LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,103 * Dow Jones Industrials 9,683 * 30 year U.S. Treasury Bond 4.27%

RAYS OF SUNSHINE

After a long year of newspaper stories about collapsing banks, government bailouts, and the decline of the American automobile industry, you might be surprised to learn that most American corporations are in pretty good shape. Corporate profits have been far higher than expected, and balance sheets are strong.

It's even fair to say that America's *manufacturers* are in good shape. In the face of a rising flood of Chinese imports and the loss of millions of manufacturing jobs, most manufacturers are still alive and booking modest profits. You'll be even more surprised to learn that our manufacturing sector is still significantly larger than that of China. A Wal-Mart full of Chinese goods is worth less than the tail section of a Boeing 737. . . .

And our economy has stabilized. It's probably even growing—not fast, but growing—in response to Ben Bernanke's aggressive action. There's been a lot of anxiety about the river of money he printed while holding interest rates at zero, but thus far he has merely replaced the money that was destroyed when Wall Street imploded.

In fact, the economic picture has improved to the point where some pundits are saying that we're in a normal (which is to say breathtaking) recovery that will exceed all expectations and drive a massive rally in the stock market. Cash 4 Clunkers was a raging success, and hundreds of billions of dollars have been stuffed into the pockets of Social Security recipients, new home buyers, and the unemployed in the last few months. They say that this recovery looks like the last one, and like all the other recoveries of the last 25 years.

2009 is not 2003. We won't have a real-estate bubble to lift the economy this time around, and consumers might not be willing or able to take on any new debt at all. Tens of millions of Baby Boomers are beginning to get serious about saving for retirement for the first time. Corporations are in good shape, but they stayed healthy via fierce cost cutting that sent millions of Americans to the unemployment lines.

And next year the stimulus program will begin to tail off. Spending a trillion dollars on stimulus and bailouts does indeed increase GDP, but when the programs end GDP subsides again. That counts as a *subtraction* from GDP, starting in the second half of 2010. And this subtraction from GDP will also occur in China, throughout Europe, in Japan, and in every other nation that launched a stimulus program in 2009.

Investors *don't* have to worry that we're going to slide into the abyss. They also don't have to worry about inflation in 2010. There's still *deflation* in the real estate market, and it's worth saying again that the consumer price index failed to pick up massive deflation—*six trillion dollars worth of deflation*—in the $22 trillion real estate market in the last three years.

It seems likely that the stock market will rise further in the near term, seizing on every release of positive economic news as proof that we're still in the Golden Age of prosperity that started in the 1980s. Hundreds

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John Lumbard, CFA

SUNSHINE...

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of millions of Americans have an emotional and financial *need* to push the Dow above 10,000, and then look back on the events of the past year as a brief aberration. We'll be able to assure ourselves that all the old rules about investments, debt, and the economy are back in place.

The big picture is that we're making a long transition toward a normal economy, from an economy that was pumped up to greater growth and greater size by borrowing. In the long term that's a good thing, but this normal economy will be smaller and slower-growing. We're in a long period of readjustment—a needed readjustment—and there's no point in trying to force an unnatural growth on consumers or anybody else. Steady as she goes. ■

The key to successful investing:
Never lie to yourself.

Back in the 1980s investors were fascinated by tales of shortage in oil, copper, silver, gold, and agricultural products. None of them panned out.

In the long run the price of any commodity—oil, copper, wheat, or platinum—will spend most of its time at a price that's just a little bit above the cost of producing *more* copper or oil or wheat. If a new copper mine will be profitable with the price of copper at $2, investors will build the mine as soon as they're sure that copper prices are going to stay above $2.

And high prices spur technological progress that brings that cost of production *down*. The effects—as with the shocking decline in the cost of producing natural gas—can be breathtaking. Today's high oil prices have encouraged new deepwater discoveries in Brazilian waters and in the Gulf of Mexico, and the Department of the Interior says that there are 100 billion recoverable barrels on our continental shelf. We're only just beginning to explore the Arctic, and there's also that nagging question of alternative fuels . . . . ■

THE NATURAL TRUTH

There are exciting things happening in the energy markets. Wind and solar power are not even at the top of the list. Biodiesel from algae is not at the top of the list, and neither are tidal power, ethanol from switchgrass, biodiesel from coal, geothermal, zero-emission electric cars powered by zero-emission nuclear energy, or any of the other fascinating ideas for completely eliminating the need for crude oil.

