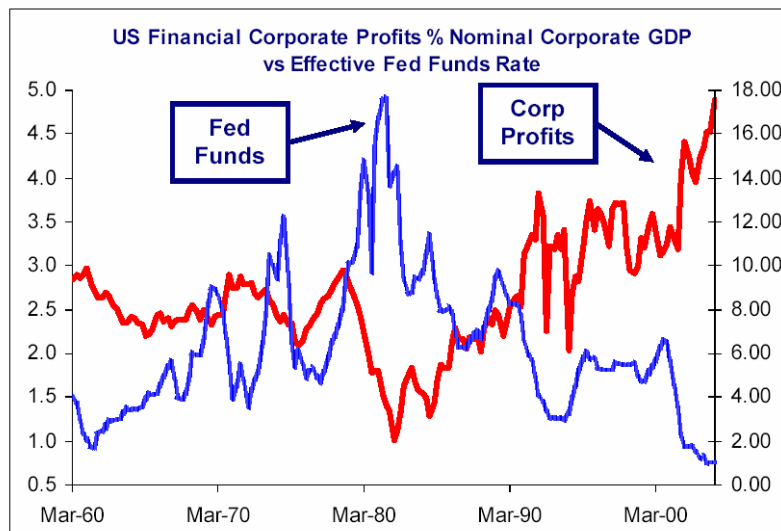


June 2004 Quarterly Review

The quarter ended June 2004 was witness to a strong economy, with robust corporate profits overshadowed by rising oil and food prices and growing geopolitical risk. As a result, the equity market remained in a tight trading range. The fixed income markets saw interest rates spike higher early in the quarter – especially in the two-year area of the Treasury yield curve – in the expectation of the Federal Reserve’s move to raise the Fed Fund’s rate by a minimum of 25 basis points at the end of the quarter, by 100 basis points (or to 2%) by year-end, and to 3% by mid-year 2005. As expected, the Federal Reserve did raise the Fed Fund’s rate by 25 basis points, to 1.25%, on June 30, 2004.



Source: ISI Group

The U.S. economy, as measured by real Gross Domestic Product (GDP) data, has been growing at a 4.5% rate over the last two years. Yet both the recently revised first quarter 2004 real GDP growth rate (from 4.4% to 3.9%) and the expected second quarter GDP growth rate of 4% may indicate a modest slowing from the explosive growth of late 2003. Meanwhile, corporate cash flows are growing, boosted by increases in revenues, gains in productivity and attractive tax changes that allow for larger depreciation charges. With employment gains continuing to look better in 2004, corporate profits should remain robust as business and consumer confidence improves. One negative, however, has been rapidly rising commodity prices. The recent over 30% rise in commodity prices was primarily due to a worldwide economic recovery, led by China’s ferocious appetite for raw materials. Speculators – for example, hedge funds and proprietary trading by financial institutions –

exacerbated the enormity of the increase. Fortunately, these trends have recently displayed a modest reversal, reinforced by the Chinese government's credit restrictions to slow their growth rate. While this initial unwinding of select commodity prices will moderate inflation risk, oil prices may be another story. Since oil prices are tied to rising demand, more uncertain reserve levels, and the increase of Saudi Arabia/Iraq terrorist risk, the floor under oil prices (possibly in the mid-\$30s) is expected to be higher than past estimates and could have a significant influence on future economic growth and inflation. The "silver lining" to this story is that research efforts on the part of many companies and governments to find more secure and stable energy sources might ultimately stimulate new industries and new products.

Throughout this period, the U.S. consumer has been resilient – spending money, buying homes and cars – but the signs are growing that these spending trends will moderate as 2005 approaches or soon thereafter. Consumer spending is estimated to grow 4% for 2004 and approximately 3% for 2005. Business spending, on the other hand, is expected to grow nearly 9% in both years. The growing current account and budget deficits will continue to be a problem, especially if foreign central banks slow down their purchases of U.S. Treasury securities. Foreign central banks, especially those of Japan and China, have financed approximately 35% of the U.S. current account deficit over the last two years. In the first quarter of 2004, that figure hit 86%! Obviously, that level of purchase may not be sustainable or wise for the long term, thus possibly resulting in upward pressure on U.S. interest rates.

