Lumbard & Kellner INSIGHT

S&P 500 4,505 * Dow Jones Industrials 34,907 * 30 year U.S. Treasury Bond 4.38%

FIRE AND ICE

"We are navigating by the stars, under cloudy skies."

— Federal Reserve Chairman Jerome Powell

Jerome Powell is telling us that the Fed is far from any shore, without a chart or a compass. If the clouds would part for just a minute they'd know where north is, but the North Star is hidden by clouds. They are lost.

The Fed should have moved quickly to cool off the economy in the spring of 2021, when inflation jumped to 5% (and then 9.1%) in response to the second and third "stimulus packages". They've enjoyed moments of hope, when GDP went negative and when inflation eased from its highs, but Congress spent another $1.5 trillion to pump it up, artificially; $280 billion for semiconductor corporations, and $1.2 trillion in "green" spending.

There is still too much money around. You don't need to squint at graphs of monetary aggregates, or the painfully slow shrinkage of the $9 trillion pile of bonds the Fed bought with

"The federal budget deficit is expected to balloon to about $2 trillion for fiscal year 2023, roughly double what it was in the previous fiscal year, according to a government watchdog group."
— *CNN*

freshly printed money. Cash is still burning holes in the pockets of consumers and investors.

You can see and feel it. Your friends are in Nvidia, or in Italy, or they're in Nvidia *and* Italy.

GDP is running strong. ***Strong enough to reignite inflation***, and a big part of the strength relates to the Inflation Reduction Act. Oil prices have jumped 36%, clawing back after a 12-month decline from $119 to $67. That means higher restaurant and shipping prices. Union negotiations seem to produce an eye-popping wage gain every week.

Consumers are still spending, but consumer debt is rising and housing is too expensive. 43 million Americans have student debt, and soon they'll have to resume making interest and principal payments on $1.7 trillion. Auto loan delinquencies are the highest since 2010, and the UAW has called a strike. The debt and deficit hawks in Congress might do the same.

So we have powerful "strong" and "weak" forces, swirling in muddy waters. We say muddy because it can take a ***loooong*** time to feel the effects of tighter monetary policy. Actions taken by the Fed last year ***haven't been felt yet***. Milton Friedman (who scoffed at the notion that the Fed can fine tune *anything*) said that the lag might be "4 months, or 29 months, or somewhere in between".

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FIRE AND ICE

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Pollyannish investors, emboldened by excessive cash, are sure that the strong and weak forces will be perfectly balanced, even if the Fed has to tiptoe along a knife edge. But the economy could be *too strong **and then** too weak*. Hot GDP growth could reignite inflation this year, and then a cold recession could snuff it out next year. Wall Street's presumptuous Pollyannas are perched precariously on a perfumed pinnacle, prattling perplexing prophecy.

Mortgage rates just jumped to the highest level in 22 years, discouraging builders from starting construction of homes that could take a year to complete. ***Future*** sales of lumber, roofing shingles, sheet rock, flooring, and appliances will be lower.

The Fed knows how to cool the economy by destroying money. They ***will*** destroy money until the unemployment rate has gone up and they are sure that inflation is dead. But they *have to overreact* because they can't see the effects of their actions for many, many months. How can they possibly know how many thousand-dollar bills to burn this week? ■

IF IT SEEMS TOO GOOD TO BE TRUE, IT PROBABLY IS.

The Employee Retention Credit (ERC) is a program that rewards corporations for not laying off employees during the pandemic of 2020-2021. It cost just $7 billion in 2020, and $38 billion in 2021.

The pandemic "ended" on 9/30/2021. The ERC nevertheless cost **$82 billion** in 2022, and **$95 billion *in the first seven months of 2023***. Lumbard & Kellner just received 3 invitations to apply! The program will end after the 2024 election is over. ■

In 2020 we had 85% of the Benchmark account in common stocks. Nearly the most in 32 years—and almost twice the level of equities that we hold now! Stocks were bound to rise because of the rivers of excess cash that flowed from the crazed economic stimulus. Interest rates had *never* been that low. Bonds had *never* been that overpriced. Cash had *never before* yielded 0%.

In the long term, **stock prices depend on interest rates and earnings, and not much else**. Corporate earnings have declined in the last year, while interest rates, including the yield on the all-important 10-year U.S. Treasury, have moved higher. ■

AI

"Almost a year into the boom ignited by the November launch of ChatGPT, some startups that epitomized the zeal for so-called generative AI are now navigating layoffs and reduced investor interest. Investors are unsure whether the new crop of AI startups will be able to survive."

