federal debt limit from $31.4 trillion to $34 trillion. **Funny thing is**, Congress could have raised the debt limit without spending anything. But Noooo … they spent $1.65 trillion to raise the limit by $3 trillion. That's Funny!

The Babylon Bee says that one of the items in the bill was **$1 billion to study the environmental impact of lighting $1 billion on fire.**

In 1998 federal spending—the whole damn budget—was $1.65 trillion.

Caffeine and candy bars can only take you just so far. And now the Federal Reserve promises to get serious about fighting inflation. Hooo boy. ■

GOOD NEWS

In July of 2021 strategists at UBS believed that the future 5-year average return for a "typical portfolio" 60% invested in stocks and 40% in bonds would be just 3.3%. Stock prices were very high, and bond yields were near all-time lows. Now, after a sharp decline in the prices of both stocks and bonds, they're forecasting a return of 7.2% over the next five years.

Future returns are getting better! A reasonable investor might invest part of his or her portfolio now, while holding enough cash to do some significant buying when the time is right.

When will the time be right? The great global investor John Templeton urged us to "buy at the point of maximum pessimism". We don't think we've reached that point yet, but meanwhile the future returns keep getting higher! ■

This April Elon Musk will pay an incredible $11 billion in tax. Not $11 million. $11,000,000,000. Of course, the federal government goes through 16 billion dollars every day.

We don't have enough billionaires. And we doubt that their taxes will go up much, because they are big political donors. For starters, let's insist that political campaigns give back the $40 million in donations they received from Sam Bankman-Fried. FTX investors would like to have that money! ■

Excerpts from the FTX 2018 offering document to investors:

We haven't had a losing week in six months

We offer one investment product: **15% annualized fixed rate loans**

For investments of $50m or more, we are willing to discuss higher rates of return."

[Editor's note:
Chortle! *Snollygosters*.]

HIGH RETURNS WITH NO RISK

These loans have **no downside** - we guarantee full payment the principal and interest, enforceable under US law and established by all parties' legal counsel.

[Editor's note:
Gormless trumpery.]

EARMARKS

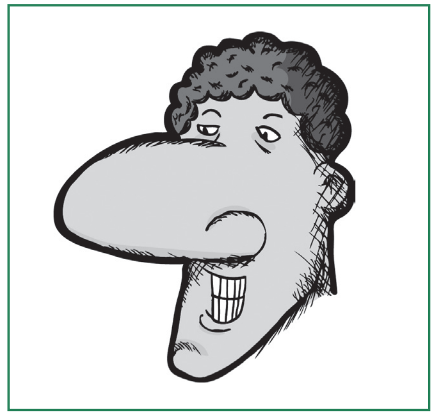
When a politician says that he, or she, will give solar panels to a YMCA or a school it sounds pretty good. But it wouldn't sound quite as good if you were told that the politician is taking money from children and using it to buy solar panels. That's true of every item in the Omnibus bill; the money will all be borrowed. It's debt piled on the backs of children, teenagers, and young adults, with a lesser impact on older adults.

In Maine we had a long conversation with a 34-year-old woman who "sat out the pandemic" by taking unemployment and pandemic benefits throughout 2021. When pressed she declared that money, in this modern era, is all "ones and zeroes" anyway. That is, it's just numbers in a computer. The government can give a million dollars to every citizen, with no negative consequences!

If *that's* the case, then it all makes sense. There might be tens of millions of voters who believe that the government's $31,000,000,000,000 debt is just an abstract idea that's never going to hurt them. For elderly voters, and especially for elderly politicians, that is probably true.

"Sam Bankman-Fried released on $250 million bond, will stay at parents' house".

— Reuters



"Beyond Meat suspends COO after alleged nose biting incident."

— Yahoo! Finance.

Sometimes, you just gotta have a bite of some *real* meat.

Social Security payments are about to jump 8.7%. Every old body gonna have a Florida vacation!

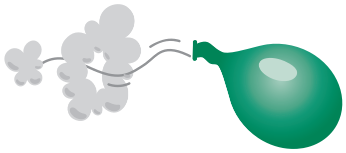
"Deaths involving synthetic opioids — largely fentanyl — rose to 71,000 from 58,000, while those associated with stimulants like methamphetamine … increased to 33,000 from 25,000."

— NY Times

The drugs are mostly manufactured from Chinese precursor chemicals by powerful Mexican cartels, and then smuggled across our porous southern border. By comparison 58,220 Americans died in the 20 years of Vietnam.

"Nothing like regular amphetamine use to make you appreciate how dumb a lot of normal, non-medicated human experience is,"

— Caroline Ellison, co-CEO of Bankman-Fried's crypto trading firm, on Twitter.com..

