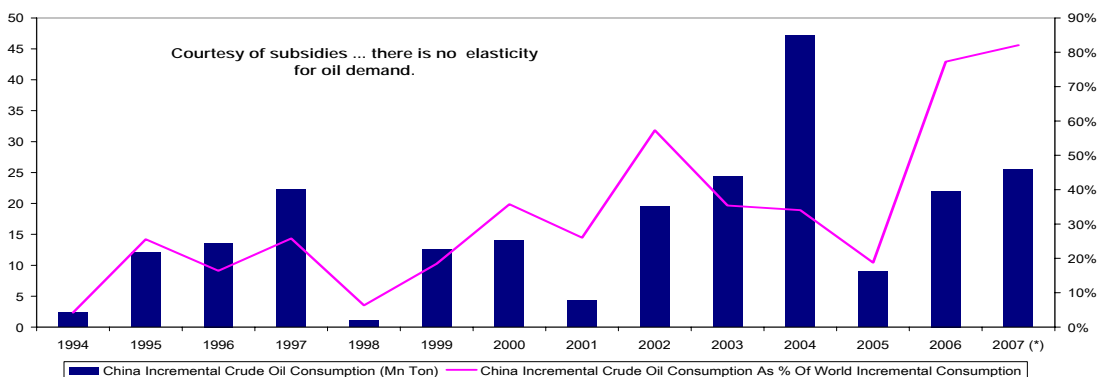


JUNE 2008 QUARTERLY REVIEW

June of 2008 will go down in the history books as one of the worst months for stocks since World War II and the worst June since 1930. We enjoyed the April and May rally, after a 9.9% S&P 500 decline in 2008's first quarter, only to have optimism shattered in June as the markets realized the financial crisis was not over. Investors acknowledged that high oil and food prices, coupled with a lingering credit crisis would ultimately constrict consumer spending, the lifeblood of economic growth.

Financials led the stock markets down. The S&P 500 is down -11.9% for the past 6 months, the DJIA -13.4% and the MSCI World Index -12.8%. While the first half of 2008 was characterized by global stock market weakness, it was also exhibited by commodity price strength. Among markets globally, the winners were the resource based countries such as Canada and Brazil. Latin America was the strongest region. On the other hand, the Chinese stock market is down nearly 50% and the Indian market down 40%. A beneficiary of this volatile environment was fixed income. Three month T-bills returned +1.2%, Lehman Aggregate Bond index +1.1% and Merrill Lynch's Municipal Master index -.08% in the first half of 2008. The Federal Reserve's focus has shifted somewhat away from growth and more towards high oil prices, the weak dollar and inflation. The two year U.S. Treasury note ended the quarter yielding 2.63%, after starting at 1.6%.



Source: ISI-CEMB Research

FEDERAL RESERVE ACTION

We believe the Fed is done easing and their next move will be tightening as the economy strengthens and inflation becomes even more of a focus. However, we do not think this will happen until there are clear signs that the current financial crisis has turned and our financial institutions, banks and investment banks, finish deleveraging and recapitalize. This process is well underway. Banks and investment banks are replenishing capital by selling common and preferred stocks. The discount window was

opened to the investment banks and the yield curve is relatively steep. Real borrowing costs are negative when you can borrow at 2% from the Federal Reserve and inflation is running at about 4%. All this ultimately strengthens our financial institutions; the big “if” is how many more write offs there will be from bad loans, mostly related to real estate.

