

---

## DECEMBER 2008 QUARTERLY REVIEW

The year 2008 was a year for breaking records. Unfortunately, the majority of these records were not as positive as Michael Phelps capturing eight gold medals at the Beijing Olympics. This year's market broke more records than in any prior year evidenced by the greatest percentage rise in the price of oil, followed by a peak-to-trough rout of 73%; an 81% drop in scrap steel prices from \$518 per long ton in May to \$97 currently; and a drop in the three-month Treasury bill yield from 3.14% in January to a paltry 0.02% today. The S&P 500 had its worst June since 1930 and worst November ever. However, the most notable and far-reaching record broken was Lehman Brothers' collapse, the largest corporate bankruptcy ever, with its unintended destabilizing felt around the world. Still, as academia and investment managers from the most respected institutions promoted commodities and global equities as necessary for risk-lowering and return-bolstering asset classes, the market painfully discovered that modeled negative correlations do not always hold. So, we saw yet another record broken in 2008 with a total convergence of correlation among asset classes. (In other words, *everything stunk!!*)

We have crossed the country speaking with clients and consultants about the fallout from the September 15th collapse of Lehman Brothers. The tragic missteps of Paulson & Company in allowing Lehman to fail created the largest credit collapse and subsequent global financial seizure of all time. There were a couple of days in September when it looked like the whole world was caving in, driving equity valuations in the following weeks to new lows. The fear was epic in size and global in scope; none of us working in the industry have seen anything like it. We do not expect this type of disruption to reoccur now that global central banks have seen just how far reaching and devastating a \$600 billion financial tsunami can be.

While KCM is critical of using federal money to salvage unsound businesses (e.g., Cerberus/Chrysler), we believe giving important companies an opportunity to unwind their global operations in an orderly manner has to be a worthy use of government funds. The Treasury Department (perhaps swayed by badly informed members of Congress) felt they were avoiding a moral hazard in letting Lehman fail. Instead, they created a global mess that public and private companies will be mopping up for years to come. Lehman's collapse created a worldwide credit seizure, bringing a significant slowdown to most manufacturing and most private and public projects, while grounding 25% of the world's cargo ships as international trade froze up.

The following chart from Thomson Reuters shows the Institute for Supply Management Index from 1989 to date. This index quickly depicts the current condition of American manufacturing. Many investors (analysts and economists alike) are looking at the decline in orders post-Lehman as a reliable predictor of future activity. This logic is the same logic followed when investors piled into companies like Cisco in 1998 and Google in 2007, when their top lines were growing at 55%. Analysts drew trend lines to the ceiling figuring the line of least resistance was straight up. Now, they are drawing trend lines to the floor figuring

that manufacturing and the world economies will continue straight down. We know that Cisco and Google did not continue to grow at 50%+, and we believe that manufacturing and the world's economies will start to recover faster than many expect.



Going forward, there are dramatic and underappreciated forces at work that should reward investors. Unprecedentedly large and globally coordinated stimulus packages commencing in the first half of 2009 should drive global GDP +2-3%. At the margin, 2009 3<sup>rd</sup> and 4<sup>th</sup> quarter revenue and EPS growth should look quite strong. There are credible expectations that we could witness enormous (or record-breaking) upside in year-over-year earnings comparisons within 7 to 10 months as depleted inventories are rebuilt and global economic activity begins to recover.

We want to emphasize that this is precisely the wrong time for investors to panic and throw in the towel. Fear is the strongest of motivators for investors and that fear has been driving investors to liquidate securities at the fastest rate ever. If we are wrong, and worse times are still ahead of us, then valuations are appropriate and markets should trade sideways for a period of time. If we are right and the economy improves by September, then the markets should rise sooner rather than later in anticipation of an inventory rebuild and a pickup in consumer and business spending.

We believe November marked a firm bottom for the equity markets. After bear market bottoms are in place, the markets usually trade sideways for a number of months. History tells us that when the next bull market begins as much as 40% of the gains are made in the first three weeks.

Fear is the dominant emotion on Wall Street and Main Street. It is hard to find an analyst who is bullish about anything. Price targets, even on those hard to find "strong-buy" stocks, are mild to anemic as shell shocked analysts cut estimates for as far as the eye can see. We believe this is partly due to non-financial (psychological) reasons as many on Wall Street have had their confidence shaken if not destroyed. Equity prices are often driven by confidence and perception, rather than valuation. Although the sentiment that prosperity is dead has become the mantra of "The Street," KCM is taking a contrarian view. We believe prosperity will return and excess returns are possible, as the unprecedented, worldwide fiscal and monetary stimulus starts to work during the first half of 2009.

