KCM
INVESTMENT ADVISORS

Investments that make sense...

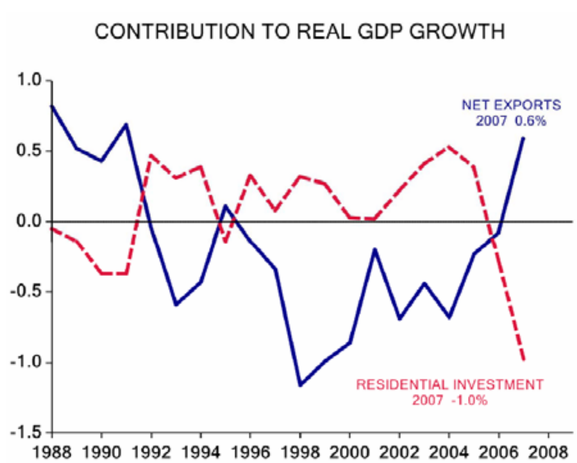
MARCH 2008 QUARTERLY REVIEW

The first quarter of 2008 may go down in history books as the peak in the credit crisis that started in August 2007. Not one major stock market index in the world posted a gain for the quarter. The S&P 500 price decline of 9.9% was the worst quarter's performance since the third quarter of 2002. This index came close to entering an official bear market, falling 16% below its October peak. The Dow Jones Industrial Average, down 7.6%, had its worst quarter in five years. The Nasdaq, which had the best return of the three indices in 2007, was hit the hardest in the first quarter of 2008 losing 14% year to date and down over 20% from its October high.

Surprisingly, the U.S. major stock markets outperformed the rest of the world for the quarter. The S&P 500 declined 9.9% versus the MSCI World Index decline of 11.9% and the MSCI EAFE (Europe, Asia and the Far East) Index decline of 15% in the March quarter.

In the United States, poor fourth quarter earnings reports, a weaker economic outlook across many sectors, and reports of higher inflation laid the groundwork for a poor performing stock market. The credit crisis that has been unfolding over the past months added significantly to the market's volatility. Also in the first quarter, the U.S. dollar experienced its biggest quarterly loss versus the euro since 2004. Furthermore, the yen had its best quarter versus the dollar since 1999 and is at its highest level since 1995.

In the March quarter, long-term U.S. Treasury bond total returns were up 3.9% and high-grade corporate bonds total return was only down 1.9%. Therefore, those investors who favor a balanced portfolio (owning bonds and stocks in their asset mix) fared relatively well in this environment and should continue to do so throughout 2008.



Contributed by ISI

THE ECONOMY / FED POLICY

Fourth quarter 2007 real gross domestic product (GDP) was a positive 0.6%. The first quarter of 2008 is expected to report a similar growth rate. Net exports, thanks to our weak dollar, are making a positive contribution to GDP for the first time since 1992 (see graph above), helping

to offset residential construction which is negatively contributing to GDP for the first time since 1992. While these GDP figures remain positive, they are much less than the 3%+ GDP figures the economy had been producing in recent years. The negatives clearly outnumber the positives and an economic slowdown, maybe a recession, is here. The housing bust and resulting severe credit crisis are the main culprits. This must be reversed and to date, the government's response is as follows:

- **Fed funds cut by 300 basis points**
- **Discount rate cut by 375 basis points**
- **$150 billion rebate to U.S. taxpayers**
- **Coordinated injections of liquidity by central banks**
- **Mortgage securities accepted at the discount window**
- **New liquidity facilities for banks**
- **Easing of FNM (Fannie Mae) and FRE (Freddie Mac) capital requirements**
- **Raising mortgage loan limits**
- **Fed's creation of a special lending facility for primary dealers and acceptance of a broader range of investment-grade securities as collateral**
- **Fed's orchestration of the "bailout" of Bear Stearns on March 14**