— *The Wall Street Journal*

THE GLOBAL CASINO

We won't be buying any semi-conductor stocks this year, because everybody's at the casino buying chips. Europe announced $47 billion in subsidies for semiconductor manufacturing under the nickname the "Chips Act", hard on the heels of our Chips & Science Act ($846 per American, including each of your children and each of your parents). China will spend $143 billion to do the same things; Japan, India, South Korea, and Singapore are in the game. Taiwan? They'll get subsidies from us, to build in Arizona. ■

Social Security and Medicare were poorly designed from the get go, so the only easy way to fix them is to throw money at them. Medicare will run out of funds in less than 3 years! Clearly, this was not the top priority when Congress gave $280 billion to chip companies, and voted for $1.2 trillion (Goldman Sachs estimate) in green spending.

All spending programs are in competition with each other. You can say that this $1.48 trillion was taken from Medicare, or you can say that it was taken from our children because all of it was borrowed. Or you can say both. ■

REDUCING POVERTY. CLEANING UP THE ENVIRONMENT

One underrated benefit of working with individual stocks is that it gives us an opportunity to learn about a lot of interesting, related companies. Every so often a theme will become attractive to us, and lo & behold a company that we have already researched appears to be a key player. In other cases, cyclical industries can give us the opportunity to "reuse" knowledge of a company when the cycle gets rolling again.

More than a decade ago we invested in Seadrill (SDRL - $47), a Norwegian company that is headquartered in Bermuda and operates offshore drillships. Their fleet can survive hurricanes in mile-deep water while drilling a mile into the seabed to gather natural gas. We sold the shares when the shale boom took off and offshore drilling fell out of favor.

But not before we learned of another Norwegian/Bermudan company called Golar LNG (GLNG -$24), which builds and operates ships that can survive hurricanes while chilling natural gas to 260 degrees below zero. Golar ships this LNG right from the deep-ocean source to gas-starved ports in Europe, and to other coastal cities that hope to replace coal or diesel fuel with natural gas.

Golar had an exciting joint venture with New Fortress Energy, but the stock was "too" expensive in our eyes at that time. A couple of years passed.

Earlier this year energy prices fell, and it seemed to be a good moment to buy drillship stocks. Valaris (VAL -$75), a well-recognized company with a large fleet, was an obvious choice. But we also took the opportunity to buy shares of Seadrill again. The carnage was so bad in the last cycle that many shipyards have said they will *NEVER* build another drillship again. That's great for the value of the existing fleet!

Meanwhile, the market was falling out of love with New Fortress Energy (NFE -$32). We decided to buy. NFE liquifies natural gas in Miami, as well as on floating units like the ones Golar operates. They provide this LNG to isolated coastal areas in Brazil, Nicaragua, and Baja Mexico, and to islands such as Puerto Rico, Jamaica, and Ireland, where they turn the LNG back into gas and pipe it ashore to efficient, clean natural gas power plants that NFE often owns.

These power plants are often designed to work hand-in-glove with the intermittent power that comes from wind and solar. Replacing coal or diesel generators with natural gas and green power is a huge win for the environment. And it often lowers energy prices for consumers! ■

In December the Teamsters union pension plan received $36 Billion gift of taxpayer money. If only, *sigh*, there could be a bailout for everybody. The national public pension funding shortfall is $1.4 trillion.

Jay Conway, CFA

"For all these hundreds of billions spent, you will slow down rising temperatures by merely 0.0009°F to 0.028°F in 2100."

— Dr. Bjorn Lomborg of the Copenhagen Consensus Center, describing the Inflation Reduction Act.

"This issue will destroy New York City. Destroy New York City. We're getting 10,000 migrants a month …I said it last year when we had 15,000, and I'm telling you now with 110,000, the city we know we're about to lose."

— Mayor Eric Adams of New York City

110,000 isn't the number of undocumented aliens in New York City. It's the number that the mayor has to house and feed right now. For billions of world citizens it's a very rational thing to spend all they have on an air ticket to Mexico, download the CBP-1 app, and wait a few weeks for a Border Patrol interview and permission to enter. Your town will need more houses. And apartment buildings!

JAPAN

Japan was a juggernaut in the 1980s. If you were born after 1975 you probably can't recall the awe that Americans felt; Japanese technology and manufacturing seemed far better. American politicians clamored for "Industrial Policy" (government investment in chosen industries) to imitate this stunning success and rising power.

