Other Than That…

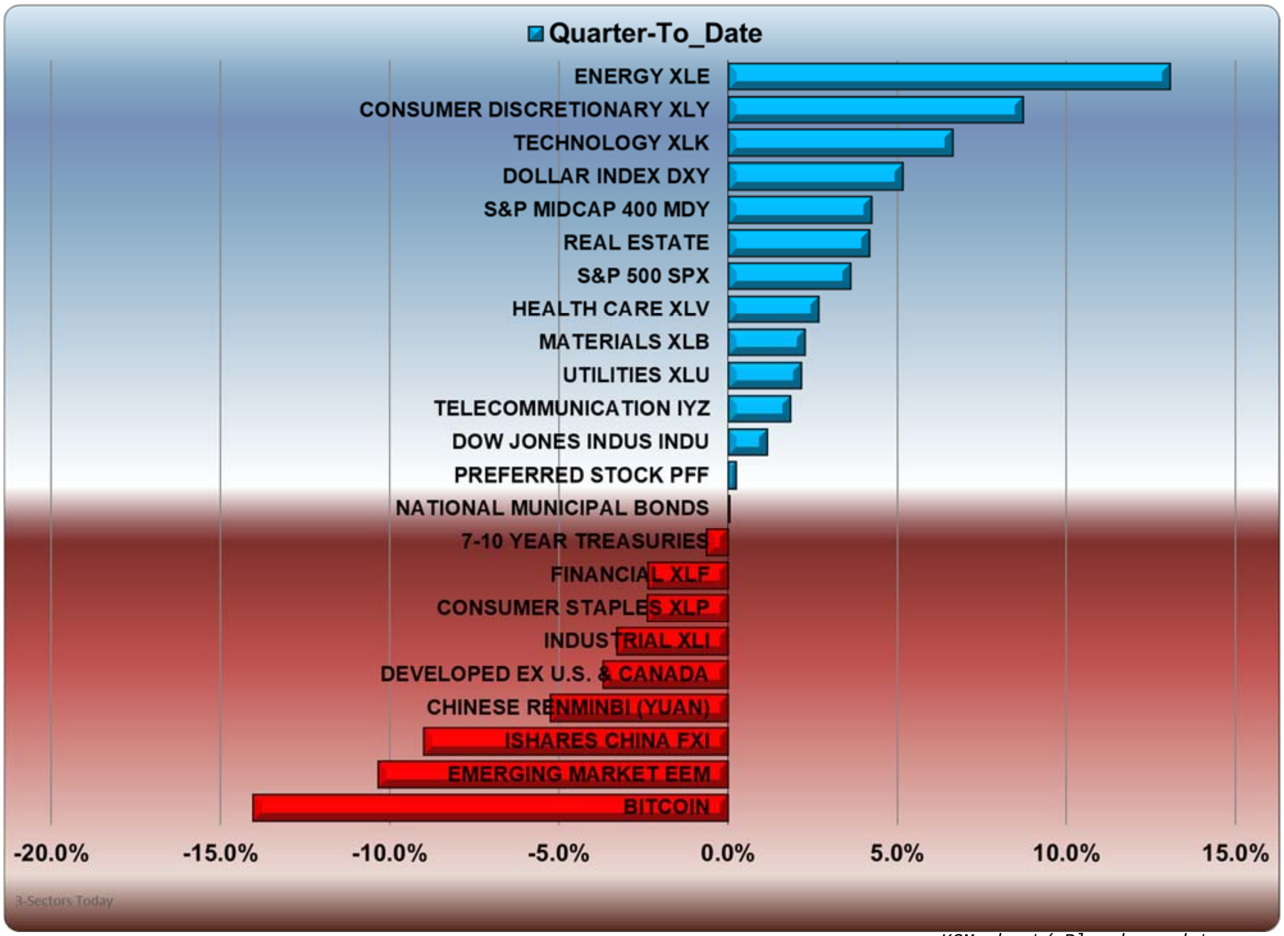
TARIFFS

Other than the market's obsessive concern with tariffs, the economy is booming. Our **current** "free trade" model is based on the idea that one country may be better at producing a certain product while another country may be best at producing something different. Accordingly, each country should devote its resources to producing the product at which it excels. This has been the dominant trade model since 1945. A nationalist approach to trade, including high tariffs (think 1930 Smoot-Hawley) has not been popular since the period between the end of World War I to the end of World War II.

The free trade model works best when there is not a clear net gain or loss of wealth between trading partners. A country with a trade imbalance may use tariffs (taxes) to restrict imports by increasing the price of goods and services purchased from overseas thus making them less attractive to consumers. As well, Governments may impose tariffs to protect domestic industries from foreign competition by making foreign-produced goods more expensive than domestically-produced ones. By protecting these industries, governments can also protect jobs. Tariffs can also be used as an extension of foreign policy: imposing tariffs on a trading partner's main exports is a way to exert economic leverage. However, tariffs can have unintended consequences. They can make domestic industries less efficient by reducing competition. They can hurt domestic consumers, since a lack of competition tends to push up prices. They can generate tensions by favoring certain industries over others, as well as certain regions over others. Finally, an attempt to pressure a rival country, using tariffs, can result in an unproductive cycle of retaliation known as a trade war.