The Fed Funds rate presently stands at 2.25%. Adjusted for inflation, this rate is negative and, therefore, very stimulating to the economy. The money supply is growing at a double-digit rate, also very stimulating. Tax refunds, running at about $135 billion in mid-March, are up 6.1% year over year and will also be stimulating to the economy. The main drag on the economy is the homebuilder sector, which is not a significant part of GDP at only 6%. Consumer spending remains the most important factor to the health of the economy at 70% of GDP growth, and the consumer is still spending but at subdued rate. This subdued rate is due to the consumer's existing high debt levels, a more realistic view on home price appreciation/depreciation, concerns about job security as the economy slows, and higher energy and food costs. Consumers are thus being faced with higher living costs and less disposable income, hence less spending. In the March quarter, 2.6% of all bank loans are 30 days or more past due, which is the highest loan delinquency rate since 1992. Consumers are simply being squeezed with higher costs.

While prices of existing homes in January were down 10.7% from a year ago (based on the Case-Shiller index for 20 cities), the median home sales price fell 3.3% in 2007. Year to date, the median home sales price is down 2.7% to $244,100. This lower price level and mortgage relief plans should start to stabilize home buying conditions. In fact, the Housing Affordability Index hit a three-year high in January. The inventory stock of existing homes is down to a 9.2-month supply versus a 10.2-month supply last October. While lower home prices have a negative impact on wealth, most people are simply staying in their existing homes since the ability to make a quick return on rising home prices is over for this cycle.

The Fed's actions should, in some respects, be viewed separately from the main economy. The Fed is attempting to re-liquefy illiquid assets held by the financial system. The Fed and others greatly feared a financial meltdown due to the amount of leverage in the financial system. That is why, in addition to the actions listed above, Henry Paulson, Secretary of the Treasury, announced a sweeping proposal to change financial regulation in the United States. Besides the Fed's original charter to maintain price stability, the plan would consolidate banking regulation under the Fed and give it the authority to protect the stability of the financial system. Paulson also proposed a mortgage commission to develop standards for the housing industry and a new merged Controller of the Currency/Thrift Supervision to oversee the U.S.

dollar. While these proposals will need congressional approval and will take time to evolve and be approved, they should create a different financial environment moving forward. We agree that regulators need to impose guidelines that disallow the excessive use of leverage. When some institutions, investment banks and hedge funds, can use leverage at 20 or 30 to 1 versus regulated banks that can only use 12-to-1 leverage, with strict capital requirements, problems will and did occur. The deleveraging of the "Shadow Banking System" will come at a price. There will be an increase in risk spreads, commercial and residential real estate, corporate debt and even the equity markets will adjust. Corporate bond spreads will widen, cap rates on commercial real estate will increase and the equity markets are not likely to trade at 1999 like price/earnings ratios.

GLOBAL INFLATION RISK

The American Farm Bureau Federation says that a basket of bread, milk, eggs and pork chops in the United States will cost Americans 8.9% more in 2008 than it did last year. A five pound bag of flour and a dozen eggs were among the items that have already experienced the greatest rise in price – up over 40% since January 2007. On the world markets, rice prices have jumped 50% in the past two months and have doubled since 2004. The rate of increase of basic food supplies is raising fears of public turmoil in many parts of the world.

In China, inflation is running at an 8.7% rate. In the United States, inflation is running at a 4% rate. Consumer inflation in Europe recently spiked to 3.5%. India reported inflation higher than 6%.

These inflation figures have been spurred by rapid money growth in many parts of the world. Money growth in the United States is 7.7% year over year and 13.9% year to date. In the Eurozone, it is 11.5% year over year, 12.3% in the United Kingdom, 16.2% in Brazil, 17.5% in China, 21.2% in India, and 48.4% in Russia. As one strategist stated, "Rapid money growth first creates excess demand, i.e. strong real GDP, then inflation." When spending goes unchecked and money is cheap, inflation is ultimately stimulated. The ultimate payer is the taxpayer. This is the long-term risk for the United States and the global community.