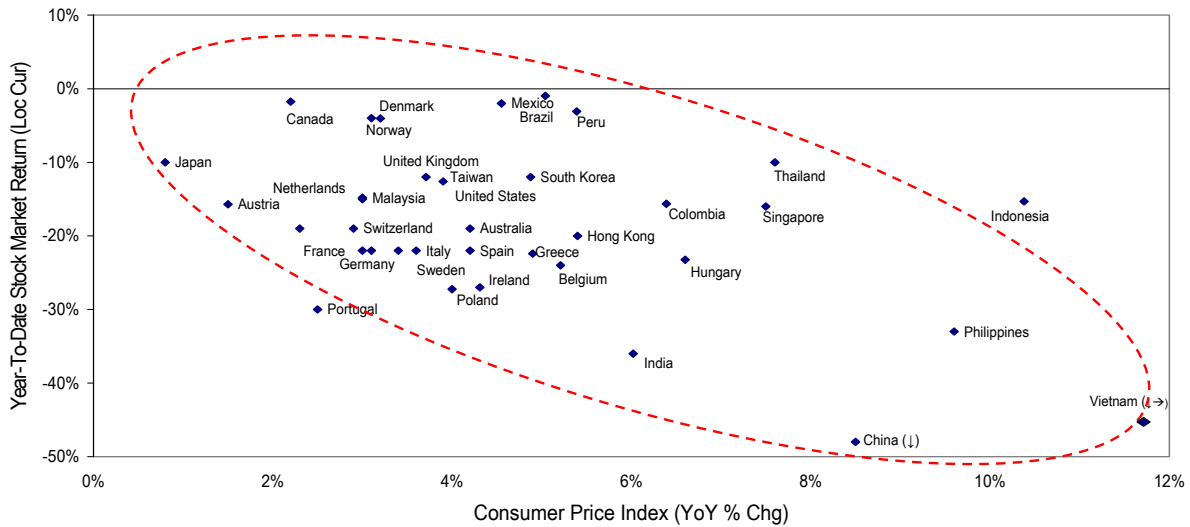
THE ECONOMY/CONSUMER

Real GDP was revised up to 1.0% in the first quarter of 2008 and is expected to rise 1.5% in the second quarter. Real consumer spending in the second quarter is expected to increase over 2%. President Bush’s stimulus checks are being distributed. The evidence is not clear that we are in a recession. On the other hand, consumer confidence has fallen to the lowest level since the 1974 recession. Consumers are being negatively impacted by rising oil and food prices and falling real estate prices. Disposable incomes are being squeezed. There is some good news. While home prices are still under pressure, the median home price in May rose to slightly over \$200,000. Housing affordability has improved. Oil and commodity prices may be nearing a cyclical peak and, according to ISI, when consumer confidence has fallen to today’s level, 50%, the stock market has been up 96% of the time over the next twelve months an average of 19%.

The unemployment rate may rise to the 6% level as the economy feels the effect of a service sector slowdown. Average hourly earnings are growing at 3.4%, the slowest pace since January 2006. While this may be good news for inflation, it also points out the obvious squeeze on the consumer’s ability to spend. The result will be more reliance on exports to maintain economic growth over the coming year. As global economies are also faced with rising oil and food costs, they too are attempting to raise interest rates to stem the rise in commodity prices and inflation in general. This adjustment process has its risks since commodity prices are being supported mainly by long-term shortages, not short-term cyclical factors. The election and policy measures to address resource issues will have major ramifications. Let us hope for the best.

CORPORATE AMERICA

In the environment of high energy and raw material costs, many corporations are announcing major price increases. Recently Dow Chemical announced it would raise prices on its products by up to 25% to offset a “staggering” increase in costs, after just announcing a 20% increase in May. This is a highly unusual event and illustrates the tremendous cost pressures faced by corporate America. After tax corporate profit margins reached a high of 8.1% in recent years, first quarter 2008 margins were 6.2% and declining. The American auto manufacturers and the airline industry have been particularly hard hit by a combination higher fuel and raw materials costs, a slowing global economy and high labor costs. Ultimately, these industries will reinvent themselves.



Source: ISI Portfolio Strategy

GLOBAL INFLATION

Recently a number of European and Asian central banks have expressed growing concern about the high rate of inflation in their respective countries. It was recently reported by Morgan Stanley that 50 countries around the world had inflation running at more than 10%. The chart above clearly shows the relationship between inflation and stock market performance. Six of these countries are also the most populous countries, and combined have 42% of the world's population. Record high food and other commodity prices are forcing policymakers to make some tough choices. Selective central bankers have indicated their desire to shift to higher short-term interest rates in order to combat a high rate of inflation. Raising short-term interest rates will reinforce an economic slowdown by tightening credit, but hopefully it will also relieve some of the pressure from commodity prices.

Fed Chairman Bernanke stated on June 3 that the fall in the U.S. dollar was a threat to further inflation since it increases import costs, which have risen 18% over the past year. This was the first time the Fed has discussed the state of the dollar and implies that current low interest rates are possibly causing more harm than good. If a modest global slowdown can relieve the pressure on oil and commodity prices, then the broader global stock and bond markets could see some relief from falling valuations that are partially due to higher inflation expectations. Recently, U.S. markets have outperformed foreign markets and we believe this trend may continue as many of the developed and emerging markets are forced to cool their economies, fight inflation and shift to more flexible currency exchange rates.

MAJOR EVENT

Over the past year, we have tried to point out the credit crisis taking place in our financial markets and its ramification. We discussed the fact that the two major rating agencies, Ambac and MBIA, risked being downgraded. This took place in June.

Because these bond insurers lost their AAA status, so too did the bonds that they insured. MBIA was downgraded to AA by S&P and A2 by Moodys, Ambac was downgraded to AA by S&P and AA3 by Moodys.

At KCM, we have always looked to the underlying credit and have not relied solely on the bond insurance rating. KCM purchases only investment-grade credits. However, we want our clients invested in municipal securities to be aware that a number of bond ratings in your quarterly statements will now be lower than the bond insurers' AAA rating of the past.

Our municipal securities clients should note that this lower rating does not impact the cash flow that is produced from the municipal bonds in their portfolios. This lower rating may mean that the institutions that issue these municipal bonds in the future will have to pay a higher interest rate to sell the bonds as investors demand a higher return versus the higher perceived risk.

BEAR MARKET

The major U.S. stock indices have declined 20% from their highs of October 2007. Bear markets are not fun, but they do create opportunities. In times like this, the theme at KCM remains a sound asset mix, sticking to quality, and careful security selection. Remember, historically, the stock market goes up more than it goes down and patience has been rewarded.