In summary, tariffs can lead to trade wars; hurting consumers, reducing innovation and heightening nationalism. On the other hand, multilateral trade deals designed to eliminate tariffs (NAFTA and the European Union) may erode national sovereignty and encourage a race to the bottom in terms of wages, worker protections, quality and standards.

We note a trade deal encouraged Britain to leave the EU and President Trump was elected championing reforms that included tariffs on China and renegotiating NAFTA.

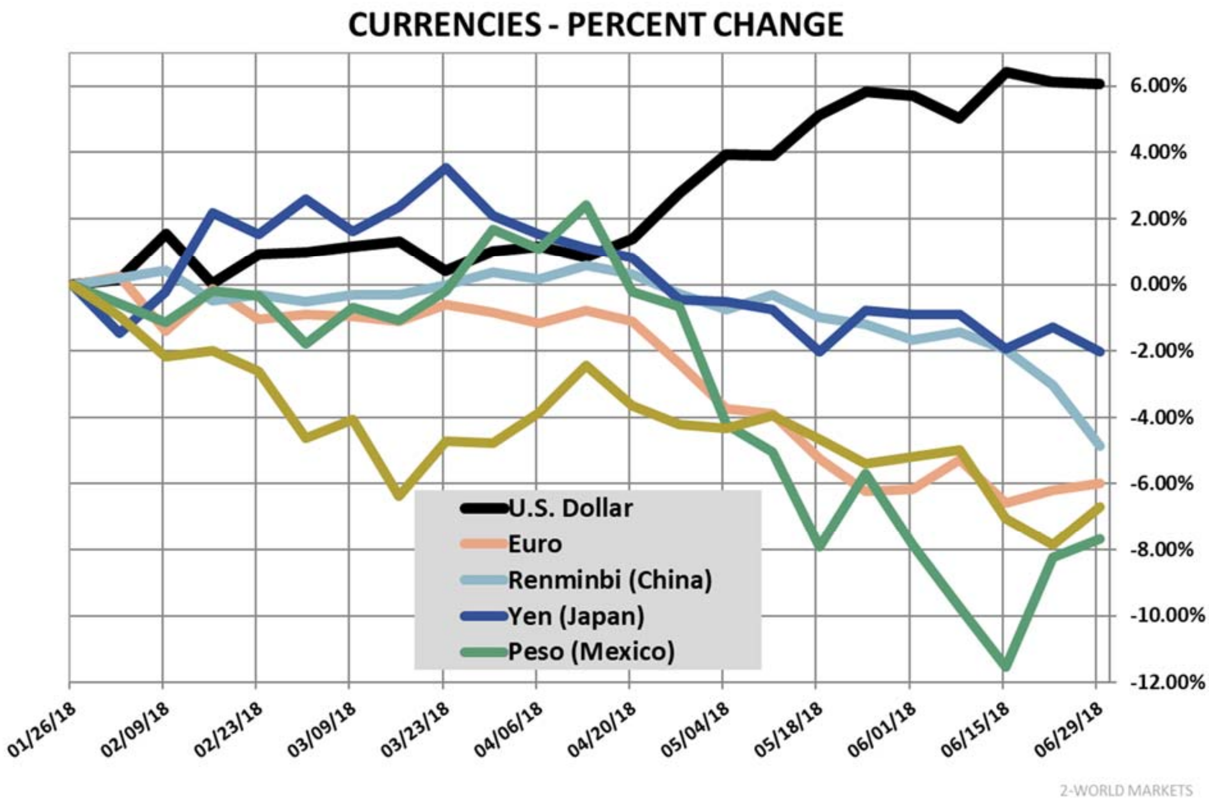


KCM chart/ Bloomberg data

The March-June quarterly returns reflect the effects of potential tariffs, Federal Reserve tightening and a stronger dollar.

Anticipating President Trump's tariffs had a major effect on stock markets around the world. The Chinese market was one of the hardest hit, down about 10% for the quarter and 20% year-to-date. The industrial sector was the worst performing U.S. market sector, reflecting concerns of retaliatory tariffs from our major trading partners.

The Federal Reserve tightened at its June meeting, raising the Fed Funds target range to 1.75%-2.0%, up 0.25%. Rising rates, actual and relative to the rest of the world, put upward pressure on the U.S. dollar which had a strong, relative, appreciation of about 5% during the second quarter. A strong and strengthening dollar attracts capital. The weakness in Emerging Markets, down about 10% for the quarter, can be partially explained by money flows leaving those markets to be invested in an appreciating U.S. dollar, via the U.S. stock and bond markets. Probable further Federal Reserve tightening and tariff threats are likely to keep upward pressure on the dollar and downward pressure on emerging markets. The uncertainty regarding trade negotiations may keep the U.S. stock market moving sideways.