We're talking about natural gas. Gas prices are now so low that it's cheaper to generate electricity from gas than from *coal*, for heaven's sake, and coal was always the rock-bottom cheapest and lung-polluting dirtiest of fuels. Natural gas isn't as clean as solar, wind, or nuclear, but it's clean enough to make its economic attractions compelling. New gas discoveries—mostly the result of technological change (capitalism at work!) that allows gas to be gathered from the continent's massive shale reserves—will keep gas prices pinned at low levels for many years.

The impact of $3 natural gas is every bit as big as $200 oil was supposed to be; and $3 gas is not a Matthew Simmons pipe dream. Simmons rose to brief fame by claiming that the Saudis were lying about their oil reserves . . . . . The Saudis responded by opening four new oil fields, and now the only thing holding the price of oil above $70 is a massive cutback in Saudi production.

On an energy-equivalent basis oil now costs *more than four times as much as gas*. City buses already run on compressed natural gas, and soon you'll see it migrate to trucks, trains, and intercity buses. Heating oil will go the way of the Dodo bird; cars will run on electricity produced from natural gas, and we've been

TRUTH...

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prodding chemists to ask why they can't run on butane or propane made from $3 methane.

While our economy is boosted by cheap gas from shale deposits, the world economy will be boosted by cheap LNG. Any nation with a coastline can now buy gas from Qatar, Indonesia, Australia, or Sakhalin Island—you don't even need to build an LNG terminal! Golar LNG (GLNG - $9.50) will be happy to park an LNG regasification ship ten miles offshore, and run a pipe to your door. D'ya think that Europe might like to diversify away from Russian gas?

Our clients own shares of Golar, but it's a bit harder to find good opportunities that will take advantage of the explosion in new *uses* for gas. Gas turbines are an easy answer—a hundred coal plants will be replaced by gas turbines—but General Electric is too big and diverse to be a good gas-turbine play. We bought Mitsubishi Heavy Industries, in Japanese yen . . . . An easier purchase, here in the 'states, is NiSource (NI - $13), a gas-distribution and pipeline company that happens to be located atop the Marcellus shale. We also own shares of Atmos (ATO - $27), but they've run up so much that we'd wait for a better price.

New technology and low prices have unleashed the laws of supply and demand, bringing a vast infusion of energy to a slumbering economy. There is radical change afoot. And hardly anybody knows it. ■

Back in December they were giving away free money in the corporate bond market. Collapsing hedge funds and banks were selling names like AT&T, Norfolk Southern, General Electric, and Alcoa at a fraction of par value—yields of 10% and more**!!!**—to raise cash. We sold most of our long-term Treasury bonds at a nice profit, and invested tens of millions of dollars in high-quality corporates at ridiculously-low prices.

Those holdings cushioned the impact of the stock market decline that finally bottomed in March, and they appreciated lustily as the stock market rebounded. When the dust had settled our benchmark account—the one that started with $100,000 in October of 1990—had hit a new high of **$514,672**. *Quintupled at last*, and up from just $446,064 at the beginning of 2009.

Better Performance Than Warren Buffett. For Ten Years.

Over the course of the last ten years (through August 31) the S&P 500 has declined 6.6%, and that's *after* adding in the dividends paid on the stocks in the index. In those same ten years Warren Buffett's Berkshire Hathaway (which pays no dividends) appreciated from $64,200 per share to $100,850, **up 57.1%**. Our benchmark account—which receives no special treatment—appreciated ***twice as much*** — **up 126%** — from $228, 039 to $514,672. Our client accounts have outperformed the market indices over one year, over ten years, and over 3, 5, 7, or 9 years.

For more information please visit our web site, www.Lumbard.com, and click on Performance. Or give us a call at (800) Lumbard, which works out to (800) 586-2273.

In June Airbus delivered the first large commercial airplane made in a Chinese plant, under a joint venture that's 51% owned by Airbus and 49% owned by the Chinese government. The agreement to build the planes in China was part of a deal that allowed Airbus to win some sales to China, and technology transfer was always an explicit part of the agreement. Talk about stupid . . . The Chinese have just announced plans to build their own 200-seat airplane. ■

BUMBLING BANKS

During every economic cycle the nation's money center banks find new and innovative ways to get themselves into financial trouble. It's always a problem of greed, poor judgment, and lax oversight, but it's usually also a matter of jealousy. Those Wall Street investment bankers are making soooo much more money . . . .