In the period 1980 to 2004, the Consumer Price Index (CPI), year-over-year, and its core rate, year-over-year (excluding food and energy), fell from a high of 14.8% and 13.6%, respectively, to 2.3% and 1.4%, respectively. This falling inflation rate, coupled with unprecedented increases in productivity, allowed for one of the greatest and longest bull market periods in our history. While we do not anticipate the reemergence of runaway inflation in the United States, we have had a substantial rise in raw material costs. Evidence that these cost increases are being passed on to the consumer seems to have caused some "cost push" inflation. The low cost of borrowing, heavy refinancing of home mortgages, and the Bush tax cuts have put cash into people's pockets. This cash has been the basis for the strong economic recovery that we have been experiencing. A robust economy and extra spending power has the potential to cause "demand pull" inflation, the kind that makes the Federal Reserve especially nervous. One of the jobs of the Federal Reserve is to maintain price stability – in other words, to "take the punch bowl away" if the party gets out of hand. Yet the question remains: Is the party getting out of hand and therefore is the Federal Reserve lagging in its responsibility to maintain price stability due to its policy of maintaining a negative "real" interest rate for too long? Only time will tell, but we know investors will be watching.

To give the tightening cycle that has just begun a bit of perspective, the low yield for this cycle's three-month T-bills was 0.85% in March 2003 and the low for 10-year U.S. Treasuries was 3.13% in June 2003. Currently, those yields are 1.20% and 4.55%, respectively. Therefore, the market is already ahead of the Fed's actions.

Consequently, if this is a tightening cycle – where the Fed goes from an accommodative to a neutral rate policy, with inflation still remaining modest – we will see increases in the Fed Funds rate over the next year or so to possibly 4% and the yield on the 10-year Treasury to about 5.5%. In this environment, we believe it is prudent to keep bond durations short, looking for opportunities to extend along the yield curve as the Fed moves along in its tightening cycle.

As for equities, the stock market can continue to perform well in a modest inflation environment, but historically it has been difficult to get “multiple expansion” (higher price/earnings ratios) during periods of rising inflation and rising interest rates. The S&P 500 is selling at about 16 times 2004 estimated earnings, which is not especially expensive assuming inflation and interest rates do not revisit the levels seen in the decade from the early 1970s to early 1980s. We at KCM, along with many other investment strategists, believe that stock price increases in the future will be more closely related to earnings growth, probably in the 5%-10% range.

Duration and Magnitude of Back-ups in 10-Year Treasury Yields and S&P 500 Returns During Past Fed Tightening Cycles						
	Start Date	Yield	End Date	Yield	+bps	S&P 500 % Change
1	3/17/67	4.47%	5/22/70	7.99%	352	-19.9%
2	11/5/71	5.72%	9/12/75	8.57%	285	-11.9%
3	12/31/76	6.81%	5/4/79	9.39%	258	-6.3%
4	5/6/83	10.13%	6/29/84	13.84%	371	-7.8%
5	8/29/86	6.95%	10/16/87	10.23%	328	11.8%
6	10/15/93	5.19%	11/4/94	8.04%	285	-1.5%
7	10/2/98	4.31%	1/21/00	6.79%	248	43.8%
8	6/13/03	3.13%	To Date	4.55%	142	17.5%

Source: ISI Group

Our emphasis at KCM continues to be opportunistic buying of attractive companies in growth industries on market weakness, as well as a readiness to extend bond maturities as the Federal Reserve raises short-term interest rates and the yield curve flattens. KCM’s investment strategy of selecting some of the best stocks in specific industry sectors and choosing both attractive and safe durations in our fixed income portfolios – while always mindful of market risk – has helped us achieve above-average returns over the years for our clients. Although potential negatives for the market remain (including high commodity prices such as oil, the degree of Fed tightening, and political instability), most of these factors are widely acknowledged and, hopefully, substantially discounted. Market volatility will occur, however, as interpreters of economic data vacillate in their predications from a robust economy to a weakening economy. Given this environment, KCM looks for modestly positive returns in the second half of 2004 as both the U.S. and global economy continue to be strong but not overheated and corporate earnings remain robust while year over year comparisons are expected to get tougher. Hopefully, rising inflation risk can be contained with a more neutral rate policy by the Federal Reserve. In response, we believe that by keeping equity portfolios well diversified and fixed income portfolios relatively short in duration, we can capture the more modest, but still attractive, returns that KCM sees in the future.