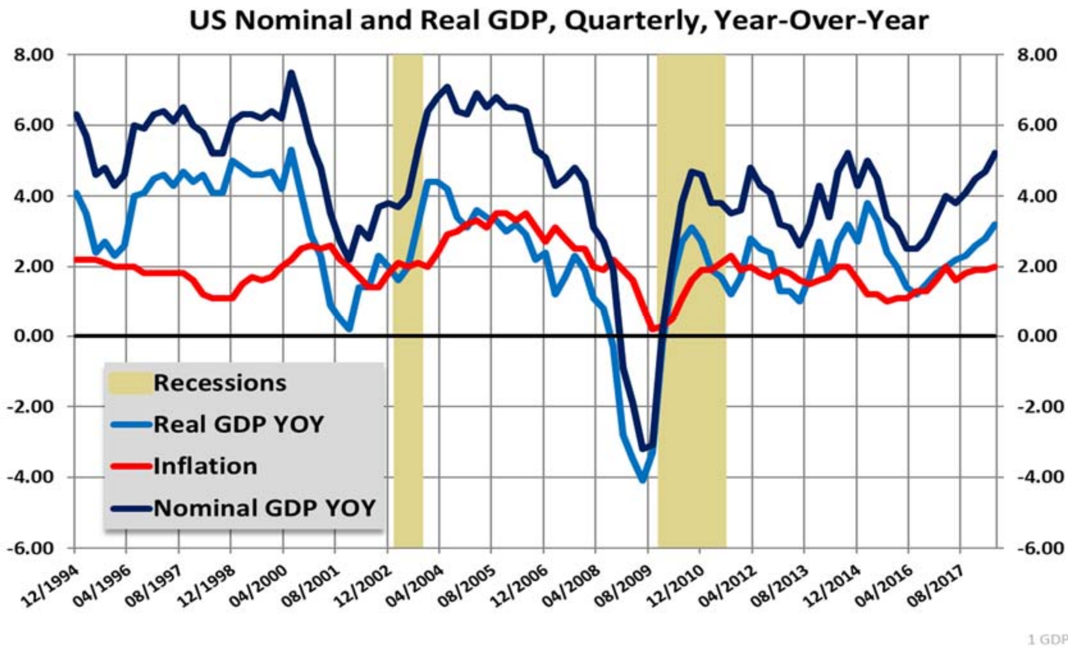
KCM chart/ Bloomberg data

One of the ways a country fights the effect of tariffs on exports is to devalue its currency. The relative appreciation of the U.S. dollar versus the currencies of our major trading partners has accelerated as trade tariff talk has heated up, illustrated by the above chart. Essentially, our trading partners have done a preemptive strike anticipating President Trump's tariffs.

Here is how it works. If a U.S. importer bought $1000 worth of goods, produced in China, on January 1, that importer would have paid about ¥6,300 yuan. Since January the yuan has depreciated about 5%. That same $1000 now buys ¥6,620 yuan's worth of Chinese goods, equivalent to about a 5% discount from prices six months ago. If President Trump then places a 5% tariff on those same goods, the cost to a U.S. importer effectively goes back to the same price he paid six months ago. So, China, by depreciating its currency, has effectively offset a 5% tariff.

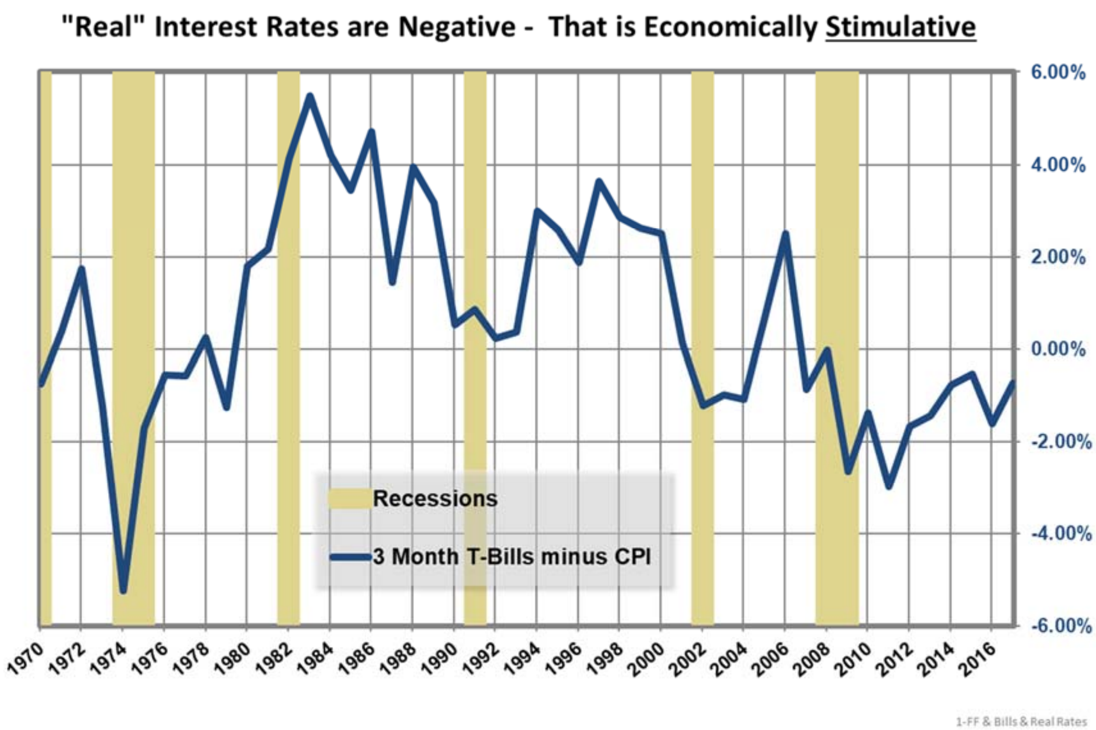
There are, however, consequences from a weak currency. The cost of U.S. goods sold overseas goes up for a country that depreciates its currency. Retaliatory tariffs and a strong dollar make things even worse for U.S. exporters. Depreciating one's currency also causes money to flow out of country, looking for investments in countries with a strong currency, such as the United States. This is less of a problem in China where it is extremely difficult to convert their yuan into another currency and invest abroad. Nevertheless, the sharp selloff of Chinese stocks and depreciating yuan are putting pressure on Xi Jinping to find a solution to their trade imbalance.