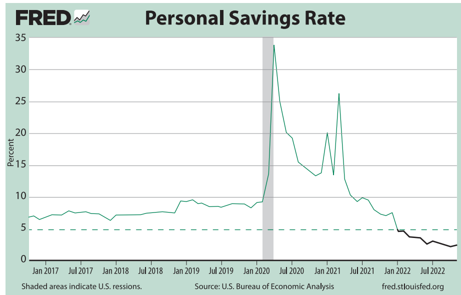


Months ago, in the Spring Issue, we said "Short-term interest rates might reach 4.5% within a year. We think that the odds of a recession, probably early in 2023, are 85% to 90%." Close enough, but wages and hiring are still very strong. Short-term interest rates will probably reach 5% or 5.5%, before a recession starts in the middle of the year.

We expect that recession to be mild. As a result, the rebound is likely to be unimpressive, as will the earnings rebound. And all this follows an uninspiring year in which GDP declined in the first two quarters.

Credit debt and home equity debt are rising. Consumers are spending, but they're draining their bank accounts. The party is likely to end towards the middle of the year, causing further pain for housing and probably auto sales. ■

Not long ago Wall Street analysts projected that S&P 500 earnings for 2023 would be higher than $230. We believe that these earnings will decline towards $185. This suggests lower stock prices. Corporate profits and profit margins have been higher than normal, because pandemic-stimulated consumers were so eager to buy that they were willing to pay almost any price for goods and services. Now, consumer demand is weakening. Worker turnover is crippling. And there's a chorus of complaints about poorly educated and poorly motivated new hires.



The personal savings rate was 8% or 9% before the pandemic hit. In April of 2020 it shot up to 33%, because people stayed home and received government cash in the mail. Savings spiked again in response to the second and third rounds of stimulus, but they've been shrinking ever since, to just **2.4%**.

Supply chain problems are fading, but wages are still rising rapidly. Probably at 5.5%. Inflation, historically, has run 1.0% to 1.5% below wage gains.

From here, inflation will be stubborn. Wage gains will have to decline to 4% or less to get inflation below 3%. It doesn't seem likely that we will be able to reach that goal without a much higher unemployment rate and a recession.

You'll never hear Jerome Powell say that his goal is a higher unemployment rate, but what other choice does he have? There is no other way to stop an inflationary spiral that is being driven by higher wages. ■

If the United States has to pay 4% interest on $31 trillion in debt, the annual cost will be more than $1.2 trillion!

Paul K. Wright, CFA

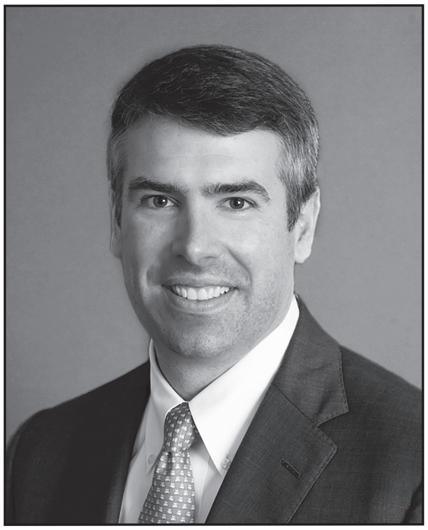
"You can't donate people out of poverty".

— Michael Roberts

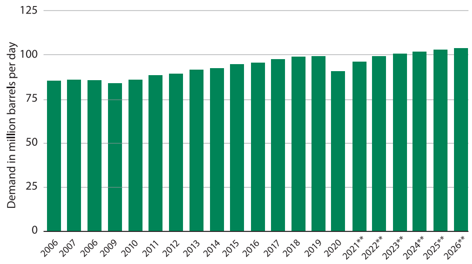
of the non-profit Hydrologic, which makes and sells a ceramic water filter that looks like a large flower pot. Villagers buy the filters with the help of microloans, and sell them to make a profit. The local economy is boosted, tens of thousands of people get access to clean water, and long-term jobs are created. All this at a modest cost; a low-tech, inexpensive factory, guidance, brilliant but simple technology, and microloans, which are usually paid back.

Now consider the condition of our inner cities. These communities haven't changed much since they were called "ghettoes". Trillions of dollars have been spent in the War on Poverty, fruitlessly trying to "donate people out of poverty".

Washington continues to offer "programs", which push money toward defined groups of voters, without any introspection regarding the continuing and repeated failure of these programs. We're doing what works for politicians, not people. ■



Jay Conway, CFA

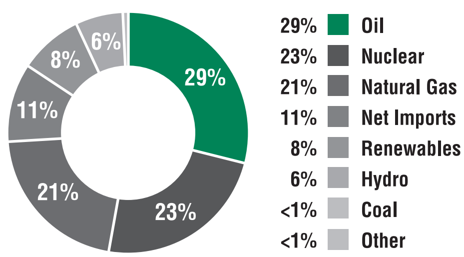


Global demand for crude oil, in millions of barrels per day; Int'l Energy Agency figures. Note the relentless growth.