We can be quite certain that the economic numbers are going to be weak for the next four to six months. We must remember that the September 15<sup>th</sup> credit crash stopped global commerce dead in its tracks. It will take months until the whirl of global supply and demand approaches any kind of equilibrium, and until then, we can expect to see lousy year-over-year comparisons. After that, something quite interesting is going to happen. Starting around mid-year 2009, the credit markets are going to loosen as banks, having repaired much of their balance sheets, begin to lend again. The appetite for risk will grow as mortgage rates approach the much telegraphed 4.50%, the government-sponsored program to enable modifications of existing mortgages kicks in, and tax incentives to new homebuyers are initiated. We are already seeing record high refinancing activity, and, in the quarters immediately ahead, we expect the United States to have passed through the trough in housing permits, starts, and sales; reversing many of the factors that contributed greatly to this credit crisis.

We do not see a quick return to yesterday's highly leveraged world of unrealistic risk spreads and lax credit standards, but it is clear to us that central banks and governments around the world are focused on inflating asset prices (homes) while recapitalizing the banks and other financial institutions which are at the very heart of our capitalist system. Mortgage rates at 4.50% will go a long way to stabilizing the housing market, and banks will eventually make riskier loans now that investing in risk-free assets, Treasury and Agency bonds, gives them little or no return.

Assets in government money market funds have grown exponentially, to the point where some fund managers have stopped accepting new investments. In many cases, the returns on these funds have shrunk to .20% or less. The Federal Reserve has stated that it will keep interest rates low for some time, and, by doing so, might force investors to take more risk if they want a return on their money. They might invest in a money market fund that buys commercial paper, then maybe short-term bonds, and eventually reach for riskier assets like stocks and real estate. Fear may be the dominant emotion now, but greed will eventually take over.

In November of 2008, we lost 584,000 nonfarm jobs; in December of 2008, we lost 524,000 jobs, a slightly better number. Watch this trend. In December of 1974, we lost 602,000 jobs, the single biggest job decline of that recession. And even though the negative numbers continued for the next five or six months, with the unemployment rate eventually peaking at 9.0% in May of 1975, the jobs lost never exceeded the 602,000 of December 1974. Meanwhile, the S&P 500 was up about 40% in the first six months of 1975. Equity markets anticipate well into the future.

### **FIXED INCOME/INFLATION**

A potential consequence of the flood of money being thrown into the world's economies is a bout with inflation a few years from now. One of the most common questions we are asked is: How do I protect myself from future inflation?

Stocks can be a good inflation hedge, unless, of course, we return to levels last seen in early 1980. Buying fixed income securities in a rising inflationary environment can also be a disaster. So what do we do?

First, do not invest in the current fixed income bubble, Treasury bonds. Last week's *Barron's* pointed out that one could lose 25% by investing in 30-year Treasury bonds that are yielding less than 3%. The last two times the Fed was raising interest rates to cool the economy and fight inflation, 1994 and 1999, clearly demonstrate the inherent dangers built into the treasury market today. If rates return to their 8% level of 1994 or 7% level of late 1999, over the next three years, investors could easily lose 40% or more of their investment.

On the other hand, we have observed that junk and investment-grade corporate bonds and tax-free municipal bonds already yield about the same as they did in 1994 and 1999 when the Fed was tightening and the Fed Funds rate peaked between 5-6%. The reason is different – credit concerns now and inflation concerns then – but the yields are still about the same. Our conclusion is that unless we go back to the hyperinflation days of the 70s and early 80s, corporate and municipal bonds have already discounted a lot of future inflation. A barbell approach to constructing fixed income portfolios may be the best strategy. Invest a portion of your portfolio in longer-term bonds to take advantage of some of the attractive long-term yields available today, while investing the balance in a short-term ladder that will have bonds maturing over the next five years allowing for reinvestment in potentially higher yielding bonds if inflation spirals out of control.

Today's market reminds us a lot of the 2002 aftermath of the Tech/Telco bubble. Back then, investors, fresh from losing fortunes in names like Cisco, JDSU, AOL, Sun Micro, etc., became frozen, even bitter. Behavioral finance responses kicked in with a vengeance, and those who suffered this global malady missed some great opportunities in the market. The 2002 bear market unwound the valuation excesses and speculations brought on by a largely uninterrupted bull market that began in 1990. At that time, investor fear emanated from the failures of companies like Enron and Worldcom. In 2008, investors focused on which company would become the next Lehman or Bear Stearns. Today's investors, who lost 50-80% in banking, housing, construction, agriculture, and basic material companies, have vowed never to buy equities again.

The market has an uncanny ability to exhaust and disgust investors just at the bottom. There is strong statistical evidence that market troughs are characterized not only by increases in downward analyst revisions, but also, decreases in upward analyst revisions, a condition which exists today. We believe the bottom is in place. If share prices double in the next five years, investors will enjoy 15% annual returns. If the earnings/multiple recovery takes 10 years, returns will drop to 7% (which is still not bad relative to investors' main enemy, inflation). We do not know where the markets will be next week or next month, but we feel strongly that American companies are on sale and assign a high probability to stocks being significantly higher 9-18 months from now.

To our valued clients, we thank you for your continued support and confidence. We understand the pain caused by the extraordinary erosion in the marketplace this past year, but continue to have the utmost confidence that our disciplined portfolio strategies will produce superior returns over the longer run. Managing money for our clients, friends and family is a responsibility we take very seriously.