THE U.S. ECONOMY IS BOOMING!

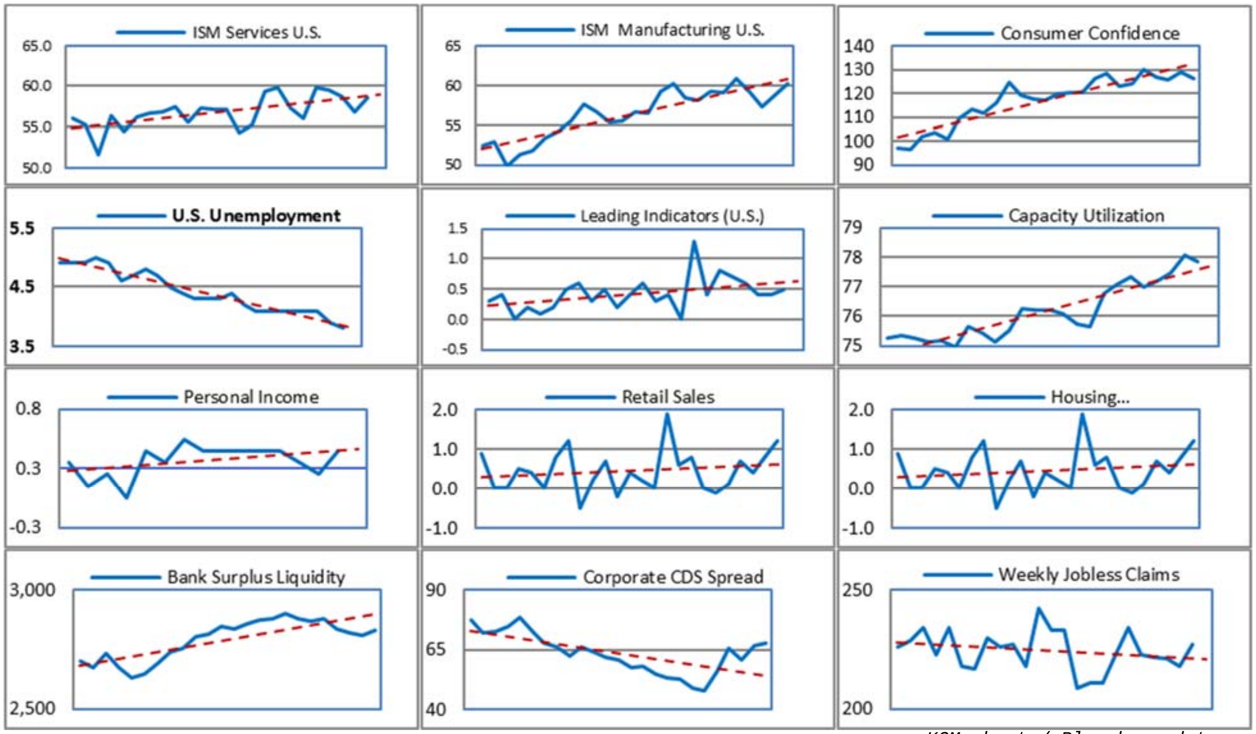


KCM charts/ Bloomberg data

Thanks, in part, to President Trump's tax cuts and increased fiscal spending, corporate earnings are expected to increase ~20% and stock dividends ~8% YOY, propelling nominal and real GDP to levels last seen in 2014 (top chart). Inflation remains tame and "real" interest rates are negative (below) they were 2% positive before the 2008 recession.