Japan's stock market and real-estate prices shot to the stratosphere and beyond. Real estate in Tokyo was worth more than 300 times that of Manhattan. The Imperial Palace in Tokyo was worth as much as the entire state of California!

In the late 80s the bubbles burst. Japan spent the next thirty years borrowing and spending on "stimulus"—infrastructure and social programs—in hopes of reviving GDP growth that had fallen to little more than 1%.

In 2012 the Japanese yen was worth 1.3 cents. Now it's worth 7/10ths of a penny! The Bank of Japan drove the value of the currency down again and again, partly to kickstart an eternally-sluggish economy, and partly to soak up the gigantic debt that the Japanese government created by spending on social programs, buying votes, and spending on stimulus.

The currency has fallen so far that, if you measure Japan's real GDP in dollars, it **declined** 24% from 1995 to the end of last year. ■

CHINA

"For decades, China powered its economy by investing in factories, skyscrapers and roads. The model sparked an extraordinary period of growth."

"Now … the country is drowning in debt and running out of things to build. Parts of China are saddled with under-used bridges and airports. Millions of apartments are unoccupied... this could be the dimming of a long era."

— *The Wall Street Journal*

Just a year ago China looked like an unstoppable juggernaut. American politicians again clamored for "Industrial Policies", and borrowed trillions of dollars so that they could invest in industries of their choosing—and lavish dollars on constituents they chose.

When Deng Xiaoping was the chairman of China's communist party, his economy was moribund. Mao had seized all the land, and put the vast majority of the workers on government-owned communes. They had no reason to work hard, work smart, or invest in better seed or better tools, so they produced very little. Deng permitted each worker to grow a small garden and keep whatever it produced. The results were so persuasive that free enterprise was allowed to grow and flourish. *Half a billion people* were pulled out of poverty.

Now, the government is pulling back on free enterprise and the illusion of property rights. These depressing influences come at a time when Western countries are restricting trade, and China's neighbors are increasing military spending in response to an inane period of "Wolf Warrior Diplomacy" that wasn't diplomatic at all. Chinese diplomats berated their host nations. Strident rhetoric and coercive behavior became the norm. ■

RUSSIA

During communist times Russian workers would say "we pretend to work and they pretend to pay us". Today, Russian troops have little reason to fight hard or fight cleverly, and they are discouraged from taking initiative. Ukrainians do all these things, and they invent ingenious air, sea, and terrestrial drones built from inexpensive parts. Farmers are using old tractors, remotely controlled and fitted with lots of welded steel, to clear mines from their fields.

Wikipedia says "As of April 2023, it is estimated that approximately 174,000 square kilometers of Ukrainian territory are contaminated by landmines." That's an area larger than Florida or Wisconsin!

On August 14 the value of the Russian ruble fell below a penny! Millions have fled Russia in the last year, and 50,000 lives have been sacrificed. Russia is running out of money and workers. ■

SHORT SIGHTED

"Even if you go back 250 years, you can't find a worse year than 2022."

— *Edward McQuarrie, a Santa Clara professor quoted by CNBC, describing the bond market.*

We've been warning about the danger of bonds for years. Since the summer of 2020 the yield on the 30-year U.S. Treasury bond has risen from 1.2% to 4.33%, so the price of a bond has *fallen* **49**%. This decline was bad for bond investors and bad for common-stock valuation calculations, and it caused mortgage rates to rise.

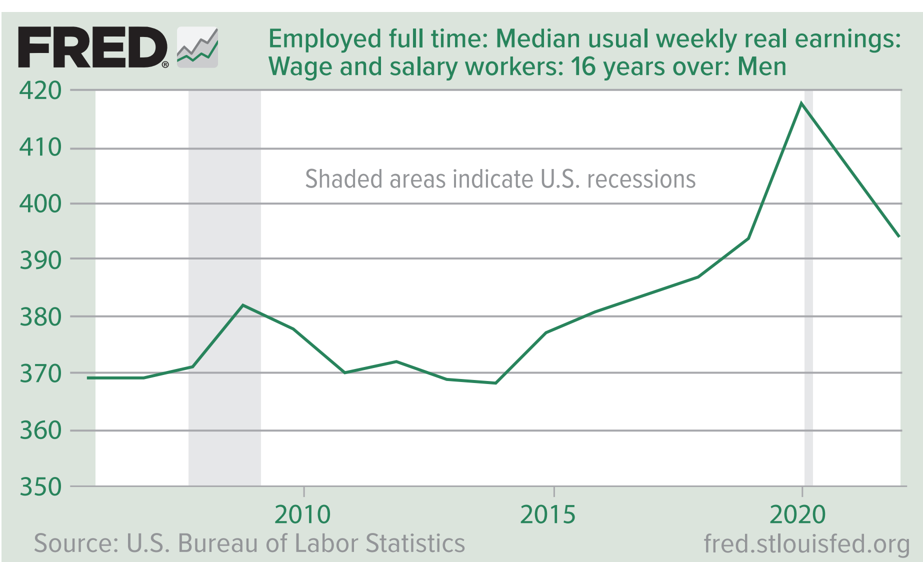
The U.S. Treasury borrows many trillions of dollars every year. It had a chance to lock in a **1.2%** rate for **30 years** in 2020, but is now paying **5.3%** on Treasury bills instead. By contrast, in 2020 lots of ordinary Americans saw the obvious opportunity and refinanced their mortgages, taking a giant step toward financial security.