So the banks hire experts in foreign lending, or collateralized debt obligations, or some other vehicle for lending money to people who can't possibly pay it back; and they dive into the feeding frenzy with enthusiasm—just as the sharks consume the last of the baitfish and begin to bite each other.

Then the US government or a couple of Saudi Arabian princes reach in to rescue Citigroup and a few other **2BIG2Fail** favorites, and the cycle begins anew. This little drama is so predictable that we bought Citigroup bonds—with floating interest rates that can't be hurt by an upward trend in rates—at half price during the market panic.

No lessons are ever learned. Next time around we'd like to see the government stand idly by while (*warning: mixed metaphors ahead*) Citigroup and the other money-center dinosaurs sink into the tar pit.

In this last crisis the Treasury Department should have focused on *principles* and system-wide fixes, and avoided actions designed to rescue individual companies. Fixing broken markets is an appropriate role for government, and Treasury should have followed through on its original plan—TARP—to sweep away the fear in the mortgage markets by purchasing all the scary mortgages that the terrified banks wanted to sell.

In hindsight that $700 billion program was chump change. When the Treasury chickened out the Fed jumped in, spending *twice* that figure to buy mortgages that nobody else wanted to buy. But a year ago Congress was threatening to withhold half the TARP money and spend it on earmarks, so Treasury officials fled to Plan B.

Plan B turned out to be massive bailouts and random unprincipled spending on whatever looked good after a three-martini lunch. If we'd stuck to principles we could have helped *all* the banks by fixing the broken mortgage market. Then we could have allowed the banks that *still* had problems to expire quietly in the arms of the FDIC, the bank regulators, and a reincarnated Resolution Trust Company—a spectacularly successful government-financed corporation that sold off the questionable real-estate loans held by the bankrupt Savings and Loan institutions of the 1980s. ■

BLAME THE RATING AGENCIES

"In January 2008, there were twelve AAA-rated companies in the world. At the same time, there were 64,000 structured finance instruments, such as collateralized debt obligations, rated AAA."

-- Lloyd Blankfein of Goldman Sachs

Who was to blame for the mortgage meltdown? Investment bankers and their Moody lovers at the rating agencies. Big Banks, Freddie Mac, Fannie Mae, Henry Cisneros, Barney Frank, *hundreds* of "affordable housing" advocates in Washington, *thousands* of regulators, *tens of thousands* of mortgage firms and their significant-other appraisers, *hundreds of thousands* of greedy and reckless mortgage investors, and *millions* of bubble-crazed, lyin' homeowners. Not to mention a nutty international agreement signed in Basel, Switzerland, that gave the banks a pat on the back for buying AAA-rated CDOs filled with toxic waste.

Still, the one thing that could have stopped the madness dead in its tracks would have been an insistence on the old-fashioned requirement that home buyers put down 20% of the value of a home. That would have put a quick end to the subprime-no-doc-NINJA-liar loans. And it would have put a serious crimp in the real estate bubble and the supply of insanely risky mortgage securities. ■

No-Money-Down Subprime Mortgages - The Sequel -

"The Department of Housing and Urban Development has decided to allow first-time home buyers to use the $8,000 tax credit included in the economic stimulus bill as a down payment on their mortgages."

-- The Business Review, May 22, 2009

California gets all the press with top rates of more than 10% on both sales *and* income taxes (tax *breaks* for Hollywood!!), but Hawaii and Oregon just raised their top income tax rates to 11%. In Hawaii a 9% tax rate starts at $150,000, and the top rate kicks in at $200,000.

"Health problems linked to aging coal-fired power plants shorten nearly 24,000 lives a year, including 2,800 from lung cancer . . . ."

--MSNBC

According to the EPA, coal kills 24,000 people a year, mostly from diseases of the lung. Coal produces more carbon dioxide, mercury, acid rain, and other pollutants than any other fuel, yet its use has grown significantly in the years since nuclear power plant construction was halted under pressure from protestors.