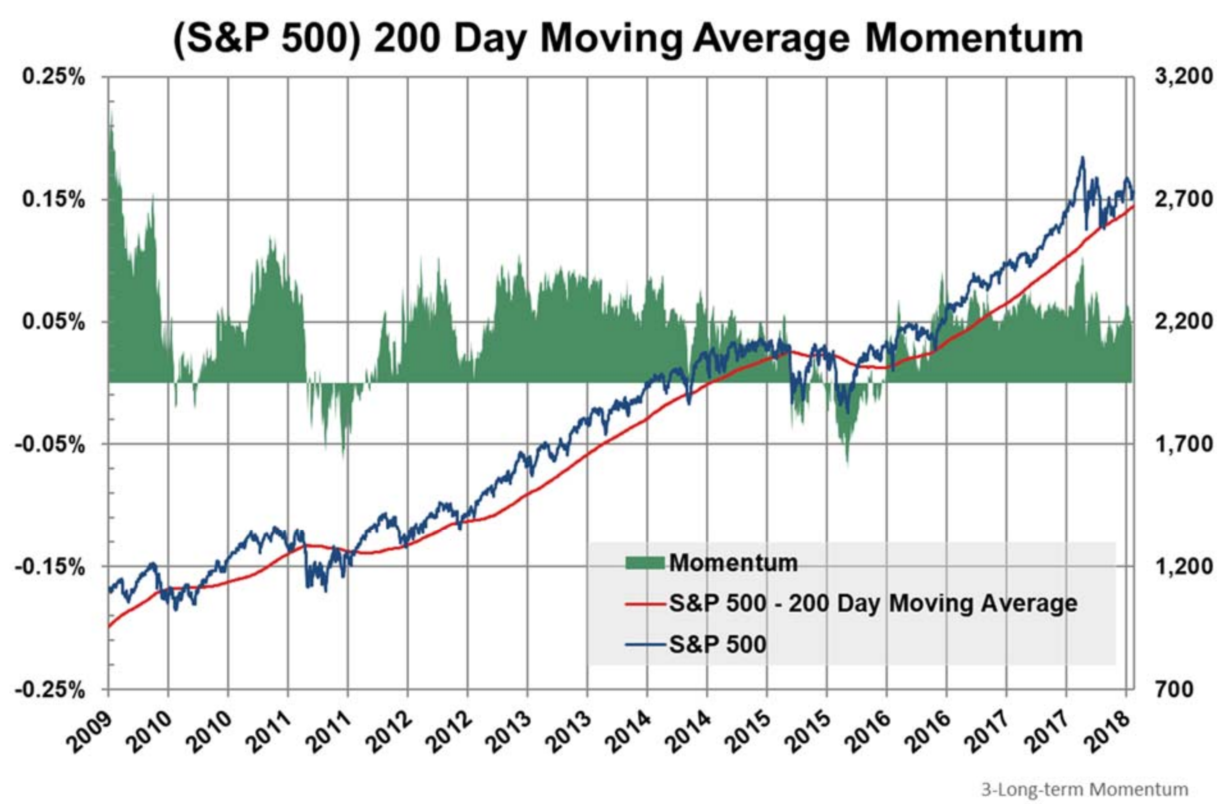


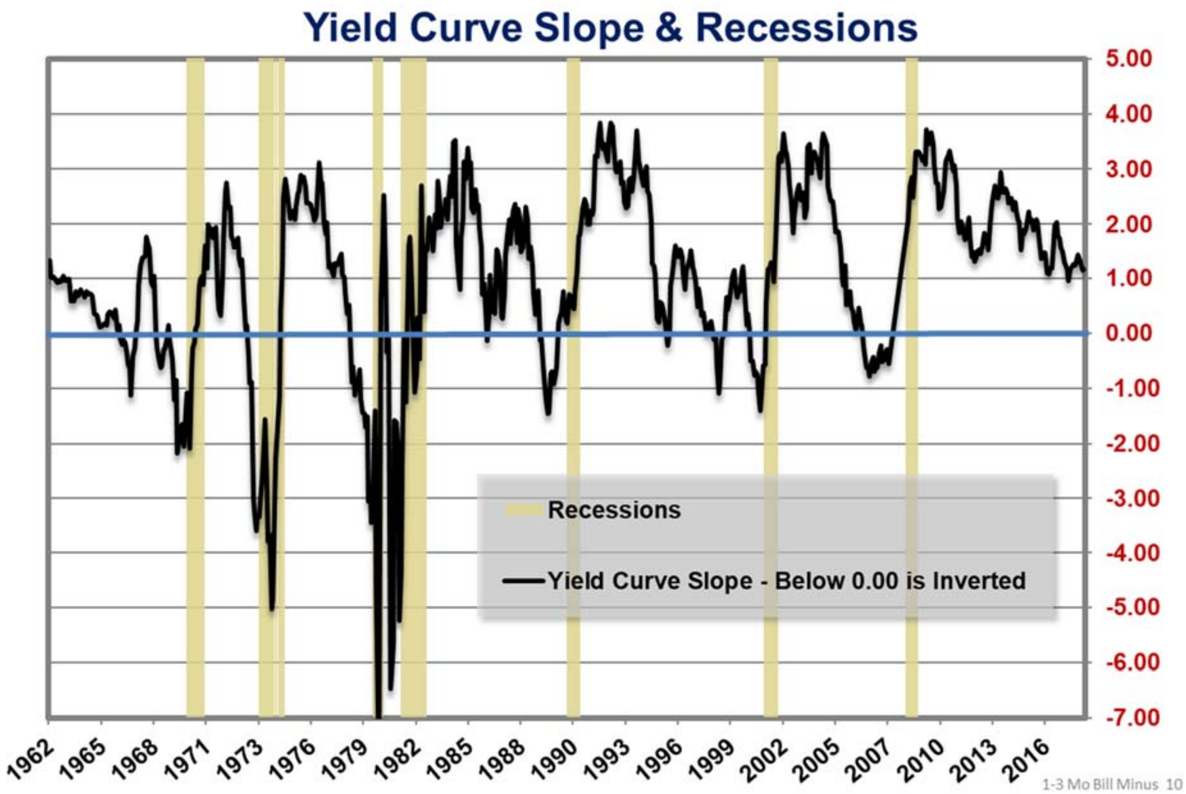
SOME KEY ECONOMIC INDICATORS



KCM charts/ Bloomberg data

The trend lines for some of the key economic indicators we follow all point to a strong U.S. economy (above chart). Stock market momentum remains positive (lower chart).



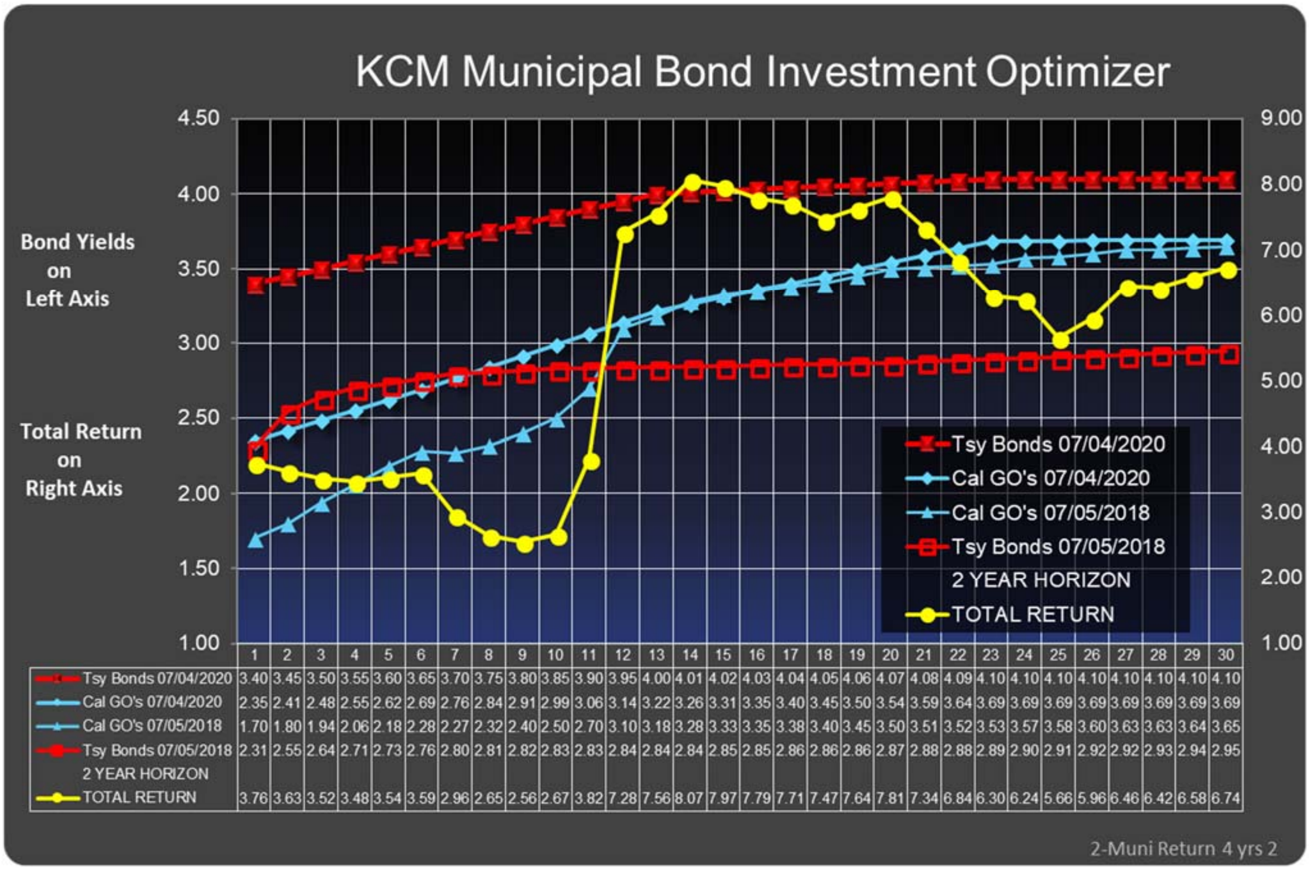


KCM charts/ Bloomberg data

In an expanding economy, short-term yields are mostly lower than longer-term yields. Banks typically borrow short and lend long, pocketing the spread. Positively sloped yield curves are economically stimulative. When short-term yields become higher than longer-term yields, often caused by Fed tightening, lending institutions have less incentive to lend. Inverted yield curves hinder economic growth.