For the first time since 2007 we just bought some long-term treasury bonds. If the yield rises more we'll buy more, because bond prices nearly always rise during recessions. At some level higher bond yields will *cause* a recession. Nobody knows what that level is. ■

REAL WAGES!

Wages, adjusted for inflation, are rising! That's a good thing, but workers are still poorer than they were in 2019. Before the pandemic wages were rising rapidly, and inflation was very low:

It's easy to see why the working class became disgruntled in the 2011-2014 years. When the line on this graph turns downward, the workers that Marx described as "the proletariat" demand change. ■



Drew D. Kellner, CFA

LITHIUM

"The world's richest known lithium deposit lies deep in the woods of western Maine."

— *Time.com*

The mother lode is less than 7 miles from the Sunday River Ski area. Are we going to allow an underground mine? Of course not!

There is dirty and exploitative mining all 'round the globe because American consumers buy electric vehicles, solar panels, and battery-powered bicycles, laptops, and power tools. Yet American voters won't allow mining here. Mining that would surely be better-regulated and cleaner than that found in third-world countries. As a nation we've decided that the American environment is more important than the global environment. ■

THE 480

The road to a 51% majority involves assembling a lot of 5% and 8% groups. The novel **The 480**, by Eugene Burdick, gives its readers a glimpse into the use of computers and polling data, way back in 1959, to divide Americans into 480 monolithic groups (ethnicity, age, income, religion) with predictable voting patterns. The Simulmatics Corporation then advised John F. Kennedy that he would gain more votes, than he lost in the Solid South, if he supported the Civil Rights Act. And they advised him that "he had nothing to lose, and much to gain, by attacking religious bigotry and dealing frankly with his Catholicism." (*Wikipedia*).

49% of JFK's 1962 budget was devoted to Defense. Medicare—a gift of low-cost health care to a very small group of voters—was still a glimmer in the eye of Vice President Lyndon Johnson, who later launched a host of other social programs even as he waged war in Vietnam.

In every year that followed politicians bought votes, in carefully-selected demographic blocks that lifted them to 51%, by expanding these programs. Or launching new ones, or simply defending programs from cuts. *Medicare is now just as big as Defense*. Each claims 13% of federal spending. Social programs ("Human Resources") comprise 70% of total spending and ***92% of taxes collected***. That percentage will eventually decline, because the interest on our fast-growing debt ***has*** to be paid. It's 14% of the taxes we're collecting, and growing fast. ■

(www.whitehouse.gov/omb/budget/historical-tables/)

CONSUMPTION

Everybody knows a story about a house that was purchased for $25,000, and now is worth more than a million. Nobody ever talks about **the normal experience**; burdened by decades of heavy real-estate taxes, expensive purgings of water in the basement and radon gas, plumbing or well-water issues, septic issues, lawn $care, plowing, driveway maintenance, chimney problems, raccoons in the garage, ants in the kitchen, roof replacement, and the replacement of the furnace and *every other appliance in the house.*

We know lots of people in generations Y and Z who are desperate to buy houses so that they will be able to "stop wasting rent" and "get into the real estate market before it's too late". Yes, 2020 was an amazingly-good time to buy a house, with low prices and **incredible** 3% mortgage rates; but that was probably a once-in-a-lifetime opportunity. It's gone. Fuggettaboutit.

Most people want to buy real estate just after a bull market, when prices are high and lots of friends have good stories about the money they just made. The same is true of stocks and bonds. ■

— John Lumbard, CFA