

## JUNE 2007 QUARTERLY REVIEW

Despite the poor showing of the financial markets in June, the quarter and the first six months of the year witnessed very attractive equity returns, the best since 2003. The S&P 500 achieved a total return of 6.96%, the Dow Jones Industrials 8.76%, and the NASDAQ was up 7.78%.

During the *first half* of 2007, six out of the ten major sectors outperformed the market, with energy the leading sector. In the *quarter* ending June 30, energy, technology and industrials were the outperformers, whereas utilities, consumer staples and financials were the laggards.

For the fixed income markets, the story was different. In the first half of 2007, inflation (as measured by the Consumer Price Index or CPI) rose 3.20% on an annualized basis. This rate of increase was higher than the trailing 12-month rate of 2.69%. Higher inflation and the fear of a higher rate of economic growth for the remainder of 2007 caused long-term U S Treasury bonds to return -1.35% for the six-month period. High-grade corporate bonds returned -1.60%. Cash returns and very short-term bonds outperformed in this environment of higher inflation expectations.

Investors have continued to fund international securities throughout the year-to-date, with emerging markets (led by Peru, Hungary and China) as the major beneficiaries. The MSCI World Index achieved an 8.18% return, very similar to the return of the major U.S. equity indexes.

	June 30, 2004*	June 2007
<b>Fed Funds Rate</b>	1.00%	5.25%
<b>10-Year U.S. Treasury Bond</b>	4.70%	5.03%
<b>Yield Curve (2 yr. to 10 yr.)</b>	+190 bp spread	+17 bp spread
<b>Inflation (CPI)</b>	3.3%	2.7%
<b>Real GDP Year over Year</b>	4.5%	1.9%
<b>Manufacturing PMI</b>	61%	60.7%
<b>Home Prices Year over Year</b>	10%	4.3%
<b>Price of Oil</b>	\$36	\$70.68
<b>Price of Gold</b>	\$413	\$651
<b>S&amp;P 500 Operating Earnings</b>	25%	4-8%
<b>S&amp;P 500</b>	1136	1503

\* Federal Reserve began to raise interest rates.

## **THE ECONOMY/ HOUSING/ THE CONSUMER**

The U.S. economy reported a meager 0.7% gross domestic product (GDP) growth rate in the first quarter of 2007. This was a surprisingly low number that was greatly impacted by declining inventory growth. The housing and auto industries were working off excess supplies, resulting in modest GDP growth for the quarter. Other drags on the economy included weak domestic capital spending and a wider trade deficit.

Over the past three quarters, residential construction has stripped from 1 to 1.2 percentage points from the economy's annualized growth rate. While the housing situation remains mixed as new home inventories are worked off, the degree of the housing drag may subside in coming quarters. The inventory of new homes fell to 538,000 in April, which was 6.1% below the peak recorded in July of 2006. Since February, the demand for mortgage applications to buy a home has risen. It is also noteworthy that the subprime loan debacle has not caused a broader tightening on credit availability, thereby not depressing home sales to prime borrowers. Even the Federal Reserve survey of bank lending practices showed little in the way of tighter lending standards other than in the subprime area. Statistics reported in June show that homeowner demand for fixed rate mortgages is up 40% from a year ago, showing that adjustable rate mortgages are being refinanced at a "fixed" interest rate. The main problem moving forward will be foreclosures on existing homes. These homes, however, will be priced to sell quickly. While these issues will continue to put some pressure on home prices, the offset will be improved housing affordability.

A recent article in *Business Week* reported that home prices have been decelerating from a very lofty level for the past two years. Home prices, however, are still up 29.2% over the past three years and 64.3% over the past five years (Case-Shiller index). The article also reported that the diminished availability of cash from home equity appears to have had minimal impact on general consumer spending trends. The strong job market, rising incomes, the rise in stock prices, and strong nonresidential construction have been significant offsets to any consumer malaise.

## **THE CONSUMER/ INFLATION**

The consumer remains the key to future economic growth projections. Unemployment remains at historically low levels, and the resulting tighter job market is raising inflationary concerns. These concerns are being voiced by the Federal Reserve ("a sustained moderation in inflation pressures has yet to be convincingly demonstrated") as they had hoped that a slowing economy in 2007 would ease inflation risks.