The shape of the yield curve is still positive, but the Federal Reserve is in the process of raising short-term rates. Their stated target for the Fed Funds rate in two years is ~3.4%. Currently, the ten-year treasury bond yields 2.85%. We are not predicting the ten-year yield will remain at today's level for the next two years and the curve invert with 3.4% Fed Funds, in fact we expect the longer end of the curve to increase in yield as the economy continues to expand and inflation picks up.

Nonetheless, **the above chart tells us we need to pay attention**. The shape of the yield curve has been a reliable predictor of stock prices rolling over and the start of a recession. **Except for 1987, an inverted yield curve has correctly predicted a recession within 6-12 months.** In the fall of 1987 the inverted curve did predict the major stock market correction.



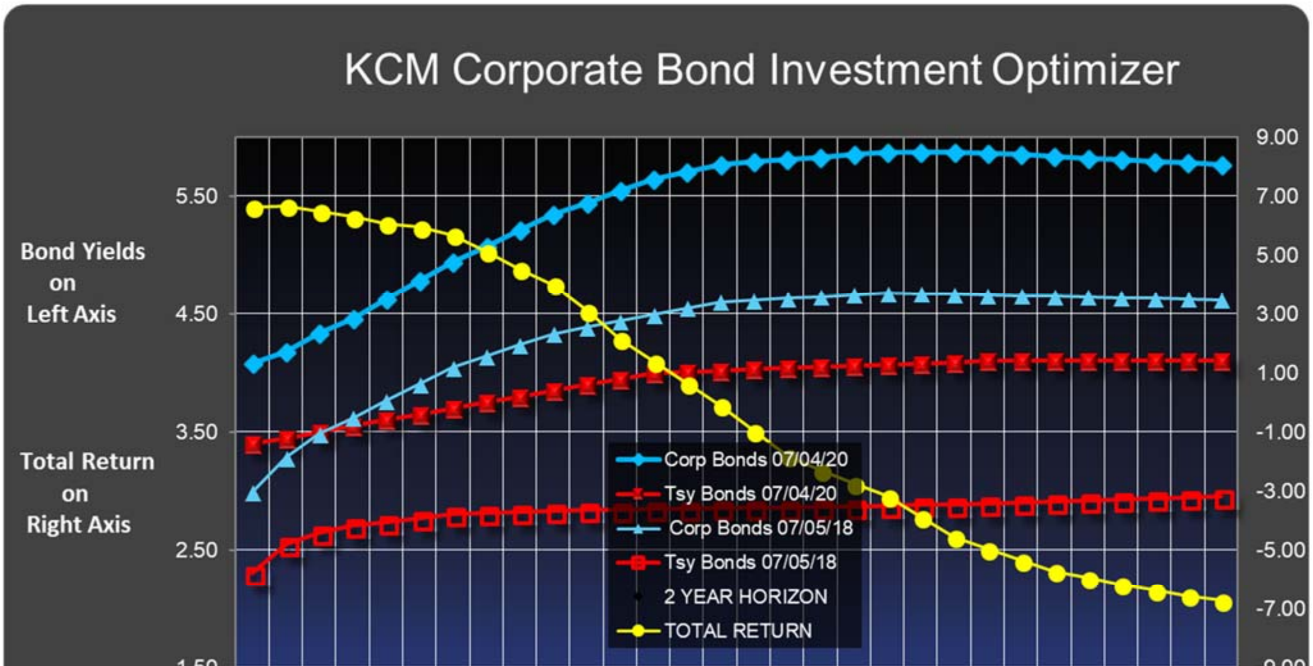
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Tsy Bonds 07/04/2020	3.40	3.45	3.50	3.55	3.60	3.65	3.70	3.75	3.80	3.85	3.90	3.95	4.00	4.01	4.02
Cal GO's 07/04/2020	2.35	2.41	2.48	2.55	2.62	2.69	2.76	2.84	2.91	2.99	3.06	3.14	3.22	3.26	3.31
Cal GO's 07/05/2018	1.70	1.80	1.94	2.06	2.18	2.28	2.27	2.32	2.40	2.50	2.70	3.10	3.18	3.28	3.33
Tsy Bonds 07/05/2018	2.31	2.55	2.64	2.71	2.73	2.76	2.80	2.81	2.82	2.83	2.83	2.84	2.84	2.84	2.85
2 YEAR HORIZON															
TOTAL RETURN	3.76	3.63	3.52	3.48	3.54	3.59	2.96	2.65	2.56	2.67	3.82	7.28	7.56	8.07	7.97