Nuclear power's 50-year safety record is extraordinary, when compared to *any* form of power generation, and yet we substituted coal plants for nuclear plants on a massive scale. For decades deadly coal has been generating half of the nation's electricity. An honest observer would have to conclude that tens of thousands of people died as a result of the 1970s protests against nuclear power, however well intentioned they might have been.

Gas turbines will replace a good part of the nation's coal-fired generation, but we'd risk shortages and dramatic price surges if we tried to produce much more than half the nation's electricity from gas. There was a brief frenzy of gas-turbine construction ten years ago—turbine producer GE actually called it a mania—and the result was soaring gas prices and bankruptcies.

Fuel costs aren't an issue for nuclear power, because the plants use so little fuel. All the waste ever produced by all the nation's 104 reactors could be stacked on a football field, ten feet high.

The initial cost of a plant is staggering, but that big outlay is followed by 60 years of low cost 24/7 operation that's perfect for re-charging electric cars in the middle of the night. And this is a perfect time—a time of low costs for concrete, steel, and labor—to build a new generation of safe, non-polluting power stations. ■

Drew D. Kellner

HOW TO SMELL A RAT

In talking with prospective clients we still see the shadow of Bernie Madoff around every corner. As we said in our February issue, the key to avoiding Ponzi schemes and scams is to entrust your assets to a respected third-party custodian. Madoff managed his clients' money, Madoff held their assets, and Madoff issued the statements . . .

Our client accounts are held by U.S. Bank (NYSE stock symbol USB). It's not well known here in the Northeast, but US Bank is one of the nation's largest financial institutions, with 15.8 million customers and $264 billion in assets. The bank has great financial strength; it didn't need the TARP funds that U.S. Treasury stuffed into it at the time of the crisis, and it was one of the first to get permission to pay the money back. Our US Bank relationship manager is Terry Schwartz, at (513) 632-4992. ■

LAND OF THE RISING . . . . DEBT

For the last 50 years American consumers have been steadily increasing their debt—through boom times and bust—and thereby boosting GDP and growth. In the next decade they will spend less and save more, while government pushes them to consume.

That last bit sounds like Japan in the early 1990s, just after the bursting of gigantic bubbles in the real estate and stock markets. Instead of comparing our current economic recovery to that of 2003—or those of 1932, 1982, or 1991—we'd be well-served to study the experience of Japan. The Japanese have been watching our markets with fascination and horror ever since the bursting of our tech-stock bubble in 2000.

Most observers say that Japan suffered a twelve year recession that started in 1991. Japan's government, which had long been admired for successfully guiding the economy with a heavy hand, launched into a program of Keynesian stimulus spending that went on and on and on. There was massive stimulus in 1992, and when it began to fade the government pumped up growth with another program in 1993. And another in 1994. And in 1995, 1998, and 1999.

As each stimulus program began to wind down the economy would settle back to where it had been. And with every round of pork and earmarks and bridges-to-nowhere, Japan's economy became more dependent on stimulus and less capable of true growth.

The nation's debt grew larger and larger, surpassing (as a % of GDP) that of the United States, then Argentina, and finally Italy. Banks were bailed out, and instead of lending they lay half-dead, smothering the green shoots of Japan's renewal. They sucked up resources of labor—Japan's best and brightest, toiling away with no purpose—and capital; and the stimulus programs did the same, sucking up labor and capital while starving the nation's entrepreneurs and gumming up the economy with inefficiency and lower productivity.

When the stimulus programs ended, Japan continued to run big deficits, pushing debt higher and higher every single year until 2006. Thankfully the interest rates paid on that debt have stayed low, held down by the robust savings of the average Japanese citizen.

Who would have thought that a country of well-educated people with laudable savings habits, excellent technology, and a strong work ethic—the land of Lexus, Honda, and Sony—could suffer near-zero growth and sharply rising government debt for decades?

Next summer, as our own stimulus program is beginning to tail off and an election looms, there will surely be calls for more spending. Just say no.

John Lumbard, CFA

A billboard announcing the paving of one of the smoothest roads in Hollis. The federal government predicts that the stimulus program will create 24,000 jobs in New Hampshire and Wyoming (yes, that is an odd combination). NH and WY say that thus far fewer than 1,000 jobs have been added. More must be on the way!

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.

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