KCM
INVESTMENT ADVISORS
Investments that make sense...

MARCH 2007 QUARTERLY REVIEW

The March quarter reminded investors that risk and volatility are still part of investing in the stock market! The consensus "Goldilocks" economy, with low inflation and moderate growth, was brought into question by a plunging Chinese stock market, a troubling U.S. factory report, former Fed Chairman Alan Greenspan's "possible recession" remarks, a 7.8% January decline in durable goods orders, and the Federal Home Loan Mortgage Corp's decision, in the midst of rising mortgage defaults, to halt purchases of sub prime loans. The quarter will be remembered for the sharp drop in the U.S. stock market on February 27th, when the Dow Jones Industrials average fell 3.3%, recording its worst decline since the bull market returned in 2003.

For the quarter the Dow Jones Industrials index was down -0.32 % and the S&P 500 was up +0.64%. Investors flocked to U.S. Treasuries in a flight to quality and at the end of February the 10 year note fell to a two month low yield of 4.52%. Since then the ten year U.S. Treasury yield has reversed course and is currently yielding about 4.75%. High grade corporate bonds achieved a +0.29% total return for the quarter.

	June 30, 2004*	March 2007
Fed Funds Rate	1.00%	5.25%
10-Year U.S. Treasury Bond	4.70%	4.75%
Yield Curve (2 yr. to 10 yr.)	+190 bp spread	+5 bp spread
Inflation (CPI)	3.3%	2.4%
Real GDP Year over Year	4.5%	2.5%
Manufacturing PMI	61%	50.9%
Home Prices Year over Year	10%	-1.3%
Price of Oil	$36	$65
Price of Gold	$413	$675
S&P 500 Operating Earnings	25%	4-8%
S&P 500	1136	1420

*** Federal Reserve began to raise interest rates.**

THE U.S. ECONOMY AND THE MARKETS:

KCM's base case is that the U.S. economy is on track to produce an average of 2.5% real GDP growth in the coming quarters of 2007, a cyclical slow down but no recession. Payroll employment rose 180,000 in March after a 97,000 gain in February and a 146,000 gain in January. The unemployment rate fell to 4.4% from the 4.5% rate in

February. This rate matches the lowest rate in six years. Average hourly earnings in the March rose +0.3%, putting the year over year gain at +4.0%. The combination of payroll earnings gains and low unemployment is highly correlated with strong retail sales. A healthy consumer should assist the economy in achieving modest economic growth even though the manufacturing and housing sectors may be a drag. The manufacturers seem to be reluctant to increase capital expenditures and the home builders need to work off excess inventories.

The Fed has been on hold since June 2006 when the Fed Fund's rate was set at 5.25%. Once the Fed stopped tightening, the money supply started growing. Over the past three months, money supply has grown at a 10% rate. This stimulus, coupled with stock buy backs, unprecedented merger activity and easy access to the worlds debt markets at historically narrow risk premiums, has had a positive effect on the global stock markets. The other side of the coin is that oil prices remain volatile and the situation in the Middle East remains unpredictable. So far the negatives have been overshadowed by record corporate profits, the $56 trillion in U.S. consumer net worth (a new high) and a consumer confidence figure close to the peak of 2004. Tax refunds in 2007 are also running 8-10% above a year ago.

We need to mention that a case can also be made for stagflation, a slowing or stagnant economy with rising inflation. The current business cycle is getting long in the tooth, high capacity utilization and continued low unemployment can produce demands for higher wages and potentially higher inflation. Current inflation levels in the U.S. are considered modest by many but the core rate, excluding food and energy, has been in a rising trend for the past year and a half and is now at 2.4% year-over-year. The Fed is hoping that more modest GDP growth moving forward will cause core inflation to recede below 2%, the Fed's upper target. So far, it is not happening. This is clearly a concern for the Federal Reserve, and if inflation continues to accelerate, (not our best guess) their next move could be to increase rates to slow the economy and control inflation, making our average 2.5% real growth number too high.

SUB PRIME MORTGAGES:

The recent turbulence in the sub prime mortgage market has shaken investor confidence and could be a precursor to bigger problems in the future. Mortgage delinquencies have risen to the levels of 2003 (2.57% for the prime, and 13.33% for the sub prime sector), over 40 sub prime lenders have gone out of business, and housing inventories continue to increase. The biggest risk may be if short-term interest rates rise further while many borrowers are still in adjustable rate mortgages. We are going through a bursting housing bubble. The bursting of any bubble is painful for some but we believe a vigilant Federal Reserve, tighter lending standards and a resilient U.S. economy will keep the risks contained.

CORPORATE PROFITS:

The main mover of the stock market over time is growing corporate profits. Corporate profits and margins are at an all time high and growth has been well above average for the past four years. As we enter 2007, corporate profit growth has started to slow. For

the year, most strategists are estimating year-over-year earnings growth of 5-8%, closer to the historical mean.

Despite over 80 interest rate hikes by central banks around the world the global economy will probably grow at a 4.5% real rate in 2007. Industrial production in the Eurozone, UK, China, Canada and Japan is at or near an all time high. Money supply is growing between 6% and 18%, in the U.S., Eurozone, UK, China and Canada. The contribution to the world's economy from emerging markets continues to grow. These factors plus the continued ability to export labor costs, helping to maintain record high margins, will be a plus for Corporate America. Rising sales, record share buy backs and record amounts of private equity money looking for a home should be a tailwind for increased earning per share and higher stock prices.

KCM OUTLOOK:

KCM remains optimistic on the financial markets due to strong global growth, controlled inflation, modest valuations, and full employment trends. Currently the US stock market is trading at a 15.5 forward price/earnings (P/E) ratio. This is a modest or fair valuation and is a far cry from the 31 P/E ratio of the S&P 500 was trading at the height of the 2000 internet bubble. The 2008 "earnings yield" on the S&P 500 is about 7% ($100 of earnings in 2008, divided by the current level of the S&P 500 index) and the yield on the ten year treasure is 4.75%. This unusually wide spread may mean the stock market is under valued.

We do see risks, including the unwinding of the excessive global leverage that exists in the system, mainly due to the yen carry trade. Other risks include geopolitical unrest, sharp spikes in commodity prices, and a more hawkish stance from the Federal Reserve due to unexpectedly higher inflation. A rallying call in the upcoming U.S. Presidential campaign for higher taxes would also negatively impact the equity markets. Risk premiums are still very low. The tailwind that leveraged buyouts have provided to the stock market would disappear if credit spreads revert to the norm, making new deals less profitable. We favor the U.S. equity markets with its supportive fundamentals; we are more cautious on the credit markets, especially lower quality credits. The winners will be good companies with a global focus, that can navigate the changing but still positively biased landscape. These companies and those sectors that play into global growth such as the industrial, materials, select technology and health care sectors will be emphasized. Financials will perform well if we have a benign or dovish Federal Reserve. We recommend keeping your fixed income portfolio durations in the three to five year range and avoiding "junk" credits that are trading near historically narrow spreads to the benchmark U.S. Treasury bond yields.