	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30
Tsy Bonds 07/04/2020	4.03	4.04	4.05	4.06	4.07	4.08	4.09	4.10	4.10	4.10	4.10	4.10	4.10	4.10	4.10
Cal GO's 07/04/2020	3.35	3.40	3.45	3.50	3.54	3.59	3.64	3.69	3.69	3.69	3.69	3.69	3.69	3.69	3.69
Cal GO's 07/05/2018	3.35	3.38	3.40	3.45	3.50	3.51	3.52	3.53	3.57	3.58	3.60	3.63	3.63	3.64	3.65
Tsy Bonds 07/05/2018	2.85	2.86	2.86	2.86	2.87	2.88	2.88	2.89	2.90	2.91	2.92	2.92	2.93	2.94	2.95
2 YEAR HORIZON															
TOTAL RETURN	7.79	7.71	7.47	7.64	7.81	7.34	6.84	6.30	6.24	5.66	5.96	6.46	6.42	6.58	6.74

KCM chart/ Bloomberg data

Fed Funds are currently 1.75-2.0%. The mean projection for the Fed Funds rate by the members of the Federal Open Market Committee two years from now is ~3.4%. Rising interest rates are not good for bond prices so we need to be careful how to invest in the bond market given a likely increase in rates. The best value in the fixed income markets can be found in the high coupon, callable, twenty-year maturity part of the municipal bond market. The above graph illustrates today's U.S. Treasury curve (empty red squares) and what a Treasury curve might look like two years from now (solid red squares) if Fed Funds are at ~3.4%. The blue triangles represent today's California General Obligation municipal bond curve. The blue diamonds represent a "normal" California General Obligation tax-free bond relationship to our projected Treasury curve, two years from now. **Notice that today's California municipal bond curve is about equal in yield, starting at about fourteen years, to our future municipal bond curve if Fed Funds move up another ~1.4% and the 30-year Treasury moves up in yield ~1.50%.**

A municipal bond with a twenty-year maturity, a 5% coupon and 10 years to its call date gives an investor a yield-to-call of ~2.90% with a better risk/reward, illustrated by the yellow dots, than investing in shorter bonds with maturities out to ten years or so. <u>This has been and remains our single best idea for fixed income investors who seek tax exempt income.</u>



	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Corp Bonds 07/04/20	4.08	4.18	4.34	4.46	4.63	4.78	4.94	5.08	5.21	5.35	5.45	5.55	5.65	5.71	5.77
Tsy Bonds 07/04/20	3.40	3.45	3.50	3.55	3.60	3.65	3.70	3.75	3.80	3.85	3.90	3.95	4.00	4.01	4.02
Corp Bonds 07/05/18	2.99	3.28	3.48	3.62	3.76	3.90	4.05	4.14	4.24	4.33	4.39	4.44	4.49	4.55	4.60
Tsy Bonds 07/05/18	2.31	2.55	2.64	2.71	2.74	2.77	2.80	2.82	2.83	2.84	2.84	2.84	2.85	2.85	2.85
2 YEAR HORIZON															
TOTAL RETURN	6.6	6.7	6.5	6.3	6.1	6.0	5.7	5.1	4.5	4.0	3.1	2.1	1.4	0.6	-0.1

	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30
Corp Bonds 07/04/20	5.79	5.81	5.83	5.85	5.87	5.87	5.87	5.86	5.85	5.84	5.82	5.81	5.80	5.78	5.77
Tsy Bonds 07/04/20	4.03	4.04	4.05	4.06	4.07	4.08	4.09	4.10	4.10	4.10	4.10	4.10	4.10	4.10	4.10
Corp Bonds 07/05/18	4.62	4.63	4.65	4.66	4.68	4.67	4.67	4.66	4.66	4.65	4.64	4.64	4.63	4.63	4.62
Tsy Bonds 07/05/18	2.86	2.86	2.87	2.87	2.87	2.88	2.89	2.90	2.90	2.91	2.92	2.93	2.94	2.94	2.95
2 YEAR HORIZON															
TOTAL RETURN	-1.0	-1.8	-2.3	-2.7	-3.2	-3.9	-4.5	-5.0	-5.3	-5.7	-5.9	-6.2	-6.4	-6.5	-6.7

KCM charts/ Bloomberg data

Corporate bond investing cannot be done the same way as municipal bond investing. The above chart illustrates our projected returns for corporate bonds in our expected rising interest rate environment. Note that the yellow dots project a lower total return the longer out on the yield curve we invest, not a good risk/return. **The way to invest in corporate bonds, in our projected rate environment, is to construct a short-term "ladder," eliminating the total return risk of buying longer-term bonds.**

KCM's core equity strategy still focuses on investing in KCM's Dividend BlueBloods. Excess returns from high quality dividend paying stocks is one trend that we believe will continue in 2018 and beyond.

We appreciate your business and continued trust in KCM,

Jay Kellett, Founder & CEO, and your KCM Team