For the United States, the credit crisis is probably negating the stimulating effect of the Fed's rate cuts. These very low short-term rates may not be inflationary longer term if the Fed raises them back to more normal levels once the credit markets stabilize.

WHERE WE ARE

The past eight months have been interesting, to say the least. Risk was rising in the markets, many prices retreated, and a flight to quality ensued. Over time, the U.S. market has shown a lot of resiliency in the many financial crises that it has faced. From the Cuban crisis, to the 1970s inflation decade, to the 1987 market crash and demise of Drexel Burnham, to the Asian crisis and Long-Term Capital Management meltdown in the 1990s, to the tech bubble and the Enron demise of early 2000, to the 9/11 terror attack, to the current credit crisis of 2007/08 and the demise of Bear Stearns, the markets ultimately recover.

Whether the Bear Stearns demise will be viewed as the "watershed" event that represents that the worst is over, we do not yet know. The S&P 500 has declined 16% from its peak of last October, historically this decline would be considered modest. We know that there have been 17 times since 1950 when the stock market has declined by more than 10%. The median decline is 20% and the median duration is eight to nine months.

Normally you have a credit crisis when you are deep into a recession. This time we had the credit crisis first. So is the recession out there? It is not yet evident, with the export, oil and farming sectors still booming. Global economic growth is projected to grow at a 3.7% rate in 2008. Consumer and business confidence will be a key factor moving forward. With 2008 being a presidential election year, politicians are anxious to promote programs to aid the consumer.

With many non-financial companies still maintaining healthy cash positions, they are better able to maintain positive earnings in the 2008 environment. KCM continues to focus on quality companies, especially large cap multinationals, in our clients' portfolios. With stock market valuations currently reasonable at a 15.8 P/E (S&P price of 1360 divided by $86 estimated 2008 earnings), the total return prospects of quality companies with attractive foreign earnings remain bright.

As for the general stock market, if we remove financial companies' continued write-offs, the rest of the stock market is still doing reasonably well. This was evident in the fourth quarter 2007 earnings, which were up 12.4% ex the financial sector. The first quarter of 2008 should report close to 7% earnings gains ex the financials. It is important to note, however, that adding back in the financial sector, S&P operating earnings for both 2007 and 2008 will be slightly negative. Estimated earnings for 2009 are for a modest gain of less than 5%, implying an elongated recovery process.

As for the bond markets, U.S. Treasuries are currently not an attractive investment for most investors. With the flight to quality that pushed their yields down sharply over the past months, newly purchased Treasury bonds are not producing a real (above inflation) return. The corporate bond market and the municipal bond market, however, have witnessed rising bond yields in the intermediate to longer-term range as spreads have widened. Quality corporate and municipal bonds are an attractive investment in this maturity range for long-term investors who want to capture an historically wide spread to Treasuries. Capturing over a 6% yield on 15-year high-quality corporate bonds and a nearly 5% tax-free return on 15-year municipal bonds is attractive. As KCM stated in the December 2007 Quarterly Review, "Probable Fed easing in early 2008 will put downward pressure on U.S. Treasury short-term yields, but the expectations of a stronger economy and increased confidence in the financial sector will exert upward pressure on the yield curve as the year progresses. For those investors who have very short-term bond portfolios, some lengthening may be appropriate if this happens." With this now happening, investors are able to capture a potentially higher real return by lengthening their maturity profile. The municipal market is especially attractive with their intermediate to long-term yields at all-time record levels as a percentage of Treasury yields.

While this credit crisis is still unfolding and a lot of things could still go wrong, it appears to KCM that the worst of the headline news may be behind us. With a lot of cash sitting on the sidelines, the demand for quality securities should be rekindled once the Fed stops pushing short-term interest rates to lower levels. This would aid the U.S. dollar and spark more confidence in economic prospects. Also, by midyear, banks and other financial institutions, hopefully, will have written off what is necessary in order to get all the bad news out. Looking forward, we are optimistic but cautious, as the recovery will struggle in a system that is being de-levered.