According to McKinsey, world oil demand reached 100 million barrels per day in November of this year, up from 91 million barrels in 2013. Each year 36.5 billion ***new*** barrels (that's 365 days times 100 million) have to be found. That takes significant investment in discovery, in drilling, in production, and in pipelines, trains, ships, or whatever it takes to get the hydrocarbons to market.

A recession could easily cause demand to stop growing or decline for a year, but otherwise the world will need an *additional* 500,000 to 1 million more barrels of oil per day, every year, to keep up with population growth and the industrialization of developing nations. Energy demand in poorer nations—*most* of the world—will continue to grow rapidly, and they will continue to prefer the ease and low cost of fossil fuels.

Shortages of energy usually create price spikes, and often lead to dirtier alternatives. The New England electrical grid is a case in point. Normally we get 53% of our power from natural gas, 27% from nuclear, 16% imported, and 12% from renewables. Cleaner than most! But a refusal to build pipelines, or ease the restrictions on LNG tankers, has caused us to burn lots of dirty oil during cold snaps like the one in recent weeks. **On the day after Christmas our biggest source of power was oil:**



ISO New England Resources 12.26.2022

The prices of gasoline, propane, natural gas, and other fuels have been sliding in recent months, but higher prices lie somewhere in the future. Higher prices will be needed to encourage oil companies and other investors to take necessary risks, especially at a time when governments are trying to bring an end to fossil fuel consumption. When governments try to reduce drilling the price of oil goes up. Restricting pipelines causes the price of oil to go up. Increased use of renewable energy to make electricity causes the price of electricity to go up.

We hold shares of ARC Energy of Canada (AETUF - $13, Antero Resources of Ohio, West Virginia, and Pennsylvania (AR - $13), and Petrobras of Brazil (PBR - $10.6), which paid ridiculously-large dividends to our clients in the last year. If oil stocks decline in the coming recession we'll probably buy more. ■

Austria issued 100-year bonds at 0.85% in 2020, locking in a crazy-low rate for a *century*. Some bond buyers, such as insurance companies, simply *have* to buy long-term bonds as a hedge against long-term liabilities. Still, buying 100-year bonds at a yield below 1% looked stupid, *and it was*; they've declined more than 50%.

Over the years we've done pretty well with bond investments, and there's a simple reason why. We don't feel that we *have* to buy anything. Mutual funds and pension plans generally can't wait for good bargains. Bargains, that is, such as the ones available in the early months of 2009, when hedge funds and other entities needed to raise cash to meet withdrawal demands. They sold corporate bonds at ridiculous prices (11% yields!). We were happy to buy.

"Once-Thin Chip Inventories Swell"

— The Wall Street Journal. Now that Washington has given **$280 billion** to the semiconductor industry, the **shortage** of computer chips has suddenly turned to a **glut**.

In 1962, when John Kennedy was President, total federal spending was $107 billion. **49%** was spent on National Defense, and 29.6% went to Social Security, Income Security, and other "Human Resources".

In the late '60s Lyndon Johnson launched the Great Society programs, even as he unleashed war on Vietnam. From $32 billion in 1962, Human Resources grew to $75 billion and 39% of the budget in 1970. They crossed the 50% mark in 1974; but even then Medicare and Medicaid cost less than $21 billion!

Total federal spending in 1998 was $1.65 trillion, or $1,652 billion. National Defense was 16.2% of spending; and Human Resources had mushroomed to 62.5%. The number of programs was breathtaking. Generations of politicians had already been elected by promising expanded benefits and new programs, and fiercely defending programs from cuts.

So now let's talk about 2022. Total federal spending was $5.85 trillion, of which Human Resources consumed **73.7%**. Defense spending was just 13.3%, or $780 billion.

Federal spending mostly transfers money from one person to another, via 1,386 programs (Cato.org). The six healthcare programs cost almost $1.5 trillion, and the states cough up another $450 billion for Medicaid. Funding also comes from hospitals, which lose lots of money on Medicaid.

Two trillion dollars would surely be enough to pay for a single-payer healthcare system. ***But the bigger message is that this is an uncontrollable mess.*** The conditions in our inner cities stand as a sharp and yet enduring rebuke of every politician who ever claimed that his "spending program" would bring improvement. You can't donate people out of poverty.