While core inflation at 1.9% remains in the upper end of the Fed's comfort zone (1-2%), headline inflation remains at the high-2% level. The recent reacceleration of oil prices back up to the \$70 range should also raise inflation estimates moving forward. In addition, food prices are also rising at a high single-digit rate. Inflation appears to

be alive and well and is the primary reason why over 80 central bankers around the world have been raising short-term interest rates over the past year.

In the United States, inflation has recently been growing faster than income levels. If this trend continues, then consumers may indeed slow their spending. This tendency could have a ripple effect, negatively impacting future economic growth. In May and June, Americans saw their income, wages, and other sources of income decline after adjusting for inflation, including food and energy costs. Personal consumption income was actually negative. While most economists expect GDP growth to be 2.5% to 3% for the remainder of the year, this continued growth may become challenging to maintain if food and energy prices remain elevated.

## **THE MARKETS**

For the bond market and for investment strategists, two major debates persist. On the one hand, the housing/subprime fears have caused a number of economists to project below-average future U.S. economic growth, lower inflation, and lower bond yields. This would support positive stock market returns as the Fed cuts rates to stimulate growth. Given this scenario, financials and consumer discretionary stocks should perform well. On the other hand, a growing number of economists are projecting that the mid-cycle slowdown is behind us, the global economy is very healthy, and Federal Reserve rate cuts are remote. This alternative scenario helps late-stage cyclical stocks but sows the seeds of higher interest rates and eventually puts pressure on all asset prices. The current price of any asset (stocks, bonds, or real estate) is the discounted value of the future cash flows from that asset. If the discount rate increases (interest rates go up), the present value (or current price) of that asset goes down.

This growing belief of a continuing healthy global economy has caused U.S. bond yields to move to higher levels in June. On June 19th, the 10-year U.S. Treasury hit a high yield of 5.33% versus 4.75% at the end of March. While this yield has declined recently to 5.04%, its retreat is seen both as a consolidation move and a flight to quality due to the Bear Stearns subprime mortgage/hedge fund debacle.

If strong growth continues, led by a weak dollar and strong global economies, there will be increased talk of tighter labor and commodity markets accompanied by subsequent inflation implications. The stock market is telling us that the economy is relatively healthy, and the industrials and energy and materials stocks have been doing extremely well. With the risk of higher inflation and higher interest rates, financial stocks have been definite laggards. Both the consumer staples and consumer discretionary sectors of the market have been relatively weak. If the economy remains strong, as we expect, late-stage cyclical stocks will continue to do well. It appears that the headwind will be for the bond market due to expected stronger GDP and a continued tight labor market over the coming quarters. KCM believes the 10-year U.S. Treasury bond yield should trade in a 4.90% to 5.30% range over the next quarter.

The credit cycle, however, will be the ultimate determinant of interest rates in the future, which in turn will dictate economic and financial performance. Easy credit usually means strong economic growth, attractive cash flow and corporate profits,

good stock market returns, and tight corporate credit spreads. Tight credit means weaker growth, weaker corporate profits, subdued market returns, and wider corporate spreads. As we have mentioned over recent years, excess global liquidity has been a huge bonanza to financial asset returns. As that liquidity gets used up due to factors such as mergers and acquisitions (M&A) and infrastructure spending, investors ultimately will demand a higher yield for the higher perceived risk. With global M&A activity running at a \$1.65 trillion rate in the second quarter of 2007 (which is 90% higher than the same period last year), some sectors of the bond market may begin to choke on the supply. High yield, junk bond, credit spreads (where private equity deals get funded) have begun to widen from very low levels. High-grade corporate bond spreads remain historically tight and may stay there as long as the economy strengthens and corporate profits continue to grow. As Ned Davis Research recently reported, nonfinancial corporate solvency is in the best shape in 20 years. However, higher interest rates over time and reduced consumption growth pose risks for sustained corporate profits and cash flow growth in the future.

As we look forward, a little more risk and a little more volatility in the markets seem to be in the cards. In our analysis of both the present and the future states of the economy, KCM will continue to build portfolios of quality stocks and bonds. The yields on intermediate bonds are the highest we have seen since the spring of 2001, but the absolute levels remain low compared to interest rates in the 1970s, 80s and 90s. We remember those decades and we remember the pain high interest rates cause. KCM does not believe it is a good time to lock in long-term interest rates as an investor. If you are a borrower, it may be a different story! We therefore are maintaining a preference for short- to intermediate-term corporate and municipal bonds.