Drew D. Kellner, CFA

Too much of our social spending is lavished on the middle class. And we've spent trillions of dollars in the war on poverty; mostly for the benefit of politicians who claimed that they had an answer. And then dropped the ball and ran away. ■

DEFENSE

We're still reluctant to sell our defense stocks. Many nations, frightened by Russian and Chinese aggression, are suddenly clamoring to buy drones, missiles, and fighter jets. Europe, Japan, Taiwan, Australia, India, and other nations are moving aggressively to defend themselves from uncertain future threats. *Pax Americana* hasn't been perfect, but it suddenly looks much better than the alternatives.

Nine years ago the European nations all agreed that they would spend 2% of GDP on defense to strengthen NATO. Instead, most kept cutting defense budgets. Germany only spent 1.5% of GDP. They spent the savings on wind towers, social programs, and solar panels. They shuttered nuclear plants and allowed themselves to become dependent on Russian gas. And then the wind stopped blowing for a whole month in 2021, and suddenly Europe needed a huge infusion of natural gas to replace the power that wind towers had suddenly ceased to provide. The price of gas quadrupled, all across Europe, long before Russia started rattling its saber.

Europe *needed* to buy gas from Russia, and its armies had been weakened by underfunding. Putin attacked Ukraine with confidence.

OCTODECUPLED

Our Benchmark account, an actual fee-paying client account, ended 2022 at $1,894,364, down from $1,922,181 at the beginning of the year. The S&P 500 declined almost 20%, but dividends brought the return back up to –18.1%. The Nasdaq 100 stocks declined 32.8%! The portfolio, which holds cash and bonds as well as common stocks, is still worth more than 8 times its $217,974 valuation on December 31, 1999, just before the great millennial tech-stock bubble burst. For further information please see our website, www.Lumbard.com

WHERE HAVE ALL THE WORKERS GONE?

"Labor force participation has remained below where we were on the eve of the pandemic ... We don't fully understand. And labor economists are looking very hard at this because it's such a consequential issue."

— Mohamed A. El-Erian, President of Queens College Cambridge, on NY Times.com.

Wages are rising, employers are eager to hire, but workers don't want to take jobs. That's weird! Economists can't figure it out. **However**,

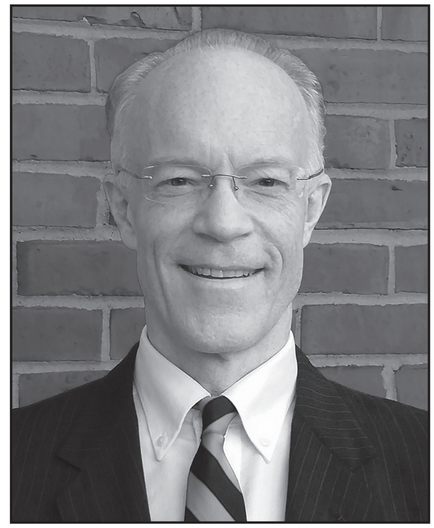
A client related that he tried to hire a man in his early forties, offering a good salary plus very good benefits. The man replied that he "could not afford to take the job", because our client was not offering to pay in cash, under the table. The applicant was already receiving cash remuneration from a part-time job with good pay, and was therefore reporting very little income. As a result, he was receiving a total of $1,680 per month *per child* from various governmental agencies for each of his 4 children, *plus* free medical care.

A reliable correspondent reported on a conversation that she had with a young man from Canada. "He told me that the paychecks from the government are too good to pass up, and he's taking jobs under the table on the side to supplement that." … We wrote about lawn-care workers in Peterborough who did the same thing in 2020… A 30-something man, in a 6-person ski gondola with 5 members of our investment team, told us proudly that he and his bricklayer friends collect Massachusetts unemployment payments every winter so that they can rent a house at Sunday River and ski every day.

Benefits look bigger those who would rather skip work, live cheaply, and get high on cheap drugs made by Mexican cartels. Twitter revealed two interviews with street people; a contented woman living on the streets of Portland, and a fentanyl addict living in a tent on San Francisco's Embarcadero.

Both of them told their interviewers, proudly, that they were being paid good money to live in these nice tents. Just make a quick phone call, and the city will give you free meals, enough money to get high most of the time, and "I got a f---- cell phone that I have Amazon and Netflix on!"

"It's a piece of cake, really. I mean, that's probably why you got so many out here, because they feed



you three meals a day, you don't have to do sh-t but stay in your tent or party, or if you smoke a lot of dope you can do that…all day long, every day."

"I appreciate the honesty. Doesn't feel like that's really helping anybody."

"It's not. That's why you see all the tents. People are up all night, sleep all day."

https://twitter.com/kevinvdahlgren/status/1609300954112987137

and

twitter.com/ShellenbergerMD/status/1491418120086454278

Click on the links in the online version of this letter to see the videos.

— John Lumbard, CFA

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